INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/14

3:00 p.m., January 23, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	P. E. Archibong, Temporary
	Jiang H.
	D. C. Templeman, Temporary
J. de Groote	
	E. Feldman
M. Finaish	
G. Grosche	
	D. V. Nhien, Temporary
	J. Hospedales, Temporary
T. P. Lankester	M. Foot
	R. Fox, Temporary
	I. Puro, Temporary
	D. McCormack
	J.-C. Obame, Temporary
	L. P. Ebrill, Temporary
	C. Noriega, Temporary
	S. de Forges
	G. Pineau, Temporary
	J. de Beaufort Wijnholds
	C.-Y. Lim
	O. Kabbaj
A. K. Sengupta	
K. Yamazaki	
	N. Kyriazidis

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

IBRD: H. Messenger, Eastern and Southern Africa Regional Office. African Department: A. D. Ouattara, Director; P. A. Acquah, C. V. Callender, T. Muzondo. Exchange and Trade Relations Department: L. Hansen, S. Kanesa-Thasan. Fiscal Affairs Department: M. Shadman. Legal Department: R. H. Munzberg. Research Department: T. K. Morrison, E. L. Rojas-Suarez. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, W. L. Coats, Jr., J. A. Gons, D. Gupta, J. A. McLaughlin, P. S. Ross. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Bertuch-Samuels, M. B. Chatah, S. M. Hassan, G. D. Hodgson, K. Murakami. Assistants to Executive Directors: A. R. Al-Abdullatif, F. E. R. Alfiler, O. S.-M. Bethel, H. S. Binay, F. Di Mauro, V. Govindarajan, G. K. Hodges, K.-H. Kleine, V. K. Malhotra, T. Morita, J. A. K. Munthali, V. Rousset, D. Saha, C. A. Salinas, H. van der Burg.

1. EXECUTIVE DIRECTOR

The Chairman welcomed to the Executive Board Mr. Ernesto Feldman, Alternate Executive Director.

2. ZAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION ON COMPLAINT UNDER RULE K-1

The Executive Directors considered a staff paper on the second review of Decision No. 8370-(86/137), adopted on August 25, 1986 on a complaint relating to Zambia's overdue financial obligations in the General Department (EBS/87/10, 1/21/87). They also had before them as background information a medium-term policy framework paper for Zambia (EBS/87/11, 1/22/87), together with a statement on Zambia by the Acting Managing Director. 1/

Mr. Abdallah said that although Zambia had tried to make some payments since November 1986, the overdue obligations had continued to rise rapidly, and stood currently at slightly more than SDR 140 million, about 20 percent of Zambia's exports of goods and services. His authorities appreciated the efforts being made by Fund staff and management to find a more durable solution to Zambia's problems with overdue obligations, and they considered that the current efforts to mobilize additional financial support to close the balance of payments gap for 1987 were crucial and urgent. Moreover, his authorities were thankful to donors for the assistance that had been pledged at the Consultative Group meeting, which had been held in Paris on December 16 and 17, 1986. However, those pledges had been insufficient to close the 1987 financing gap, and a greater response was required from the international community if the difficult situation currently prevailing in Zambia was to be solved in an orderly, socially reinforcing manner.

The authorities were determined to implement a strong and comprehensive adjustment program along the lines of the fundamental economic policy reforms introduced in late 1985, Mr. Abdallah went on. However, the civil disturbances that had occurred late in 1986, including some loss of life, had created new political realities that could not be ignored. That situation called for greater support and understanding from institutions such as the Fund; he had been pleased to note that the staff paper had gone some distance in that direction. The most recent evidence that Zambia's commitment to adjustment was undiminished had been provided by President Kaunda at the opening of the budget session of Parliament a few days earlier. In his statement, which had been reported in the press, the President had given clear notice to the Zambian people that they would have to persevere with austerity in the period ahead because the existing subsidies were no longer affordable.

1/ Reproduced in Annex.

