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04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/152

10:00 a.m., October 17, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

| Executive Directors | Alternate Executive Directors |
|---|---|
| A. Alfidja | |
| C. H. Dallara | M. K. Bush |
| | G. Ercel, Temporary |
| | X. Blandin |
| | C. A. Salinas, Temporary |
| M. Finaish | |
| H. Fujino | |
| G. Grosche | |
| | Jaafar A. |
| | L. Leonard |
| A. Kafka | |
| | I. Angeloni, Temporary |
| R. N. Malhotra | A. S. Jayawardena |
| | J. E. Suraisry |
| J. J. Polak | T. de Vries |
| A. R. G. Prowse | |
| G. Salehkhou | O. Kabbaj |
| F. Sangare | S. M. Hassan, Temporary |
| | J. E. Rodríguez, Temporary |
| | A. Lindå |
| N. Wicks | |
| Zhang Z. | Wang E. |

J. W. Lang, Jr., Acting Secretary
L. Collier, Assistant

Also Present

African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director. Asian Department: R. G. Di Calogero. European Department: L. A. Whittome, Counsellor and Director. Exchange and Trade Relations Department: C. D. Finch, Director; M. Guitián, Deputy Director; S. Mookerjee, Deputy Director; C. Brachet, H. W. Gerhard, S. Kanesa-Thasan, M. R. Kelly. Legal Department: G. P. Nicoletopoulos, Director; P. L. Francotte, W. E. Holder, A. O. Liuksila, S. A. Silard. Research Department: N. M. Kaibni. Treasurer's Department: D. Berthet, K. Boese, D. S. Cutler, D. Gupta, Q. Md. Hafiz, T. B. C. Leddy. Bureau of Statistics: M. R. P. Salgado. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, H. A. Arias, J. Delgadillo, L. K. Doe, H.-S. Lee, G. E. L. Nguyen, G. W. K. Pickering, A. Steinberg, E. M. Taha, D. C. Templeman, N. Toé, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, W.-R. Bengs, R. L. Bernardo, J. Bulloch, M. B. Chatah, Chen J., V. Govindarajan, G. D. Hodgson, A. K. Juusela, H. Kobayashi, S. Kolb, K. Murakami, M. Rasyid, A. A. Scholten, Shao Z., S. Sornyanyontr, L. Tornetta, A. Yasseri.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Charles Dallara as Executive Director for the United States.

2. MISREPORTING AND NONCOMPLYING PURCHASES UNDER FUND ARRANGEMENTS - GUIDELINES ON REMEDIAL ACTION

The Executive Directors considered a staff paper on guidelines on remedial action relating to misreporting and noncomplying purchases under Fund arrangements (EBS/84/196, 9/13/84; and Cor. 1, 9/18/84).

Mr. Kafka made the following statement:

The staff has submitted a series of suggestions for possible remedial action relating to the important problem of misreporting and noncomplying purchases. As indicated in a recent paper (EBS/84/94, 4/27/84), such cases have been rare. Nevertheless, the Board obviously must provide that drawings in the absence of observance of relevant performance criteria should be rectified, unless the nonobservance is waived, whether or not the nonobservance came about involuntarily on the part of the member.

The practical issues involved in bringing about a repurchase must be carefully examined. They include the procedures leading to a finding of nonobservance; the period of limitation; the period of repurchase; the nature of the repurchase requirement; and the possible waiver of nonobservance.

Procedures

The first stage of the procedures recommended by the staff is a notice to the member that an apparent problem of a drawing without observance of applicable performance criteria exists; the period of limitation would cease to run from the date of the notice. This is unexceptionable in principle. But since confidentiality cannot always be guaranteed, the sending of the notice alone--which has quite different potential implications (bad faith) than, for example, the possible nonobservance of a performance criterion before a drawing--may, however the matter is finally resolved, grievously harm the member's international credit standing. In view also of the rarity of such cases so far, it should be made clear that such notice should be given only if there is an almost overwhelming likelihood that a problem may exist. 1/

1/ One additional point should be mentioned: it is not clear what is meant by the words "or other conditions" in the introductory paragraph of the proposed decision.

The second stage of the proposed procedure is a finding of nonobservance by the Managing Director, the submission of his report to the Executive Board, and the creation of an immediate requirement--obligation or expectation--to repurchase. There are two exceptions proposed by the staff: the Managing Director may propose a waiver of the nonobservance, and the member may request the Board to review the Managing Director's finding. The second stage of the procedure, as proposed by the staff, is unacceptable. A finding of nonobservance must be made by the Executive Board itself as a matter of routine, and not only upon appeal to the Executive Board by the member against a decision of the Managing Director. Let us consider other instances where substantive decisions are taken without Executive Board deliberation. A drawing under an arrangement does not require a Board decision if it is in accord with the terms of the arrangement, because that procedure is precisely the raison d'être of the arrangement. A finding that the right to draw under an arrangement is suspended is never made in a formal sense: it is not even reported as such to the Executive Board, unless a waiver is sought; it is, on the other hand, a formality whereby the member refrains from requesting a drawing, instead of being told by the Fund that it cannot draw. However, a suspension carries no opprobious implication. A finding of past nonobservance, on the other hand, suggests, unavoidably, knowing our staff's careful work, that something very questionable may--indeed, is likely to--have happened. A finding with such implications should be made only after careful Board consideration.

There is a further consideration. As mentioned in our discussion of EBS/84/94, the appropriate technique to avoid nonobservance of any kind is the careful formulation of performance criteria. Before a finding of nonobservance is made, the Board, which approved the original formulation, should be obliged to consider whether the criterion was not too ambiguous to warrant a finding of nonobservance.

Since cases of nonobservance of the kind considered here are rare, as the staff has shown, adopting the position that a finding of nonobservance should be made by the Board itself, on the recommendation of the Managing Director, can hardly burden us excessively. In any case, we should not avoid this burden.

Finally, it should be mentioned, in this connection, that the Managing Director's summary of EBM/84/81 (5/23/84), states: "All cases of misreporting, whether motivated by an intention to conceal information and to draw on an illegitimate basis, or whether only the result of inaccurate reporting, should be brought by management to the attention of the Executive Board, which should decide what to do on a case-by-case basis." The staff proposal seems to go far beyond that statement, because,

in the absence of an explicit Board decision, the Managing Director's finding alone would trigger a repurchase requirement.

Period of limitation

The two-year period of limitation proposed by the staff after the discussion of EBS/84/94 is inappropriate. It may also be unfair to those who cofinance a country with the Fund. A shorter period than two years should be chosen. While few objected to the two-year period at EBM/84/81, even fewer explicitly supported it. A natural length for the period of limitation would be the time between a drawing and the subsequent review. Another natural option would make the period of limitation for any drawing contemporaneous with the disbursement by private creditors linked to the incriminated drawing from the Fund. A relatively short period would encourage the staff to give due importance to the investigation of the "apparent problem" dealt with here. Uncertainty about whether a drawing is final or not, which has scarcely existed so far, would become the rule under the staff proposals. Such uncertainty would detract from the usefulness of Fund arrangements and should, therefore, be of minimal length.

Period of repurchase

The staff proposes a 30-day period of repurchase after a finding. This makes no sense in cases where repurchases cannot be made from reserves and--as will almost unavoidably be true--where the member has no access to credit. It is pointless to create a repurchase requirement that cannot be honored, or can be honored only at the cost of economic disorganization of the member country. For this reason, the period of repurchase expected in cases of overcompensation under the compensatory financing facility is normally--not invariably--30 days. For obvious reasons, a short period is particularly inappropriate combined with a legal obligation as distinct from an expectation. If a period that is variable within limits, at the discretion of the Board, is considered inappropriate, then a fixed limit of not less than six months might be adopted. Such a period would enable a country to liquidate invested resources and to take reasonable measures to correct the balance of payments.

Nature of repurchase requirement

The next question addressed by the staff paper refers to the nature of the repurchase requirement. The paper recommends an obligation, on the grounds of analogy with municipal law. One of the peculiarities of the Fund is that the Executive Board--or, ultimately, the Board of Governors--serves as both prosecutor and judge; there is no independent, judicial review. This is a matter that we may, at some point, have to reconsider.

But for the time being the Fund's members are in a radically different situation from those who have unduly enriched themselves against the rules of any municipal or even any other international legal system.

The proper way to deal with this matter would be to pronounce an expectation of repurchase. In those cases where it was overwhelmingly clear to the Executive Board that the nonobservance was deliberate and in bad faith, the Managing Director could then initiate action under Article V, Section 5, as proposed by the staff. No need for a formal finding of fraud would be necessary. In other cases, however--we are, after all, dealing with a rare type of occurrence, where part of the causation may even lie with us, because of ambiguously worded performance criteria, for example--such action would be excessive, compared with the less abrasive method of applying moral suasion, for which the Fund is well equpped. Only in those cases of deliberate nonobservance in bad faith, moreover, should the arrangement prevent future purchases until the repurchase has been made. The reasons for avoiding the creation of a legal obligation also argue against creating a legal nonobligation with automatic further action, as proposed by the staff, which has the same practical effects as a legal obligation. We have, for good reasons, avoided such a procedure for the compensatory financing facility.

Waivers

The staff's recommendations on waivers are acceptable.