He had received a message from the Honorable Basil Kabwe, Minister of Finance, Mr. Abdallah noted. The message read as follows:

> My Government is committed to the economic adjustment program that has been worked out in collaboration with the Fund and the World Bank. Some deviations from the original program have occurred. We are working closely with the officials of the Fund to find corrective measures.
>
> With regard to the government budget, the major expenditure slippage will be in respect of the maize meal subsidy. I am confident that we will find appropriate ways of substantially offsetting or financing the additional subsidy. My aim is to keep the budget deficit at a level which is consistent with the objective of achieving price and exchange rate stability. The level of the deficit must, of course, be judged in the context of the expected volume of the imports. I say this because import tax revenue depends a great deal on the volume of imports.
>
> My Government is anxious to settle the overdue financial obligations to the Fund. But given the size of the obligations, we must necessarily arrange a bridging loan from one or more of the major commercial banks. Our discussions with some of these banks indicate that such a bridging loan would be forthcoming once a revised policy cum external financial base has been agreed with the Fund.
>
> I believe that the external assistance that was offered at the last Consultative Group meeting in Paris will, with minor adjustments to reserves and import volume, be sufficient to close the external payments gap for 1987. The only remaining area is the policy base for the 1987 budget. The budget is due for presentation on January 30. Before that I will, through my ongoing contacts with officials of the Fund, ensure that there is basic agreement between us and Fund officials on the budget. Once the budgetary issues have been resolved, as I believe they will be, the way should be clear for the commercial banks to provide a bridging loan for the payment of the arrears and for the Fund to reactivate the stand-by arrangement.
>
> In conclusion, I wish to reassure the Board of the Government's desire to cooperate with the Fund in this important matter.

The staff report and the statement of the Acting Managing Director clearly indicated that the authorities were doing everything that they could, but the external circumstances were quite serious, Mr. Abdallah stated. He therefore wished to plead for some understanding with respect to the proposed decision. For example, it would be desirable for the period for the next review to be at least three months hence, to avoid giving the impression that the Executive Board was insensitive to a most

difficult situation facing the authorities just as they were preparing to present their budget. Moreover, references to a possible declaration of ineligibility might not be helpful. Accordingly, he wished to propose concluding paragraph 4 of the decision with the clause, "the Fund will consider the appropriateness of further steps," and deleting the remainder of the paragraph. If the Board insisted on referring to a possible declaration of ineligibility, it would be better to state that message in a letter from Fund management rather than in the decision. He was making those suggestions because in the light of the civil disturbances in Zambia, there was a heightened public awareness about the Fund. It was desirable for the Minister of Finance and his colleagues to be taking the difficult decisions themselves, without external pressure, and thus it would be helpful if references to a possible declaration of ineligibility were not a part of the decision.

Mr. Lankester said that Zambia's continued commitment to adjustment, despite most difficult circumstances, as evidenced by recent statements by President Kaunda and the message from the Minister of Finance, was indeed welcome. Nonetheless, Zambia's continuing and increasing arrears to the Fund were a serious problem both for the country and for the Fund, and time was running out to find a satisfactory, credible solution.

It was regrettable that since the previous review of the matter (EBM/86/187, 11/24/86), Zambia's arrears had increased significantly and that only a small payment had been made, Mr. Lankester observed. In the absence of a solution, those arrears would exceed SDR 350 million by the end of the year, more than double the current level, which was indeed an alarming prospect. The clearance of the arrears depended to a considerable extent on the successful arrangement of bridging finance from commercial banks, and the level of arrears was rapidly approaching the maximum for which such a bridging loan might be possible. Of course, agreements with the Fund on fiscal measures would be a prerequisite.

Therefore, there was an urgent need for the authorities to finalize and implement the remaining measures to form the basis of a Fund-supported program, Mr. Lankester added. In many respects, policy implementation had improved since the previous review. The foreign exchange auction and treasury bill markets were both working better, and a variety of fiscal measures had been implemented. Nonetheless, there was still considerable room for improvement. It was most regrettable that without the benefit of offsetting savings as yet, the maize subsidy--which accounted for a significant part of the fiscal deficit--had had to be reinstated fully. While he appreciated that in the circumstances there was probably no alternative to the reintroduction of the subsidy, he did wonder whether that sad turn of events would have occurred if the subsidy had been phased out as originally intended rather than abolished overnight. He welcomed the authorities' statement that the subsidy had to paid for by new budget measures. Those measures were a crucial element--indeed, a precondition--for a successful solution to Zambia's economic problems and its arrears

to the Fund. He was glad to learn from Mr. Abdallah that the authorities were determined to reach agreement with the Fund on those budget measures, and he urged them to reach agreement as quickly as possible.

However, even if the budget measures could be agreed, the problem of a significant financing gap would remain, Mr. Lankester pointed out. It was disappointing that the Consultative Group had been unable to close that gap fully in December 1986, despite considerable efforts by a number of major donors, including the United Kingdom. However, that was as much an indication of the scale of the problem facing Zambia as it was an indication of inadequate donor support. Nevertheless, donor assistance was running substantially below its previous levels and he hoped that donors might be able to make some further contribution to closing the residual gap. At the same time, the Zambian authorities needed to improve significantly their administrative procedures to expedite the flow of aid.

He felt quite strongly that the Zambian program should not be allowed to fail simply for lack of funding, but that meant that all options for closing the gap had to be explored, Mr. Lankester stated. The staff had already pared the financing gap to a bare minimum of SDR 57 million by providing for a further compression of imports and reducing programmed reserve increases below what was probably desirable. Incidentally, he would welcome assurance from the staff that that figure took into account recent increases in oil prices and the continuing weakness in copper prices. Debt relief of about the maximum amount possible had also been assumed. With a gap still remaining, however, Zambia's best hope might be not to continue trying to reactivate the current Fund program, but to start afresh with a new program, which would have the advantage of allowing the program to begin with a slightly higher level of arrears to creditors--other than the international financial institutions--than was envisaged under the existing program. Such a solution, although regrettable, would at least acknowledge the realities of the situation; it would also provide some scope, given Zambia's exceptional circumstances and considerable adjustment efforts, for increasing Fund access above the current rate of 42.5 percent. Staff comment on those possibilities would be helpful. He also thought that the World Bank should be asked once again to review its own plans with a view to providing more IDA funds, if possible, to support the program.

All the aforesaid, of course, had to be conditional upon a quick finalization by Zambia of the details of the program with the forthcoming Fund mission, and the up-front implementation of as many of the measures as possible, Mr. Lankester remarked. As the matter of Zambia's overdue financial obligations was becoming increasingly urgent, there was considerable merit in having the Board return soon to the matter. At the same time, sufficient time had to be allowed to work out details of the fiscal measures and of the bridging finance. Although he appreciated the reasoning behind Mr. Abdallah's suggestion to postpone the next review, he preferred to retain the proposed decision, which stated that the matter would be reviewed again not later than March 23, 1987. He was concerned

that if the Board waited three months as Mr. Abdallah had suggested, the arrears would have reached such a level that it would not be possible to arrange bridging finance.

Mr. Grosche, concurring with the views expressed by Mr. Lankester, added that because of the seriousness of Zambia's fast-growing overdue obligations, the next review should be held at an early date. He could go along with the staff's suggestion to hold that review not later than two months hence, and he supported the proposed decision. He believed that the wording in the last part of paragraph 4 of the decision was quite common, and that such wording had been used in situations comparable to that of Zambia.

Mr. Wijnholds said that he could associate himself with Mr. Lankester's views. He welcomed the efforts of the authorities to get their adjustment program back on track, and did not doubt their good intentions. Nevertheless, the statement by the Acting Managing Director on Zambia had indicated that in some areas, implementation had not always been as it should have been. For example, more vigorous action was desirable in such vital areas as the civil service reform, parastatal rationalization, monetary management, and budget discipline. At the same time, however, he welcomed the improved operation of the auction system.