Mr. Polak said that he broadly supported the staff's approach as reflected in the proposed decision. He agreed with Mr. Kafka that, although only a few cases of misreporting had occurred, they were serious and unacceptable, and the proposed decision should deter as well as correct misreporting problems. Although the Board had previously considered the broader subject of nominal compliance with performance criteria (EBM/84/80 and EBM/84/81, 5/23/84), the present discussion would center on the narrower subject of misreporting.

A drawing based on incorrect data must be reversed because the member concerned had not been entitled to use the Fund's resources, Mr. Polak continued. Article V, Section 3 (b)(i) stated that a member should be entitled to purchase the currencies of other members from the Fund provided that "the member's use of the general resources of the Fund would be in accordance with the provisions of this Agreement and the policies adopted under them." It was immaterial whether the reversal took place through a repurchase--the normal means--or through another technique, for example, if another member purchased the currency concerned from the Fund.

The staff had proposed that a finding that misreporting had occurred should be made by the Managing Director, Mr. Polak noted, and that the member could appeal that finding to the Board. That would not be the best procedure. Because misreporting cases were rare but serious, he shared Mr. Kafka's view that the Managing Director should present his finding for Board consideration in the first instance.

The proposed decision gave the Board too narrow a choice: oblige the member to reverse the transaction within 30 days, or dismiss the case as being so minor that a waiver could be given in good conscience, Mr. Polak commented. There might be cases where neither outcome would be reasonable. When a member was overcompensated under the compensatory financing facility, but could not repurchase within 30 days, the Managing Director reported to the Board, and it decided what constituted a reasonable repurchase period. That provision had been in effect since January 1982 but had never been used, although there had been some cases of delay in handling overcompensation. A similar provision should be included in the proposed decision; he was confident that it would not be abused. Moreover, as the Fund was more interested in reversing a noncomplying purchase than in gaining a repurchase as such, it might be preferable to state in paragraph 3 of the draft decision that the purchase should be reversed, rather than that the member should be obliged to repurchase.

He was not convinced by the staff's argument that an 85 percent majority would be required to adopt the proposed decision, Mr. Polak said. Presumably, the staff's view was based on specific provisions on repurchases in Article V, Section 7(c) and (d). Section 7(c), which regulated repurchases on the basis of a five-year period, provided that "the Fund, by an eighty-five percent majority of the total voting power, may change the periods for repurchase under this subsection, and any period so adopted shall apply to all members." Section 7(d) stated that "the Fund, by an eighty-five percent majority of the total voting power, may adopt periods other than those that apply in accordance with (c)..., which shall be the same for all members, for the repurchase of holdings of currency acquired by the Fund pursuant to a special policy on the use of its general resources." If those provisions were relevant to noncomplying purchases, an 85 percent majority would be needed to instruct a member to undo such an inappropriate transaction, while an ordinary majority would suffice to take the more serious step of declaring the same member ineligible to use Fund resources for having engaged in that transaction. In addition, Section 7(c) stated that a member that had purchased under Article V, Section 3 should repurchase, whereas noncomplying purchases were in violation of Section 3. It seemed unusual for the Fund to recognize as legitimate those transactions that should never have taken place. In short, he did not believe that the provision in Article V, Section 7(c) and (d) for an 85 percent majority applied in the cases of noncomplying purchases.

Of course, Mr. Polak continued, there must be a remedy for misreporting problems. The most plausible approach was that the obligation to reverse a noncomplying purchase was inherent in Article V, Section 3(b)(i).

Accordingly, any drawing that proved not to have been in accordance with the basic rules for the use of Fund resources implied a transgression of the Articles and must be reversed. Although the obligation to make the reversal therefore existed from the moment the noncomplying purchase occurred, it became operative only when the misreporting was established. Under the proposed decision, the obligation would merely be noted, and the member would be required to rectify its position within 30 days; the Board could conclude that that procedure was unreasonable in certain cases. No special majority was needed, because the Articles stated that, unless special majorities were specified, the ordinary majority held.

Mr. Grosche stated that his authorities were in broad agreement with the proposed procedures for dealing with noncomplying purchases. The guidelines adequately reflected their serious concern regarding the improper use of Fund resources. Drawings on the basis of incorrect data should be prevented because they undermined the credibility of the Fund's policy on conditionality, impaired the revolving character of the Fund's resources, and violated the principle of evenhanded treatment of all members. A clear understanding that improper drawings would give rise to a repurchase obligation, unless a waiver was granted, was the best way to prevent misreporting.

On whether the finding of nonobservance should be made by the Managing Director or the Executive Board, Mr. Grosche said, he had found Mr. Kafka's arguments interesting. If a repurchase became overdue, the normal procedures should apply: the country's right to purchase under current arrangements should be suspended, and a limitation on future use of Fund resources, or even a declaration of ineligibility, should be envisaged.

Like Mr. Polak, he doubted whether the need to reverse improper purchases had to be decided by an 85 percent majority, Mr. Grosche remarked, and he was not sure whether Article V, Section 7(c) and (d) was relevant. Section 7(c) referred to changes in the periods for repurchase, but only those repurchases in respect of purchases that were in compliance with the Articles and decisions of the Fund, and particularly Article V, Section 3. A member that had made a drawing on the basis of incorrect data, however, was not complying with the provisions set out in Article V, Section 3(b); therefore, Article V, Section 7(c) did not apply. As to Article V, Section 7(d) it was relevant only with regard to drawings under a special policy. In addition, it was illogical to apply Section 7(c) and (d) to cases of improper use. Those provisions safeguarded the Fund's resources against an extension of the repurchase period by requiring an 85 percent majority for such a decision. It seemed strange to ask for an 85 percent majority to achieve, not an extension of the repurchase period, but the enforcement of a prompt repurchase. He invited the staff to comment.

Repurchase obligations due to overcompensation under the compensatory financing facility clearly were not relevant to a consideration of the treatment of purchase that a member had not been entitled to make in the first place, Mr. Grosche commented. Overcompensation occurred because

data projections could not be precise; nonetheless, the member was entitled to draw in compliance with the provisions of the Articles and Fund decisions. In instances of misreporting, drawings not in compliance with the Fund's Articles and decisions should never have occurred and needed to be reversed promptly.

The staff's alternative proposal of a repurchase expectation, rather than a legal obligation, was too weak a safeguard against improper use of Fund resources, Mr. Grosche remarked. A simple expectation did not entail the automatic interruption of the right to make further purchases and could not lead to the initiation of limitation or ineligibility action.

The option of granting a waiver should be used only in exceptional cases where there had been only minor temporary deviations from targets or where the member had undertaken immediate corrective measures to bring the program back on track, Mr. Grosche stated. A waiver should never be granted in cases of intentional misreporting. Accordingly, the staff should state on page 10 of its paper, that the Managing Director "will not recommend" a waiver if he considered that misreporting was intentional and designed to mislead the Fund.

Mr. Angeloni said that the proposed procedure was reasonable and simple, and should deal effectively with the majority of misreporting cases. In particular, he fully shared the staff's preference for a repurchase obligation, as opposed to an expectation. The proposal was not perfect in all aspects; nevertheless, if a broad consensus emerged in the Board for the decision as it stood, he was prepared to support it.

A critical issue was the appropriate degree of involvement of the Executive Board in each case of misreporting, Mr. Angeloni continued. On the one hand, as the staff had proposed, there could be a fully automatic procedure, administered essentially by management, which would consult the Board and request its approval of a decision on a lapse-of-time basis; a repurchase deadline also could be specified. That option's main advantages were clarity, guaranteed equality of treatment, administrative simplicity, and avoidance of excessive emphasis on individual cases. A possible disadvantage was the lack of flexibility in handling individual cases. On the other hand, every misreporting case could routinely be brought to the Board's agenda, an alternative favored by Mr. Kafka on the ground that a finding of misreporting might have implications that should be considered carefully. Obviously, the advantages and drawbacks of the second option were the reverse of those of the first alternative.

In order to establish the proper degree of involvement of the Board, consideration should be given not so much to the seriousness of the case as to the potential usefulness of fexibility in individual cases, Mr. Angeloni commented. That flexibility appeared limited, because of the wide range of circumstances--from error to deliberate falsification--where a repurchase was appropriate, and where the Board should not analyze a country's underlying intentions; the Board discussion in May 1984 had

indicated clearly that such a cause should be avoided whenever possible. Therefore, the more standard procedure proposed by the staff presented obvious advantages.

Favoring the adoption of a standard procedure did not mean that the serious implications that might arise from misreporting, such as those mentioned by Mr. Kafka, should be overlooked, Mr. Angeloni remarked. In fact, he agreed with Mr. Kafka that even the first notice of misreporting should be backed by strong evidence. The Board should retain the option to review the evidence in every case, not only at the request of the member concerned. Unfortunately, that practice might not be easy to follow under the proposed decision; in cases where the Managing Director did not recommend a waiver, Executive Directors would have as little as 30 days to examine the matter, decide to review it, schedule a Board meeting, and possibly decide on a waiver. At best, there would be a drastic reduction in the repurchase period, which ran from the moment the necessity to repurchase was established with certainty until the moment the repurchase had to be made. However, the repurchase period should remain unchanged because it was a minimal, and possibly too short, time span for many countries. Consequently, if the Board wished to retain the option to review a case, as it should, the repurchase period should start after the Board's deliberation or, alternatively, after the decision to forgo the review.

In sum, he favored the automatic procedure proposed by the staff because it was clear, simple, and easy to implement, and it avoided undue emphasis on individual circumstances, Mr. Angeloni stated. Where that emphasis was warranted, however, the Board should have the option, in principle and in practice, to look more closely at the evidence, without making it technically more difficult for the member to repurchase.

On a related issue, Mr. Angeloni recalled, during the Board discussion in May, it had been noted that problems with performance criteria could include loopholes, nominal compliance, or lack of congruency between criteria and final objectives. They were separate from, but no less serious than, misreporting. They involved the problem of program design at different levels, from the choice of the most appropriate statistical data to more fundamental questions, such as the selection of the right policy instruments and of intermediate targets for policy implementation in the light of the final objectives. On program design, the Board should insist that performance criteria relate most frequently to policy instruments, occasionally to intermediate targets, but never to the final objectives. In view of recent experience, some rethinking of those issues would be useful.

Mr. Alfidja said that during the May 1984 meeting, his chair had reiterated its firm position that members should respect the Articles of Agreement, particularly the requirement to provide economic and financial data. His chair had also stated its doubts about the need for new rules or for the reinforcement of existing ones on misreporting, because of the circumscribed nature of the problem. Consequently, his chair continued

to favor a case-by-case approach to misreporting. However, should most Directors support a formal decision, he preferred to base it on certain considerations.

First and foremost, a distinction must be made between misreporting with the intent to defraud and unintentional misreporting due, inter alia, to the weakness of the statistical apparatus in a member country or the inadequate definition of performance criteria, Mr. Alfidja stated. A clear line must be drawn between the two categories of misreporting so that they could be treated in an evenhanded manner. In particular, unintentional misreporting should be handled flexibly; a Fund member should not be penalized for misreporting due to factors beyond its control. The guidelines proposed in EBS/84/196 were applicable to misreporting with the intent to conceal unsatisfactory performance. Therefore, the proposed decision should be recast in order to dispel any ambiguity about the unintentional or deliberate nature of any case of misreporting. It was not easy to determine accurately the motives behind misreporting, but that should not lead the Fund to enact rules that were blind to the differing circumstances of misreporting.

Second, Mr. Alfidja said, he favored submitting to the Executive Board for review and eventual action all relevant recommendations concerning cases of misreporting. Third, the two-year period of limitation indicated in paragraph 1 of the proposed decision was too long. Sound economic and financial management by users of Fund resources could be seriously impaired if their purchases were subject to suspicion for such a long time. Consequently, the period should be of six months, or until the next review of the adjustment program, whichever was shorter.

Fourth, Mr. Alfidja said, members should be allowed up to six months to reverse a purchase. A shorter repurchase schedule could defeat the entire adjustment effort and create undue financial strains. Finally, the repurchase obligation should take the form of an expression of expectation as opposed to a legal action.

Mr. Wicks said that he agreed with the general approach in the staff paper. In a case of nonobservance and misreporting, the Board should not judge whether or not members had acted in good faith; attempts to find the motives would lead to difficulties. Although misreporting was infrequent, the Board must agree on firm and fair rules for dealing with it. He agreed with Mr. Polak that the rules under discussion should be a deterrent to the occasional lapse as well as guidelines for dealing with actual situations.

The paper addressed the specific question of how to remedy the situation where there was misreporting regarding performance criteria, Mr. Wicks remarked. Presumably the paper and the proposed decision would also apply to misreporting in the form of, for example, failure to take prior actions.

There were two possible approaches offered by the staff, Mr. Wicks continued: either a member would be obliged to make a repurchase within 30 days unless the Board granted a waiver, or a member would be expected to make a repurchase. He strongly favored the first alternative. The Managing Director should take responsibility for the finding of nonobservance, subject to the procedures proposed for an early review by the Executive Board; the Board had already entrusted similarly important decisions to the Managing Director. Such a finding would be made only if there were a real justification; if there were any doubt, he was confident that the Managing Director would consult the Board. If Executive Directors were to debate a member's nonobservance of a performance criterion, he agreed with Mr. Angeloni that they would inextricably be drawn into the question of motivation.

The guidelines would establish an automatic procedure that would protect the interests of both the Fund and its members, Mr. Wicks considered. The guidelines were phrased in neutral language that did not carry any implication about the good faith of the member, and the procedure would be a private one, relying on those mainly concerned with the problem--the staff and the Managing Director--to reach a finding on the fact of noncompliance and to recommend a course of action to the Board. If the finding of noncompliance were the Board's responsibility, the procedure would be less private and could entail difficult discussions; therefore, the initial decision should rest with the Managing Director. At the same time, it would be open to any Executive Director, for example, in a case where no waiver was proposed, to recommend a different course of action to the Board.

The 30-day period for repurchase seemed appropriate, Mr. Wicks continued, because a transaction that should not have occurred in the first place should be reversed promptly. To do so within 30 days should not be onerous for a member that would have been aware of the possibility since receiving the Managing Director's notice some time previously. However, to help reach agreement in the Board, he could support a period longer that 30 days, although it should be neither open-ended nor as long as the period suggested by Mr. Kafka.

In general, Mr. Wicks said, the proposed guidelines would protect the correct use of the Fund's resources, the equality of treatment of members, and the integrity of the reporting relationship between the Fund and members. The guidelines should be reviewed after two years. He looked forward to the General Counsel's comments on the voting majority required to adopt the present decision.

In conclusion, Mr. Wicks stated, the present decision would provide only one part, although a very important one, of the solution to the problem of misreporting. As Mr. Angeloni had stated, the Fund must continue to work to prevent misreporting, for example, through improving where possible the specification of performance criteria and the flow of data reported by members.

Mr. Fujino recalled that at the previous Executive Board discussion of the present subject in May, his chair, along with others, had stated that it was important to address the problem of misreporting and noncomplying purchases to avoid undermining the credibility of the Fund's policies on conditionality.

It would be highly desirable to have overall guidelines, such as those proposed in the staff paper, not only to preserve the credibility of the Fund's policies, but also to ensure equal treatment of members, Mr. Fujino continued. He could, in general, support the staff proposal, although he sympathized with Mr. Kafka, who had suggested that the finding of nonobservance must ultimately be made by the Executive Board.

The provision that corrective action should be required only if the misreporting were discovered within two years after the date of the purchase seemed reasonable, Mr. Fujino said. It was undesirable for members to be exposed indefinitely to the risk that their past transactions might be reopened. Also, he agreed with the staff that the guidelines should indicate the circumstances in which an ex post facto waiver would usually be granted, to ensure the uniform treatment of members in similar circumstances. In that connection, paragraph 4 of the proposed guidelines was acceptable.

He supported the staff's proposal to require the member to repurchase within 30 days after the finding of misreporting, Mr. Fujino commented. That approach was more appropriate because of the potential seriousness of the problem, and because it paralleled the treatment of an excess purchase under the compensatory financing facility. However, if that approach were not supported by the necessary majority, he could go along with the second approach--whereby the guidelines would include an "expectation" that members would repurchase within the prescribed period--provided that the two additional measures to reinforce the repurchase expectation, as described on page 11 of the staff paper, were adopted. The most important aspect of the Fund's approach to misreporting would be close monitoring of the actual implementation of an efficient reporting arrangement, so that there would be little likelihood of misreporting as a result of insufficient data bases or a lack of appropriate procedures.

Mr. Leonard considered that the quality of an adjustment effort and the authorities' determination to succeed, rather than adherence to specific performance criteria, should be the dominant factor in the relationship between the Fund and members using its resources. Nevertheless, performance criteria were an essential part of Fund arrangements, and he welcomed the staff's continued commitment to working with members to improve the formulation and definition of those criteria. Even greater emphasis might have been given to that commitment in the draft decision, as it was clearly the Fund's responsibility to minimize or eliminate the risk of misreporting by diligently helping members to improve the accuracy and completeness of information reported to the Fund. However, in some rare cases, there might be deliberate misreporting that would result in noncomplying purchases. Fund policies to handle those cases should be

clearly defined and enunciated; the paper under consideration represented a useful advance in that direction, and he broadly supported the staff's approach.

With regard to the finding of nonobservance, Mr. Leonard said, he agreed that the Managing Director should notify the member whenever it became apparent that there was a problem regarding a purchase made within the previous two years, and that the two-year limitation should cease to run as of the date that notice was sent. It was, however, unclear from the staff paper what form that notice would take. Would it consist in a formal notice by the Managing Director and, as such, be communicated to the Board, or would it be a muted and less obvious notification? As Mr. Kafka had said, the need to safeguard a member's international credit standing warranted a low-key notification following strong evidence that a problem of misreporting existed.

The Managing Director should be responsible for making the definitive finding that, on the basis of clear and convincing evidence, misreporting and nonobservance had in fact occurred, Mr. Leonard continued. However, the staff paper did not clearly state whether that finding would have to be approved on a lapse-of-time basis or simply presented to the Board. If approval by the Board were not envisaged, he would support Mr. Kafka's suggestion for careful Board consideration as a matter of routine. At a minimum, the member concerned should have the right to ask the Board to review the Managing Director's finding.