His authorities had been providing donor support to Zambia and would consider further balance of payments support, but of course continuous requests for additional support did meet with increasing resistance from donor authorities, who sometimes viewed the matter as one of making payments to resolve difficulties for the Fund, Mr. Wijnholds pointed out. That perception made it more difficult to secure additional support, as did any problems experienced by the Zambian authorities in living up to donor expectations in terms of adjustment. Thus he agreed with Mr. Lankester that time was indeed running out, and he looked forward to a clear statement from the authorities on the budget and adjustment measures. He could go along with the proposed decision as outlined in the staff paper.

Mr. Templeman stated his regret concerning Zambia's continued accumulation of arrears to the Fund, and the lack of substantial payments since the first review of the decision adopted by the Fund on August 25, 1986 to limit Zambia's use of the Fund's general resources (EBM/86/187, 11/24/86). He urged the authorities to make every effort to become current with the Fund as soon as possible and to adopt economic measures sufficient to restore the adequacy of the adjustment effort in Zambia.

He supported the forthcoming Fund mission, which was returning to Zambia in order to consult as soon as possible on the status of the economic policies there, Mr. Templeman added. The United States would cooperate, within its own financial constraints, to provide financial support for adjustment and development in Zambia, and he hoped that the

residual financing gap could be closed. He agreed with Mr. Lankester that there was a real danger that the financing gap would grow to such proportions that it would become insolvable.

Given Mr. Abdallah's latest reassurances, Zambia's continued close cooperation with the Fund, the ongoing economic adjustment measures in Zambia, the continuing efforts to obtain the needed financing, and the treatment that had been accorded countries in similar circumstances, Mr. Templeman indicated that he could support setting the next review for no later than March 23, 1987. It was his impression that language referring to the possibility of a declaration of ineligibility had been used in decisions in similar circumstances, and he was thus inclined to retain that language in the current decision. He thought that there was some danger of progressive watering down of the Fund's procedures if the Board diverged from the precedents that had been set in the past.

Mr. McCormack said that the Zambian authorities had attempted on a number of occasions to implement the difficult adjustment policies required to improve the country's economy. The problems facing the authorities were immense. Zambia had quite limited room for maneuver in view of the continuing weakness in international markets for copper. The Government had to maintain a delicate balance between different elements of the adjustment process in order to avoid rekindling social unrest. Nevertheless, decisive action was clearly needed to achieve a viable fiscal and balance of payments position.

It was regrettable that Zambia had been unable to settle its obligations to the Fund, and had made only a small payment since the past review (EBM/86/187, 11/24/86), Mr. McCormack continued. Giving priority to a regularization of relations with the Fund would help to pave the way for negotiations with other creditors and donors. He was therefore encouraged to note the continued close consultation between Fund staff and the authorities, and it was clear, in the context of the draft decision, that those efforts would have to be intensified over the next two months in order to reach agreement as early as possible on a viable adjustment program.

In conclusion, Mr. McCormack stated his support for the draft decision in EBS/87/10 (1/21/87). He agreed with Mr. Templeman that the reference to ineligibility was so common that on the basis of equality of treatment for Fund members, the exclusion of that reference would not be warranted.

Mr. Noriega said that his authorities regarded with deep concern the problem of Zambia's overdue financial obligations to the Fund, as those arrears hindered the Fund's role of supporting other members with similar problems. He urged the Fund to inform the international financial authorities of the need for support to ease the bridging of Zambia's financing gap before the next review.

Mr. Hospedales expressed his deep regret that Zambia had again incurred overdue financial obligations to the Fund. An important part of the solution to the problem of overdue obligations was based on the strengthening of adjustment efforts in debtor countries and increasing the cooperation of debtors, creditors, and the Fund. To that end, Zambia had remained in close cooperation with the Fund, had designed a strong adjustment program with Fund assistance, and the message from the Minister of Finance had underlined Zambia's deep commitment to the program and to the efforts to arrange appropriate external financing.

He believed that both the Fund's and Zambia's interests would be served if the current initiatives were strengthened, Mr. Hospedales remarked. Mr. Abdallah's requests that the review be held in three months and that the decision not refer to the possibility of declaring Zambia ineligible were consistent with the Fund's case-by-case approach. Consequently, he supported the proposed decision with the two amendments suggested by Mr. Abdallah.