He agreed that rapid repurchase should be required, since a purchase made when performance criteria had not been met constituted an inappropriate use of Fund resources, Mr. Leonard remarked. The proposed 30-day period between official notification to the member and the Executive Board that applicable performance criteria had not been observed and the deadline for the repurchase seemed appropriate. However, it was not clear how that period would be combined with the member's request for a Board review of its case. Perhaps the procedure would be clearer if the 30-day period were to run from the date of Board approval of the Managing Director's finding. While he would, in fact, expect most members affected by the proposed guidelines to make repurchases voluntarily, he agreed with the staff that a mechanism should be put in place to ensure that such repurchases were made, and that the inappropriate use of Fund resources would not continue. Such repurchases should be a legal obligation; in stating that preference, he had in mind primarily obvious cases of deliberate misreporting or nonobservance.

A member's right to make further purchases during the investigatory period should be generally unaffected, Mr. Leonard said. He also recognized that, in circumstances where subsequent purchases were governed by criteria similar to those in question, the Fund would have to scrutinize the data closely and be satisfied that comparable noncompliance was not taking place. Finally, like Mr. Kafka, he agreed with the staff's recommendations on waivers.

Mr. Jaafar stated that he found it difficult to support the staff proposal for two reasons: the infrequency of cases of misreporting, and the lack of distinction between willful intent to misreport and inadvertent error in reporting. Cases of misreporting and noncomplying purchases were uncommon, and no increase was expected that would warrant special treatment in the form of firm and formal guidelines and corrective actions. Of course, willful intent to misreport was tantamount to fraud, and in such cases the Fund would be justified in imposing maximum sanctions, but, as those occurrences were rare, the proposed recourse to a formal procedure by the Executive Board appeared to be an overreaction. It would be more efficient to act on a case-by-case basis in a flexible manner. At EBM/84/80 and EBM/84/81 (5/23/84), the Executive Board had agreed to treat minor cases of misreporting with flexibility and, in appropriate cases, to propose waivers or modifications of performance criteria. He reaffirmed his support for such an approach.

In addition, Mr. Jaafar remarked, the Executive Board should introduce preventive measures along the lines of those reflected in the Chairman's summing up of May 23, 1984 at the conclusion of the discussion on reporting and other problems regarding performance criteria. The importance of carefully formulating and defining performance criteria and of improving the administrative and statistical apparatus in member countries should be stressed. The Fund should provide technical assistance where applicable in administration and statistics.

It was difficult to judge between cases that involved fraud and those that involved error, Mr. Jaafar continued, and it would be inappropriate to assign that task to the Executive Board; however, applying the guidelines in the present form, would also be inappropriate, as they did not discriminate between the two main kinds of misreporting and prejudiced the standing of a member that misreported accidently. To be fair, the Executive Board would have to be more understanding in looking at technical misreporting; the proposed decision was more punitive than helpful, although he would not object to a harsher sanction in a case of fraudulent reporting.

If the proposed guidelines were found to be necessary, Mr. Jaafar commented, they should be modified. In paragraph 1, the period of limitation should coincide with the usual review of programs or the annual Article IV consultation. If noncompliance existed, it would probably be detected during the review following the purchase. The proposed two-year limitation period appeared somewhat long. As to paragraph 2, like other Executive Directors, he would prefer that any alleged misreporting be discussed first by the Executive Board and that the finding should be made by the Board not by management. Decisions to waive the nonobservance of performance criteria should also be taken by the Board.

In paragraph 3, Mr. Jaafar said, the 30-day notice for repurchase was too short; lengthening the period to three, or preferably six, months after the finding should be considered. A member would thus have a reasonable length of time to make arrangements for financing if needed. In view of the likely implications for a member, he would prefer not to

impose a repurchase obligation. It would be more appropriate to opt instead for an "expectation" clause; the means of coping with overdue obligations were provided in the Articles. In conclusion, he supported Mr. Polak's suggestion that a member should "reverse" a purchase rather than "repurchase."

Mr. Lindå said that, as stated by his chair during the previous discussion on misreporting, his constituency favored clear guidelines on misreporting and noncomplying purchases. The staff guidelines broadly fulfilled that requirement, and he could therefore support the proposed decision. He preferred to make the repurchase an obligation instead of an expectation. As to paragraph 4(b), in considering a waiver the Fund should pay due attention to the member's efforts to correct the misinformation as early as possible.

Mr. Malhotra remarked that he agreed in general with Mr. Kafka's views on the problem of misreporting and noncomplying purchases. In paragraph 1 of the draft decision, the limitation period of two years appeared far too long, because it would increase potential uncertainty with regard to purchases made by members. Such uncertainty was clearly undesirable, especially when many members had parallel arrangements with commercial banks. Therefore, it was important that the period should be much shorter. He agreed with Mr. Kafka that the time between an impugned purchase and the subsequent review, when it should be possible to detect such cases of misreporting, would be appropriate. However, should it be considered that the period between an impugned purchase and a subsequent review might vary greatly between members and that there was need for uniformity, the period should not exceed one year and preferably not exceed six months.

Drawings under Fund arrangements were phased and subject to performance criteria, including reviews, Mr. Malhotra continued. If a drawing considered to be noncomplying were followed by a drawing that met all prescribed conditions, repurchase of the improper drawing would be unnecessary. It would also not be correct to suspend further purchases under the program if it were on track and the reporting problems had been corrected. In sum, before initiating formal procedures, the Managing Director should ascertain whether, subsequent to the purchase based on possible misreporting, there had been purchases with no suspicion of noncompliance with performance criteria. In those circumstances, formal action should not be initiated, and management should merely notify the member concerned that its reporting had not been proper and should be improved, perhaps with technical assistance from the staff.

With regard to paragraph 2, Mr. Malhotra noted that, in the course of consultations, the member might share the views of management that there had been an irregularity in its reporting, and it might agree to a repurchase; in that event, no further action would be needed. If there were a difference of opinion between management and the member as to whether there had been misreporting leading to an irregular purchase, a comprehensive report should be presented to the Board for a formal finding.

However, issuing a notice for repurchase while the Board considered either a waiver or another position should be avoided. There should be a clear understanding that a notice expressing an expectation of repurchase would be the result of a Board decision; the proposed guidelines should be redrafted on the assumption that the decision would be taken by the Board.

The requirement to repurchase should be an expectation, Mr. Malhotra stated. As the staff noted, there were provisions enabling management to complain to the Board if an expectation had not been met. He could not support language that would make the repurchase obligatory.

The period of 30 days within which the member would be expected to make the repurchase might be too short, Mr. Malhotra remarked. Although nothing would prevent the member from reversing the purchase in an even shorter period, there would be cases where a member might not be in a position to make the repurchase, especially if the limitation period were as long as six months to a year. Believing that the purchase had been correct, the member might have used the funds or might for other reasons not be in a position to return them immediately; therefore, a repurchase period of six months would be in order.

The staff formulations regarding waivers appeared to be appropriate, Mr. Malhotra considered. If subsequent purchases by a member had been correct, a technical waiver should be considered. Therefore, instead of issuing a notice to the Board and holding a consultation, management would follow a more practical course of action if it reported to the Board that there had been a technical irregularity that should be condoned.

Mr. Prowse said that the draft decision was broadly consistent with the views expressed at the Board meeting on May 23, 1984. He agreed with the staff that "a requirement that a member take action to correct...a purchase transaction that it was not entitled to make is not a penal action, nor does it necessarily imply any fault on the part of the member, in a pejorative sense"; it was important to approach the proposed decision with those conclusions in mind. The Fund would not establish a new or additional investigative technique for the purpose of carrying out that decision. Therefore, as the staff had suggested on page 5 of EBM/84/196, "a past transaction should not be reopened without good reason," and there would need to be convincing evidence before any action was taken.

As to the preamble of the decision, Mr. Prowse suggested that in the third sentence, after "completeness of the information to be reported to the Fund by the member under the arrangement," the following phrase should be inserted: "and also to ensure that the performance criteria are so defined as to enable feasible and accurate testing." Accordingly, if misreporting occurred early in an arrangement, the Board would consider not only the accuracy of the information but also the nature of the performance criteria. On the guidelines, he could accept a two-year limitation, since a statistical review could take that long to complete. The argument that a shorter period was necessary to reduce the uncertainty that might attach to arrangements did not have much weight.

The second proposed guideline was acceptable, Mr. Prowse stated, as it constituted what were already normal activities for the staff and management. It would be contrary to the wishes of Board members who wanted misreporting and noncompliance handled in a low-key manner to escalate the notification of such cases to the Board. That action would produce a new test category and a new emphasis on those matters. Management and staff should decide whether performance criteria had been satisfied; when, in their judgment, they had not and a purchase had been made, the Board should be notified. In addition, the Board should not have to make decisions about matters of fact that might involve questions of motivation that did not affect the facts. The proposal--that the Managing Director should establish the facts, submit a report to the Executive Board, and recommend courses of action--lacked sufficient options. It allowed the Board, on the recommendation of the Managing Director, either to grant a waiver or to support a call for repurchase or reversal within 30 days. The Board should not be confined to making decisions within that limited framework, but should be free to take other courses of action. It was impossible to foresee the circumstances in which noncompliance or misreporting would occur and in which the Board would ask for repayment; therefore, the options were too restrictive for normal Board practice.

On paragraph 3, Mr. Prowse said, he could accept Mr. Polak's suggestion that "reversal" might be more appropriate than "repurchase." As to the period within which a repurchase should be expected, logic and practice argued that the Board should adopt a procedure as close as possible to the provision affecting certain purchases under the compensatory financing facility. That provision had been determined on the basis of previous practice and procedure and allowed some flexibility by stating that repurchase "would normally be made" within 30 days; that understanding was made clear to members that might be in a position to experience overcompensation. Similarly, the Board should agree that, where a review indicated that a purchase had not been justified, because of misreporting or other factors, the Fund would normally expect a purchase to be reversed within a period of 30 days. The compensatory financing decision also provided that, if repurchase could not be made within 30 days, the Treasurer and management would report the matter and propose a prompt and appropriate solution. It was logical to apply the same rules to misreporting, which in a technical sense, was similar to overcompensation. It would not be necessary, or perhaps even desirable, to write into the guidelines a limit on the period for exercising flexibility, although six months would seem appropriate.

Paragraph 4(b) was acceptable, Mr. Prowse stated. Particularly, it retained the word "normally," which would give the Board the desired flexibility.

Although the staff had concluded that, under Article V, a member that had made a noncomplying purchase was legally bound to reverse the transaction or make a repurchase, some Executive Directors disagreed, Mr. Prowse

stated. He invited the staff to clarify the legal aspects of the proposed decision. He hoped that the decision could be adopted by the ordinary majority, rather than an 85 percent majority.

In paragraph 5, Mr. Prowse continued, the "prescribed period" might have to be altered to incorporate any suggested modifications of the draft guidelines. As references to the Fund in the guidelines apparently meant the Board, the guidelines implied a two-stage process: after the Managing Director had made a factual report, the Board would consider either a waiver or repayment within 30 days or some other period; if the Fund were not repaid, the Board would, under paragraph 5, have to reconsider the matter. Paragraph 5 should state: "If the repurchase has not been effected, the Managing Director will report again to the Executive Board, recommending courses of action that might include suspension of further purchases, and limitation or ineligibility." The Board's role should be clarified in the paragraph. When repurchase or reversal was not made, the Board should decide on subsequent action. As the Board had seemed unanimous on its right to decide on a reversal, the more serious action of suspension or ineligibility should also be decided by the Board.

Mr. Ercel stated that guidelines for dealing with future cases of noncomplying purchases were needed to protect the credibility of Fund-supported programs. If data indicated nonfulfillment of a performance criterion, but a drawing had been made that was not otherwise justified, the outcome should normally be a requirement to repurchase. Although there was a need to establish guidelines to deal with the problems that arose in exceptional circumstances, the Fund should continue to pursue its traditional flexible approach, dealing with each problem on a case-by-base basis. In addition, the Fund should avoid conveying the impression that it was distrustful of members; on the contrary, its conduct should preserve the atmosphere of mutual trust and good faith between itself and members.

He endorsed the general approach of the draft decision, Mr. Ercel said. He agreed with Mr. Kafka that the period of limitation should be shorter than that suggested by the staff. With regard to paragraph 3, he favored a mandatory period for obligatory repurchase longer than 30 days, and perhaps as long as six months. Finally, as other Directors had indicated, the questions of adequacy of performance criteria and program design were closely linked to the issue of misreporting. Improvement of the formulation and definition of performance criteria, and of the systems used by members to report their data, could prevent misreporting and noncompliance.

Mr. Suraisry commented that the staff paper reflected many of the concerns raised at the Board discussion in May. Clearly, the issue of misreporting was sensitive, and the Fund had to balance a number of different considerations. On the one hand, misreporting was rare and could usually be corrected fairly easily, with little or no effect on a Fund-supported program. Therefore, any new procedures should allow the Fund both to respond flexibly, on a case-by-case basis, and to help

members to improve their reporting systems, so that misreporting could be prevented in the future. On the other hand, misreporting was a potentially serious problem that was in no one's best interest: it was contrary to the Fund's purposes and undermined its role in the adjustment process; it discriminated against other borrowers that were reporting correctly; and it could weaken the confidence of Fund creditors. The Fund, therefore, needed to have clear procedures to deal with the problem in a manner that would ensure uniform treatment of members. The proposed guidelines incorporated the two essential requirements that he had outlined; first, the principle that noncomplying purchases due to misreporting should be corrected as quickly as possible, and second, the need for flexibility to take account of the circumstances in each case.

As stated in the preamble, it was sensible that if misreporting should occur, the Fund and the member should cooperate to ensure that it would not happen again, Mr. Suraisry said. It was also reasonable that a member should repurchase a noncomplying purchase unless there were good reasons for it not to do so. That provision was fair to other borrowers and consistent with the revolving character of the Fund's resources. He supported Mr. Prowse's proposal to include a reference to the definition of performance criteria so as to enable feasible and accurate testing.

In paragraph 1, he could go along with the proposed two-year period, Mr. Suraisry continued, as it would assure members that transactions that had occurred before that period would not be reopened. It also gave the Fund and its members an appropriate length of time to detect, and to act on, misreporting when it was directly relevant to a program. A two-year period seemed to provide adequate safeguards on both sides. The meaning of "other conditions," apart from performance criteria, that a member might not have observed was unclear to him, and he invited the staff to comment.

The Board would have to set out the procedure for determining misreporting and informing the member concerned, Mr. Suraisry noted. It was sensible for the Board to rely on management and staff to establish the facts in each case; like Mr. Wicks, he believed that that method would be more private than Board participation. The Board should be kept fully informed of developments in a misreporting case and should be in a position to give its views at any stage. Once the facts had been established, he was sure that in most cases the staff and the member would be able to sort out any problems, and that in many cases there might be good reasons for the Managing Director to propose a waiver of the repurchase requirement. In other words, the Board should normally be able to rely on management's discretion. But in the rare cases where there were differences of view between the Fund and a member, it would be necessary for the Board to take a decision. He therefore attached considerable importance to the provisions for consultation between the Fund and a member. Such consultations must be thorough and must examine the implications for a program. They should also be conducted with all possible speed, to avoid interrupting the member's drawing rights or jeopardizing the Fund's good relations with the member.

With regard to paragraph 3, Mr. Suraisry continued, he supported the proposal that a member should have an obligation to make a repurchase, unless a waiver were justified, once it had been determined that a noncomplying purchase had taken place. Nevertheless, if necessary, he could go along with a repurchase expectation in those circumstances, provided that it was accompanied by additional safeguards as outlined by the staff on page 11 of EBS/84/196. He could go along with the 30-day repurchase period proposed by the staff since a member would have adequate warning that a repurchase might be necessary. However, he would be willing to consider a slightly longer period, perhaps 45-60 days, which would provide more than sufficient time. He also supported Mr. Prowse's suggestion to follow the relevant procedure adopted for the compensatory financing decision.

Paragraph 4, regarding possible waivers, gave the Fund the flexibility that it needed, Mr. Suraisry stated. It allowed for a case-by-case approach within a uniform framework and was consistent with the present policy on waivers. He agreed with the staff that a waiver should not be considered by the Fund if it were established that misreporting had been intentional.

The staff and management should take every opportunity to remind national officials of the importance of accurate reporting, Mr. Suraisry remarked. The Fund should also help members to improve their data base and reporting procedures. He supported the provisions in paragraph 5; although he hoped that it would not be necessary to implement them, the provisions would provide necessary safeguards in extreme cases.

Mr. Blandin said that, as underlined during the Board's preliminary discussion of May 23, the problem of misreporting and noncomplying purchases, although not widespread, was a serious one affecting the Fund's credibility and the equality of treatment of members. Guidelines were necessary to prevent member countries from misreporting or effecting a noncomplying purchase and to require remedial actions when those cases occurred. However, it was clear that prevention would always be preferable to sanctions.

It was clear from the Board's previous discussion, Mr. Blandin recalled, that the formulation and definition of performance criteria should be improved and that the Fund should, through close collaboration between members and the Board, elaborate on performance criteria that were unambiguous and easily controlled. He supported the proposal to stress the need for clearly defined performance criteria to enable feasible and accurate testing of the criteria. In that connection, the Executive Board had an important role to play in helping the staff. Moreover, if a country's statistical apparatus were deficient, the staff's technical assistance would be particularly useful. The earlier discussion also suggested the need for a flexible approach, on a case-by-case basis, although that flexibility should not exclude firmness in extreme cases. Intensification of the normal dialogue between the staff and a member should be adequate to settle most of the problems related to noncomplying

purchases. Furthermore, the adoption of too general or too firm guidelines to be applied systematically to all cases could be seen as a sign of lack of confidence in the spirit of cooperation. In those exceptional cases where fraudulent intention could be proved, the Board would be in a position to introduce appropriate sanctions on a case-by-case basis.

The guidelines should be applied only in exceptional circumstances and with the necessary flexibility, Mr. Blandin continued. The first step--giving notice to the member when there was sufficient proof that a problem existed--raised the question of confidentiality. Although noncompliance was a potential threat to the country's creditworthiness, the staff's well-known, careful approach to relations with members provided a guarantee of discretion on that sensitive subject. Like Mr. Kafka and others, he invited the staff to define the "other conditions" mentioned in the proposed decision; more precise wording could be sought. He supported Mr. Kafka's views on the second stage--the finding of misreporting, the report to the Executive Board, the creation of a requirement to repurchase, and waivers. As Mr. Polak and other speakers had said, cases would be rare but serious, and it seemed reasonable to provide that the Board should take the initial decision.