Mr. Ebrill stated his support for the decision as outlined in EBS/87/10 (1/21/87).

Mr. Kabbaj said that he welcomed Zambia's adjustment efforts that had been made despite the recent disturbances. The current position of the Government, as outlined by Mr. Abdallah and the message from the Minister of Finance, was indeed encouraging but for those commitments to materialize, the Fund program had to be reactivated. Reactivation of that program would in turn unlock the bridging loan that would allow Zambia to become current with the Fund. He hoped that the staff would be able to show the necessary understanding in order to reach an agreement with Zambia. Finally, he supported the proposed decision with the two amendments suggested by Mr. Abdallah.

Mr. Yang and Mr. Fernando indicated their support for the draft decision as amended by Mr. Abdallah.

The staff representative from the African Department recalled that unfortunately, Zambia's projected resource gap for 1987 could not be closed at the Consultative Group meeting in December 1986. Subsequent to that meeting, the staff had taken a hard look at the balance of payments projections and in the process had taken into consideration the possibility of obtaining maximum debt relief for Zambia. The staff had also explored the possibility of stretching out some of the payments to commercial banks that had been factored into the original calculations. As a result of that review of the balance of payments projections, the staff had reduced the resource gap to SDR 57 million, a figure that took into account the maximum possible that could be expected in terms of debt relief, further reduction of imports, and other measures. Nonetheless, the crucial problem was how quickly an arrangement could be put in place before the next Consultative Group meeting. The staff had made contact with several donors, and had discussed bridging financing with commercial banks, but ultimately all the parties concerned had found themselves in a

"Catch-22" position, whereby if donor assistance was not forthcoming to help close the resource gap, the Fund could not give assurances to commercial banks to provide a bridging loan to cover Zambia's arrears to the Fund, and unless the arrears were paid, there could be no arrangement between Zambia and the Fund.

Because Zambia's arrears to the Fund were mounting quickly, and because more time was needed to mobilize the additional resources, the staff had considered--most reluctantly--the possibility of redesigning a program that accepted the present constraint imposed by the available external resources, the staff representative continued. It might be necessary, albeit undesirable, to cut back imports to close the gap, at least initially, in order to avoid the Catch-22 situation. The staff had been in contact with the authorities for preliminary discussions on the possibility of following such a course of action. Thus, the option of cutting imports further was under consideration but with the expectation that additional assistance would be forthcoming early during the year in the event that a Fund program was put in place after the financing gap had been closed.

The financing gap was sensitive to developments in the copper and oil markets, the staff representative noted. The financing gap estimate was based on the assumption that the oil price would remain at $15 a barrel. The staff had built in a small safety net in the sense that the authorities had an oil import facility with a consortium of commercial banks, which allowed the possibility of short-term credit and a measure of flexibility. The staff's assumptions on copper prices had been as conservative as possible relative to the projections that had been made in the world economic outlook exercise, the copper price for 1987 had been assumed to be 60 cents a pound and to remain virtually unchanged thereafter.

Given Zambia's financing gap, it was not clear that a new stand-by arrangement would be appropriate, the staff representative from the African Department remarked. In its calculations, the staff had assumed the maximum debt relief and the slowest possible rate of retirement of Zambia's arrears, and had made conservative estimates of oil and copper prices. Even if a new stand-by arrangement were put in place, the gap was not likely to be reduced further. Moreover, it was not clear whether a new stand-by arrangement would make any difference. The staff and the authorities had had discussions based on a budget for 1987 and financial policies for 1987, and it was hoped that the policy slippages that had occurred could be corrected in the context of the budget exercise, thereby facilitating the efforts to obtain a bridging loan to clear Zambia's arrears with the Fund and to pave the way for putting a program into place as soon as possible.

The staff representative from the Treasurer's Department stated that the language in paragraph 4 of the draft decision was identical to language used in other decisions involving member countries in broadly similar circumstances.