The period of limitation within which procedures could be set in motion to remedy a noncomplying purchase should be fixed in order to remove uncertainties regarding past purchases, Mr. Blandin stated. An excessively short period could undermine the soundness of the staff's analysis and adversely affect the member. On the other hand, an excessively long period could also cast unwarranted suspicion on the member. One year was perhaps a better compromise; in any event, the period should be reviewed later, in the light of experience.

The staff's proposed 30-day period for repurchase after the finding of nonobservance seemed too short to be practicable, Mr. Blandin stated. He supported a longer fixed period--three months, for example--on the basis of Mr. Kafka's arguments. He could support parallelism with the compensatory financing decision in particular.

The most important issue at hand was the nature of the repurchase requirement, Mr. Blandin continued. While the staff had recommended that a repurchase be a legal obligation, he preferred an expectation to repurchase, because of the greater flexibility afforded by that option. He did not support the two additional measures proposed by the staff to reinforce the repurchase expectation, as they implied the rigidity and automaticity inherent in a legal obligation. Nevertheless, an obligation to repurchase should be required in cases where fraud had been established by the Board. Finally, he had no difficulty in accepting the staff's recommendations on waivers.

Mr. Dallara said that he broadly supported the approach outlined in the staff paper. He agreed with each of the general principles set forth, particularly, that the requirement of a repurchase did not necessarily imply any fault on the part of the member and was not a penalty. The

Board should look into the reasons for any failure to identify a lack of compliance when the drawing had originally been made and, as provided in the decision, to try to correct any reporting or other deficiencies. There should be no doubt that the Fund would not tolerate intentional misreporting, and it was incumbent on the Board to act swiftly and decisively to discourage such behavior and to protect the Fund's credibility. As noted in the Chairman's summing up of the Board discussion at EBM/84/80 and EBM/84/81, the credibility of the Fund and its role in giving a seal of approval to members' adjustment efforts were at stake, as the institution operated on the basis of good faith and trust among members.

Although cases of intentional misreporting were rare, they could be very damaging to the Fund, Mr. Dallara commented. The language in the staff paper was broadly satisfactory, regarding intentional misreporting but there was no reference to that issue in the draft decision. While recognizing the need for flexibility to deal with those rare cases, he suggested that the following text be included in paragraph 3: "Where there is clear and compelling evidence that inaccurate information has been deliberately reported to the Fund, the Executive Board will promptly consider whether additional actions may be appropriate." That phrase would draw attention to the potentially serious nature of the case without specifying what course of action might be appropriate.

As noted in the staff paper and by other Directors, in considering a finding of nonobservance by a member, the Board should take account of the broader implications for the achievement of the objectives of the country's current program, Mr. Dallara remarked. He was basically satisfied with the proposed relative roles of the Board and the Managing Director in reaching a determination concerning misreporting. He agreed with Mr. Prowse that, in requiring extensive Board involvement in each decision, the Board would be involved to an unprecedented extent in a largely statistical exercise of determining the accuracy of the data and the subsequent finding. Of course, any proposals for waivers would be submitted for approval on a lapse-of-time basis, and any report that did not contain a proposal for a waiver would be subject to review by the Board if the member concerned so desired. He did expect cases of intentional misreporting to be brought to the attention of the Board.

On the question of whether a purchase reversal should be an obligation or an expectation in the event of misreporting, Mr. Dallara continued, the provisions relating to the compensatory financing facility did not provide a useful precedent. The Board had decided to allow some estimations under the compensatory financing facility, in order to provide flexibility for members using the facility. The repurchase provisions for compensatory financing were required because estimation was permitted, but in cases of misreporting the Board was dealing with what had been believed to be hard facts that were later found to be inaccurate. There should be a clear obligation for a repurchase in cases of misreporting, but he wondered whether it should be viewed in the context of the repurchase provisions of the Articles of Agreement. Mr. Polak's arguments for

referring to the "reversal" of a purchase were persuasive, and he invited the staff to comment on whether the proposed decision should refer to a reversal, which seemed to be implied in the Articles.

He had no problems with the waivers suggested in the staff paper, Mr. Dallara said. However, like Mr. Grosche, he believed the staff should have stated on page 10 that the Managing Director "will not recommend" a waiver in cases of intentional misreporting, because there could be no question of granting a waiver in those circumstances.

He supported the two-year period during which the question of nonobservance could be pursued with a member, Mr. Dallara stated, and he was puzzled by a proposal that had been put forward to set the period until the next program review, thereby leaving undetermined the procedure to be followed when there was no program in effect or when a program had been interrupted and no review would be conducted. He also supported the proposed 30-day period for repurchase. Any determination of misreporting that would trigger a requirement for reversal would likely be made only after extensive work by the staff and management of the Fund; during that period the member would have had adequate time to take the necessary steps to reverse the purchase, should that become necessary. Finally, he supported all the other provisions in the proposed decision.

Mr. Zhang recalled that, at the Board discussion in May 1984, he and a number of other Directors had pointed out that instances of misreporting were uncommon and that there was no tendency toward proliferation. That point had also been recognized by the Chairman in his summing up of that discussion. In fact, there had been no significant new developments warranting any fundamental change in the main conclusions reached during the previous discussion on misreporting.

There had been broad agreement in May 1984 that the present Fund procedures for reviewing members' programs and taking remedial action were generally adequate and sufficiently flexible to deal with misreporting cases, Mr. Zhang continued. The procedures could be adjusted to respond to exceptional circumstances, but there was no need at present to adopt a set of rigid new rules for that purpose. There had also been a clear indication during the earlier discussion that a case-by-case approach was preferred; moreover, all cases of misreporting should first be brought by management to the attention of the Executive Board, which would then decide on appropriate action. Those two points should be the basis for the guidelines on remedial action.

He favored a clear distinction between intentional misreporting and misreporting due to error, Mr. Zhang stated. The proposed decision seemed appropriate only with regard to intentional misreporting. The wording should therefore be made flexible enough to encompass both cases.

With regard to the role of the Fund, Mr. Zhang said that he agreed with the proposal to have the Managing Director notify the member and report to the Executive Board his finding of nonobservance. But if the

notice to the member was taken as the starting point of the repurchase process, as paragraph 3 of the guidelines seemed to suggest, that procedure would deprive the Board of the opportunity to discuss the case and to pass judgment. That failure clearly contradicted the general inclination of the Board expressed at EBM/84/80 and EBM/84/81, and paragraphs 2 and 3 should be amended.

Like some previous speakers, Mr. Zhang said, he believed that a two-year period of limitation was too long. If that period were accepted, a member's relations with the Fund would in effect be held in limbo for two years, as the member would not know whether its earlier purchases would be questioned. He preferred a period of one year, or the established procedure of using the periodic reviews under arrangements as the time frame for such purposes. The staff's proposal of 30 days in which to make a required repurchase was too short, and it would be particularly impractical for developing countries. A period of three to six months would be more reasonable.

In ordinary misreporting cases, the required repurchase should be an expectation, Mr. Zhang remarked. Given the relationship between the Fund and its members, an expectation to repurchase was, to all intents and purposes, as good as a legal obligation. Therefore, he saw no need to dramatize the repurchase by calling it a legal obligation. Moreover, if the repurchase process were to be initiated automatically by management, as some Directors favored, it would be all the more appropriate to limit the repurchase requirement to an expectation. Finally, the staff proposal concerning waivers was acceptable.

Mr. Hassan recalled that during the previous discussion of misreporting, his chair and others, while recognizing the genuine concern regarding the problem, had cautioned against overreaction in view of the rarity of such cases. The Board had also stressed the need for a clear distinction between the different types of incidents that the staff had labeled misreporting. Both points remained relevant.

The paper did not provide a clear and specific definition of the situation under which a purchase could be labeled "noncomplying," Mr. Hassan said. That failing was important in view of the questions raised in May 1984 by many Directors regarding so-called nominal compliance and statistical discrepancies arising from technical difficulties and data problems. In addition, as misreporting cases occurred infrequently, there was no need to adopt general rules to deal with them; a case-by-case approach would be more appropriate.

The two-year period for the questioning of past transactions seemed excessive, Mr. Hassan continued, as it could subject members using Fund resources to a long period of uncertainty about the validity of their drawings. Fund-supported programs were normally reviewed every 6 months, and cases of misreporting would be thrashed out during such reviews; moreover, any misreporting would come to light during the 12-month cycle for Article IV consultations. The staff had stated in the paper that a

problem of past nonobservance would "usually be discovered within a few months after the event." He agreed with the staff that, during the inquiry period following the discovery of an apparent problem, the member concerned should be able to make subsequent purchases if it were meeting the relevant performance criteria. The need for a careful examination of data should not lead to unnecessary delays in members' scheduled purchases.

Regarding the proposed procedure for a finding of nonobservance, Mr. Hassan stated that the Executive Board should be involved. As the original purchase had been approved by the Board, the definitive finding of noncompliance--which could lead to the requirement of a reversal of the purchase transaction--should be determined by the Board on the basis of a report by the Managing Director after necessary inquiries had been made. Although he agreed that a definitive finding of the existence of past nonobservance should lead to corrective action, the extent of that action and the manner of its implementation should vary with the nature of the noncompliance under consideration. In the case of inadvertent noncompliance resulting from data problems, it would be appropriate action to explore the possibility of a waiver or a retroactive modification of the performance criteria to permit the purchase. If the evidence indicated clearly that there had been deliberate misreporting or fraud, repurchase should be required. However, a member's right to use Fund resources should be limited only after the member had failed to meet its financial obligations to the Fund and after the accepted procedures had been followed. Thus, while he certainly did not endorse deliberate misreporting, he could not support the staff's proposal to include a standard provision in all arrangements that would mechanically lead to the suspension of a member's right to purchase under existing arrangements as soon as a finding of past noncompliance had been made.

When noncompliance was the result of deliberate misreporting, the repurchase should be an expectation, Mr. Hassan stated. The Managing Director could bring the matter to the Board under the Articles, which reinforced the expectation as in effect a binding legal obligation. However, he found it difficult to classify noncompliance resulting from unintended error or technical difficulties as a breach of a member's obligations under the Articles. The appropriate course of action under such circumstances should be to examine the possibility of granting a waiver or a retroactive modification of the performance criteria. As many Directors had stressed in May 1984, the nature of the noncompliance was an essential consideration, and different cases required different remedies. Therefore, he did not support the staff recommendation to require a repurchase obligation in misreporting cases. If the Fund were more flexible, prescribed performance criteria in terms of ranges rather than fixed positions, and made it known to borrowing members that it was prepared to consider prevailing conditions in assessing performance under programs, the incidence of noncompliance would be even rarer than at present.

Like other Directors, he considered the proposed 30-day repurchase period too short, Mr. Hassan said. In determining the period, the Board should consider the economic and financial position of the member; three to six months would be appropriate.

No rigid rules for granting a waiver should be adopted, Mr. Hassan remarked. Each proposal should be considered on its own merits, and management and the Board should maintain the needed flexibility. Apart from the circumstances prevailing at the time of a disputed purchase, consideration should be given to subsequent policy changes and other developments, as well as the prospective future performance under a program. Moreover, the nature of the noncompliance should be an important factor in considering a waiver.

Mr. Rodríguez stated that he fully agreed with Mr. Kafka. A finding of nonobservance of performance criteria because of reporting problems was a procedure in which the Executive Board should be involved. The staff proposal indicated that the Managing Director's findings alone would trigger a repurchase requirement. Such a provision would place a heavy burden on the Managing Director's findings and would exclude the Board from a matter in which it should be involved. Like Mr. Kafka and others, he believed that the Board should not avoid assuming that burden.

As the staff had pointed out, Mr. Rodríguez continued, it would not be appropriate for the member to be exposed indefinitely to the possibility of a finding of a reporting problem and the subsequent need to repurchase, especially considering that most cases would involve inadvertent, involuntary, or good faith errors by the member. Although a period of limitation was warranted, the two years proposed by the staff was too long. One year would give the Fund enough time to make such findings and would be more acceptable to members concerned.

He also agreed with Mr. Kafka that the proposed 30-day period for repurchase was inappropriate, Mr. Rodríguez said, and that a period of not less than six months should be adopted if a variable period, within limits, could not be agreed upon. There were some similarities between misreporting cases and overcompensation under the compensatory financing facility. Under the decision on the compensatory financing facility a prompt repurchase was expected, but problems had arisen in that respect, and he had advocated that the prompt repurchase requirement should be made more flexible. The same flexibility would be appropriate in misreporting cases.

Repurchase in the case of misreporting, as in the case of overcompensation, should not be an obligation, Mr. Rodríguez considered. An expectation of repurchase would have the same result as an obligation, as experience with the early drawing procedure of the compensatory financing facility had shown. The Fund was based on cooperation and good faith among its members, and making the repurchase requirement an obligation would not reflect those qualities.

Mr. Finaish said that he shared the views expressed by other Directors regarding the importance of the issues under discussion. It was essential for the integrity and effectiveness of Fund-supported programs that measurements of performance upon which drawings were conditional be reflective of the actual performance of the economy. Moreover, noncomplying purchases might have important implications with regard to the principle of uniform treatment of members. Thus, the incidence of misreporting should be minimized, partly through better formulation of performance criteria. In addition, once misreporting had been detected--and verified--appropriate measures to deal with the problem should be taken. Any decision taken at the present meeting with respect to such measures should reflect the relative rarity of misreporting. It would also be advisable that those measures be initiated only after a strong indication of misreporting had been detected.

As the period of limitation was measured from the time when possible misreporting or noncompliance came to the attention of management--and it did not include discussions with the authorities, Board consideration, or the repurchase period--the proposed period would, in effect, be longer than two years, Mr. Finaish considered. A somewhat shorter period would reduce the element of uncertainty that the proposed procedure would entail regarding the reversibility of purchases from the Fund.

With regard to the determination that misreporting had indeed occurred, Mr. Finaish continued, the Managing Director's summing up of the previous Board discussion on the subject stated that all cases of misreporting should be brought to the attention of the Executive Board, which would decide what action to take. That procedure seemed advisable in the light of the sensitivity of the matter and the infrequent occurrence of misreporting. Although he recognized the validity of other Directors' arguments on the desirability of adopting a low-key approach to the question, it would still be appropriate for the report presented to the Board to serve as a basis for a formal Board decision. It might also be useful to include in the report the member's views and response to the Managing Director's notification. In some cases--he hoped all cases--the member might agree to a prompt repurchase; in others, the member might disagree with the finding. It might therefore be useful for the report to be submitted only after the member's position on the issue had been fully clarified. Of course, the member concerned would have the chance to present its case to the Board through its Executive Director.

While he had no strong views on the period in which a member would have to repurchase, one month appeared to be too short, Mr. Finaish commented, particularly since the country would have to raise the necessary liquidity under difficult circumstances. Therefore, he could go along with a period of perhaps three months. In any case, the period should be measured from the date of the Board decision, rather than from the date of the notice referred to in paragraph 2 of the proposed guidelines.

A repurchase resulting from nondeliberate misreporting was in many ways similar to one resulting from overcompensation under the compensatory

financing facility, Mr. Finaish remarked. It therefore seemed appropriate to treat the two cases in the same manner and to make the repurchase of a noncomplying purchase an expectation rather than an obligation. Of course, when overwhelming evidence existed of deliberate misreporting, the matter could be dealt with in a stronger manner, since the nature of the problem would be different and the implications more serious.

Mr. Salinas noted that, under Fund arrangements, a member was able to make a programmed drawing only when it was in compliance with all the performance criteria agreed in the program, or when a waiver had been granted by the Board. Accordingly, should a purchase be made under different conditions, it should be promptly rectified. Although he agreed with the general thrust of the approach suggested by the staff in its guidelines on corrective action, some issues deserved additional consideration. First, like other speakers, he believed that the suggested two-year period of limitation was excessive. Regular Article IV consultations provided the best opportunity for an appropriate review of actual conditions under which a member had made drawings under a program; if, at that stage, it appeared to the staff that all purchases had been appropriate, there would be no need for further reviews of such conditions.

Second, Mr. Salinas continued, if a purchase by a member proved to have been made when the country was not observing the performance criteria, the member should be promptly notified of the finding by the Executive Board; that action would start the procedure to require a repurchase. Third, the nature of the requirement to repurchase should be an expectation rather than an obligation. He agreed with Mr. Kafka that a legal obligation to repurchase would be excessive compared with the application of moral suasion, particularly in those cases where some of the blame for the problem might lie with the Board.

Fourth, once the expectation of repurchase had been notified to the member, it should be allowed to request a waiver by the Board, if the conditions set forth in paragraph 4(b) of the guidelines were met, Mr. Salinas said. If a waiver was not granted, the 30-day period in which to make the expected repurchase seemed appropriate. Finally, if there were good reasons to assume that the original purchase had been made in bad faith, the Managing Director should initiate action under Article V to limit the member's right to further use of Fund resources.

Mr. Salehkhou observed that the staff paper left him somewhat uneasy and perplexed. The comprehensive discussion of misreporting and noncomplying purchases at EBM/84/80 and EBM/84/81 (5/23/84), concluded by a summing up, did not correspond with the proposals in the present paper. To illustrate, the Chairman's summing up of those earlier meetings had stated that "all cases of misreporting, whether motivated by an intention to conceal information and to draw on an illegitimate basis, or whether only the result of inaccurate reporting, should be brought by management to the attention of the Executive Board, which should decide what to do on a case-by-case basis." He failed to find a reference to that accepted

approach in the paper under consideration; indeed, the Board was being asked to approve a decision incorporating an automatic and standard approach to all cases.

Another point that he and other Directors had stressed was the distinction that should be made in treating intentional misreporting and drawings made in good faith that were nevertheless noncomplying because of statistical error or other reasons. The paper had almost ignored that distinction. In fact, paragraph 4(b) of the proposed decision could be interpreted as making a case for exonerating intentional misreporting in stating that "a waiver will normally be granted only if...subsequent to the purchase the member has adopted additional policy measures appropriate to achieve the objectives of the program supported by the arrangement under which the purchase was made."