In answer to a question from the Chairman, the staff representative from the African Department said that the proposed review date provided a time frame that allowed the necessary work to be completed with the authorities. Such a time frame did not permit any slippages, of course, but he hoped that the staff and the authorities could quickly make all the necessary arrangements.

Mr. Templeman inquired about the amount of additional repayments that would fall due if the review date were postponed by a month.

The staff representative from the Treasurer's Department responded that in the next two months, additional obligations of about SDR 28 million would fall due, and one month later, that figure would rise to SDR 41 million.

Mr. Abdallah emphasized that Zambia's current situation was most difficult, and encouraged donor countries to do as much as possible to help Zambia to surmount its difficulties and resume its path toward adjustment. Moreover, the World Bank should redesignate Zambia as a least developed country so that it could qualify for additional resources and assistance. At the same time, he was sure that the authorities were willing to demonstrate that Zambia was indeed worthy of additional support, within the constraints imposed by the need to maintain the equilibrium of the social structure of the country. Finally, he looked forward to the forthcoming staff mission.

The Executive Directors then took the following decision:

1. The Fund has reviewed further Decision No. 8370-(86/137), adopted August 25, 1986, in light of the facts described in EBS/87/10 (1/21/87) pertaining to Zambia's overdue financial obligations to the Fund.

2. The Fund regrets the continuing nonobservance by Zambia of its financial obligations to the Fund in the General Resources Account and notes that further substantial obligations will fall due in the near future. The Fund again urges Zambia to make full and prompt settlement of the overdue financial obligations to the Fund.

3. The Fund notes the economic measures implemented recently by Zambia and again calls upon the authorities to adopt the further measures needed to bring about necessary economic adjustment.

4. The Fund shall review further Decision No. 8370-(86/137) not later than March 23, 1987 taking into account any further developments. Unless by the time of that review Zambia is current in its financial obligations to the Fund, the Fund will consider the appropriateness of further steps, including the possibility of declaring Zambia ineligible to use the general resources of the Fund pursuant to Article XXVI, Section 2(b).

Decision No. 8506-(87/14), adopted
January 23, 1987

3. SUPPLEMENTARY FINANCING FACILITY SUBSIDY ACCOUNT - SUBSIDY PAYMENTS FOR JULY 1, 1985 THROUGH JUNE 30, 1986

The Executive Directors considered a staff paper on the subsidy payments proposed for the period July 1, 1985-June 30, 1986 under the Supplementary Financing Facility Subsidy Account (EBS/86/276, 12/17/86).

Mr. Sengupta made the following statement:

We welcome the staff paper because the issue has a material bearing on the situation of low-income developing countries and on the spirit in which the Subsidy Account was established in 1980. The staff analysis is indeed consistent with the spirit in which the Account was established.

It is of course disquieting to observe that the rate of subsidy payable to the eligible members with respect to charges paid during FY 1987, on the basis of present calculations, declined compared with earlier periods. This is mainly because the differences between the charges payable on borrowed resources and the rate of charge on ordinary resources has narrowed substantially, owing to a number of decisions taken by the Fund in recent years--for instance, on the rate of remuneration and the level of the Fund's reserves--which have affected the rate of charge. Therefore, it is valid to ask whether the subsidy recipients who participate in the coverage of deferred income should at the same time experience a loss of subsidy payments.

We do not think that there is any organic link between the burden sharing of deferred income and the subsidy payments from the Subsidy Account, which are two separate items. The adjustments made to deal with deferred income are currently depriving the eligible countries of the subsidy that they would have received if no such adjustments had been made. Since the need for those adjustments was not attributable to any failure on the part of the eligible countries, it is inequitable to deprive them of the subsidy that they would ordinarily have received.

In order to deal with the issue, the staff has proposed three options. The first option, which suggests continuation of the present basis for calculating the subsidies, is not appropriate because it would add even more to the burden on low-income developing countries at a time when the rate of charge is already high, and for reasons that are not of their own making. Therefore it is inequitable and we cannot support it.

The second option is to calculate subsidy payments as at present, but to provide for subsequent supplements upon receipt by the Fund of the deferred income. Under this option, although the recipient countries may not be deprived of payments from the Subsidy Account, their position would remain uncertain because the payments would be dependent on the repayment of overdue obligations. This option would result in delays in the receipt of supplemental amounts, which would adversely affect many countries already facing serious liquidity constraints, and which would result in losses in interest. In addition, there appears to be no logical connection between the Subsidy Account and the deferred charges. Finally, as the staff has pointed out, this option would be cumbersome and could lead to a considerable administrative and operational inconvenience to the Fund and its members. Therefore we do not see merit in the second option.

We feel that the third option--namely, to calculate the subsidy based on the basic rate of charge--is most appropriate. This proposal is in conformity with our view of excluding the impact of deferred income from the subsidy calculations. It also merits support because it would provide the fullest possible interest rate subsidy, in accordance with the spirit of the Subsidy Account to the low-income devoloping countries when they are actually in need of it. Countries with a good track record should not be penalized twice by experiencing adjustments to ordinary charges because of deferred income, and by suffering a loss of subsidy payments by virtue of these adjustments to ordinary charges.

Mr. Ebrill stated that this chair would strongly prefer to utilize the rate of charge on ordinary resources as adjusted in respect of deferred income as the basis against which to compare the SFF charges, for two reasons. First, any reduction in subsidies that this may imply will only be temporary. Whatever funds were not disbursed through the Subsidy Account would be transferred back to the Special Disbursement Account and would therefore be available for disbursement under the structural adjustment facility. In that way, the benefit would be spread across the broadest spectrum of the neediest members. Second, the burden associated with deferred charges should be shared by all members. His chair had emphasized that point in the Board's recent discussion of the mitigation of the U.S. burden through the operational budget (EBM/87/7, 1/13/87).

Mr. Lim noted that for the first time, the Subsidy Account would pay a subsidy less than the maximum rate of 3 percent to eligible members, given that the difference between the rates of charge on purchases under the supplementary financing facility and on purchases of ordinary resources had been less than 3 percentage points throughout the period of calculation, and that the rate of charge on ordinary resources had been raised from 6 percent to 6.39 percent to cover deferred income during the first half of FY 1987. The increased rate of charge under the policy of burden sharing in respect of deferred charges had led to a reduction in subsidies of only SDR 1.5 million at present, but future adjustments might be considerable, because it was not likely that a net reduction in overdue obligations would occur in the medium term.

The issue that was raised in the staff paper was whether subsidy recipients who participated directly in the coverage of the deferred income through adjustments to ordinary charges should at the same time also experience a loss of subsidy payments by virtue of those adjustments, Mr. Lim commented. The situation was one of double jeopardy, whereby a nondefaulting eligible member paid more to cover for defaulting members and received less as a result. To rectify the situation in the quickest possible manner, his chair would go along with the third option proposed by the staff, namely, that subsidies should be calculated and paid according to a reference rate equivalent to the rate of charge on ordinary resources before any adjustment in respect of deferred income.

Mr. Grosche said that, like Mr. Sengupta, he favored the third option suggested by the staff. In his view, the concept of sharing the burden of deferred income between debtor and creditor members should not be extended to the point of reducing the subsidies paid to eligible members, as such a reduction would collide with the very idea underlying the Subsidy Account Instrument. The subsidy beneficiaries should be spared that additional burden, which in any case should be only temporary, because he continued to expect that deferred charges would ultimately be paid and that the adjustments to ordinary charges would be refunded to members as a result. He agreed with the staff that because of the considerable administrative and operational inconvenience related to the second option, it should not be pursued.