The distinction between intentional and unintentional misreporting, Mr. Salehkhou continued, had also been noted in the Chairman's summing up, where he had stated that "the staff paper has been criticized for having lumped together two very different issues: misreporting, either intentional or accidental; and, second, the problem of 'nominal compliance' with performance criteria." Before proposing general, extreme remedies, the staff should have given some thought to the real problem of nominal compliance and its relation to the design of programs and performance criteria; as responsibility was shared by the staff and the member countries, it was advisable for the staff to explore the problem further. The mismatching of the staff proposal with the previous Board discussion was also illustrated by the references in paragraphs 1 and 4 of the draft decision to the nonobservance of a performance criterion or "other condition." He asked the staff to comment on the phrase "other condition," which could be interpreted in several ways and was therefore unacceptable.

He regretted that in drafting its proposals, the staff had not, taken into account the Board's views, as reflected in the Chairman's summing up at EBM/84/81, Mr. Salehkhou concluded. On the basis of that consensus, a case-by-case approach was warranted and a distinction should be made between intentional and unintentional reporting. Those procedures should not be taken lightly, as they could have dire effects on the international credibility of member countries. The Board's previous discussion had clearly shown that the cases of misreporting were few. The adoption of the proposed decision per se could cast suspicion on borrowing member countries that, in general, were performing well in an adverse international environment.

Mr. Malhotra asked whether the mere use of the word "reversal," instead of "repurchase"--the usual terminology, could make a difference in the majority required to adopt a decision. He invited the staff to comment.

A large number of Directors had asked whether "other conditions"--in addition to performance criteria--mentioned in the draft decision covered prior actions that might have been stipulated by management in negotiations with a member, Mr. Malhotra continued. It was his understanding that the

misreporting would relate only to the written criteria in the "contract" between the member and the Fund and not to any qualitative judgments as to whether prior action had been taken by a member. Presumably, management would have satisfied itself that agreed prior action had been taken before an arrangement was either brought to the Board or made effective. Going beyond written performance criteria would lend uncertainty to an arrangement and would open to doubt the mutual obligations of the Fund and the member. Finally, he asked the staff whether only "performance criteria" should be mentioned in the guidelines, as the expression "other conditions" was open to several interpretations.

Mr. Wicks inquired whether Mr. Malhotra's use of the word "contract" indicated a proposal that the Fund's relationship with a member should be placed on a contractual basis. To do so might alleviate some of the difficulties faced by the Board; if action specified under a contract were not taken, the remedy would be much clearer than that indicated by the present discussion.

The Chairman noted that a letter of intent was not a contract.

Mr. Malhotra explained that he had meant to refer only to the mutual understanding--implied under an arrangement--between the Fund and the member on the conditions that would be fulfilled by the member and on the obligation of the Fund to provide resources if those conditions were met.

Mr. Polak remarked that his comments on the term "reversal" had not been motivated by a desire to change the provisions of the Articles. The terminology to describe a normal and proper reversal or repurchase transaction should remain, while a different expression should be found to describe the rectification of a transaction that should never have occurred.

The Director of the Legal Department said that the approach of the staff paper and the proposals put forward were those recommended by the Board as included in the Chairman's summing up of the earlier discussion, namely, that the cases should not be considered in terms of blame, whether or not the misreporting was to be attributed in some pejorative way to the member. Thus, the purpose of the guidelines in the staff paper was not to determine whether or not the member was at fault, but simply to establish a policy for dealing with cases involving a purchase made when the member had not been entitled to make the purchase because it had not met all the performance criteria. In the paper, the staff had indicated a procedure by which the Fund could, in a low-key fashion, bring about what Mr. Polak had called a rectification of the transaction, along the lines of present practice. The staff believed that if a purchase had been made in circumstances that were subsequently found to have been such that the member should not have been allowed to purchase, irrespective of whether the member was at fault, that transaction should be reversed or rectified, as would be expected under the general principles behind national laws.

At the meetings on May 23, 1984, the Executive Board had considered the sanctions that could be taken against a misreporting or noncomplying member and had asked whether a repurchase obligation could be established, the Director recalled. It was in that context that the present paper and proposed decision should be examined. Although the staff was aware of the irregularity of noncomplying purchases and the need to rectify them, any remedies introduced must have a basis in the Articles of Agreement. Under the Articles, a member could make purchases if it met certain conditions, including compliance with the performance criteria in a stand-by arrangement and meeting the requirement of need. In various cases, a member had not met the requirement of need; it had purchased and subsequently discovered that, contrary to its representation to the Fund, its reserves had increased or its balance of payments position had improved. In such cases of misrepresentation through either negligence or no fault of the member, the Fund had not taken the view that there was an obligation to repurchase, although it had expected that there should be a reversal.

The Articles provided that, when a member's use of the Fund's resources was contrary to the purposes and provisions of the Fund, it could take the action specified in Article V, Section 5 and the policies established by the Fund for that purpose, the Director stated. Those sanctions could be imposed even if the inappropriate use of the Fund's resources had not been a deliberate act on the part of the member. It sufficed that the member had made a purchase that it should not have made and that, when called upon to rectify the situation, the member had not done so. In those circumstances, the Articles prescribed what the Fund could do. The Fund could also create a repurchase obligation--which was not a sanction--to ensure the temporary character of the use of the Fund's resources, by requiring in certain specified circumstances an earlier repurchase than would otherwise have to be made. The Board had accepted that view when, in connection with the compensatory financing and buffer stock financing facilities, it had decided that, in addition to the regular repurchase period of three to five years, the Fund could prescribe that in particular circumstances a member was required to repurchase earlier.

The Board could create such a repurchase obligation, the Director continued, in accordance with the provisions of the Articles on repurchases, which required an 85 percent majority for the establishment of repurchase periods different from the standard period of five years. That high majority had been introduced not only to prevent what might be an undue extension of the repurchase period, but also to prevent the shortening of the repurchase period that would make it more difficult for members to meet their obligations. An additional provision that no shortening of a period of repurchase would apply except in respect of future purchases had also been included in the Articles in order to safeguard the interest of members that felt that they should not be called upon to repurchase too early. In sum, a member that, for whatever reason, had made a purchase in circumstances in which a performance criterion had not been observed could not be regarded as having a repurchase obligation unless the Board, by the appropriate majority, decided to create such a repurchase obligation. On the other hand, an expectation to repurchase could be introduced by a

simple majority of the votes cast. It would be a declaratory decision, because the member, on the basis of general principles, would be expected to rectify the situation if it were found that its use of the Fund's resources had been contrary to the purposes of the Fund and the provisions of the Articles.

The term "other condition" referred to requirements incorporated in a stand-by arrangement that were not performance criteria, the Director explained. For example, the Board might have decided that the stand-by arrangement would become operative and that purchases could be made only if the member had eliminated arrears by a certain date. The member might make a purchase on the representation that those arrears had been eliminated, when in fact they had not. The "other condition" had to be a clear condition that was not formulated in terms of a performance criterion and that should have been met before the arrangement became operative. If the members of the Board had difficulty with the expression, some more descriptive language might be used.

A stand-by arrangement was not a contract, the Director stated. In legal terms, it was a Board decision that gave the member an assurance that, subject to certain conditions and in certain circumstances, the member could draw certain amounts from the Fund. Thus, a stand-by arrangement did not establish a contractual relationship, although there were understandings incorporated in the agreement; if the member did not carry out those understandings, it could not draw.

It had been argued by some Executive Directors that an expectation to repurchase was too weak and did not lead to ineligibility, the Director said. However, an expectation could lead to ineligibility in the same way as a repurchase obligation, because Article V, Section 5, did not make such a distinction. An inappropriate use of the Fund's resources could occur even if there was no obligation to repurchase; in fact, it was precisely when there was no repurchase obligation that the Fund had to be able to force action on the part of the member.

Many Executive Directors believed that a 30-day period for repurchase was inadequate, the Director noted, because under the staff proposal the member or an Executive Director could bring the matter to the Board, and Board consideration would have to occur during the 30 days. Nevertheless, the staff believed that the proposed period was adequate for the several reasons already cited by some Directors. The definitive finding of the Managing Director that the member had misreported would be the result of consultations with the member, which could be extensive if the member disagreed. The finding would be made only when the Managing Director was convinced that there had been misreporting that had not been of a nature that called for a waiver. The member therefore would have been forewarned, and it would have had ample time to bring the matter to the Board. However, if a 30-day period were considered too short, the Board could decide on a longer period.

Although the Board had asked the staff to examine the present case in the light of Fund practice with respect to the compensatory financing facility, the Director of the Legal Department said; the repurchase period and formulation under the facility had not been used, for reasons already given by some Directors. Many cases of overcompensation occurred under the compensatory financing facility, because countries did not have complete and accurate data. If the normal period of 30 days were considered not appropriate for a repurchase under the facility, the matter could be brought to the Board for its decision. In that event, the relevant decision clearly stated that the period would not be protracted, and that a repurchase would be called for as soon as possible, according to the staff's proposals to the Board.

The Executive Directors agreed to resume their discussion in the afternoon.

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/151 (10/15/84) and EBM/84/152 (10/17/84).

### 3. APPROVAL OF MINUTES

a. The minutes of Executive Board Meeting 84/70 are approved. (EBD/84/263)

Adopted October 15, 1984

b. The minutes of Executive Board Meeting 84/71 are approved. (EBD/84/265)

Adopted October 15, 1984

### 4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/214 (10/12/84) and by an Assistant to an Executive Director as set forth in EBAP/84/213 (10/12/84) and EBAP/84/217 (10/15/84) is approved.

APPROVED: July 19, 1985

LEO VAN HOUTVEN
Secretary