Mr. Archibong made the following statement:

> Since the calculation and payment of the subsidies for the period July 1, 1985-June 30, 1986 have already been approved on a lapse of time basis, I will limit my intervention to the issue that has arisen with respect to the calculation of the subsidies. Two developments have affected the outcome of that calculation: a general narrowing of the differences between the rate of charge on borrowed resources and ordinary resources, and the increase in the rate of ordinary charges from 6 percent to 6.39 percent to cover deferred income during the first half of 1987. Because the subsidy is based on the difference between the two rates of charge an upward adjustment of the rate of charge to account for deferred

income necessarily reduces the subsidies payable to eligible members. Consequently, the subsidies in Table 2 of EBS/86/276, calculated on the basis of the adjusted rate of charge, are quite constrained.

In this situation, subsidy recipients are confronted with two problems. First, they participate in the coverage of deferred income through payments of adjusted ordinary charges, and second, they experience a loss of subsidy payments by virtue of these adjustments to the ordinary charges. The staff appropriately seeks guidance on this matter, and it should be given unequivocally. Unfortunately, it was not possible to foresee this anomalous situation at the time that the Subsidy Account was established. I strongly urge the Board not to allow adjustments to ordinary charges in respect of deferred income to undermine an important objective of the Subsidy Account, namely, to reduce the cost of purchases under the supplementary financing facility to the low-income developing countries.

In view of this, therefore, and barring the provisions of the Subsidy Account Instrument, I would have preferred the application of 6 percent rather than the adjusted 6.39 percent rate of charge in the calculation of subsidies payable to eligible members. I believe that the third option suggested by the staff deserves our support. Subsidies should be calculated and paid according to a reference rate equivalent to the rate of charge on ordinary resources before any adjustment in respect of deferred income. This could effectively isolate subsidy calculations from the constraining effect of adjustment to ordinary charges to cover deferred income. In this connection, the Subsidy Account Instrument could be amended accordingly.

Mr. Nhien stated that the issue before the Board was whether subsidy recipients, who carried their fair share of the cost of deferred income through payment of the adjustments to ordinary charges, should at the same time also experience a loss of subsidy payments by virtue of those adjustments to ordinary charges. He believed that a loss of subsidy payments was not justified for countries that participated in the coverage of deferred income through higher charges; consequently, his chair preferred the third option described in the staff paper. Under that option, which was preferred by the staff as well, subsidies would be calculated and paid according to the rate of charge on ordinary resources before any adjustments were made on account of deferred income. The arguments in favor of the third option were well documented in the staff paper. He wished to emphasize that his chair endorsed the staff's view that the third option would be more in keeping with the underlying concept of excluding the impact of deferred income from the subsidy calculation, and that it would provide considerable administrative and operational convenience.

Mr. Finaish made the following statement:

We are strongly in favor of making the basic rate of charge the reference rate for the purpose of calculating SFF subsidy payments. In our view, this would be consistent with the spirit and intent of both the Subsidy Account Instrument and the burden-sharing decision.

Of course, the question of which rate of charge to use in calculating subsidy payments did not arise when the Instrument was created simply because at that time, there were no surcharges associated with deferred income. However, the choice of the rate of charge on ordinary resources as the reference rate was not arbitrary. As the staff paper correctly points out, the degree of concessionality in the rate of charge at that time was a major factor in the choice of that rate for subsidy payment calculations. A number of developments over the past few years--for example, the adjustment in the rate of charge associated with deferred income--have reduced the degree of concessionality in Fund charges. Hence, the exclusion of this adjustment in the calculation of subsidy payments would be perfectly consistent with the reasoning behind the original choice of the rate of charge as the reference point. Indeed, the same line of reasoning leads one to wonder whether a more fundamental reconsideration of the reference rate is not justified. Clearly the adjustment associated with deferred income is only one element in the reduced concessionality of Fund charges. Thus a legitimate question can be asked as to whether the rate of charge, even after excluding the deferred income surcharge, is still consistent with the principles underlying the Subsidy Account Instrument. I would appreciate staff comment on this point.

The exclusion of the deferred income surcharge would also be consistent with the spirit of the burden-sharing agreement. The principle of equal burdens on debtors and creditors, through charges and remuneration, is clearly a fundamental element of that agreement. If the adjustment associated with deferred income is not excluded from the reference rate, the result would be tantamount to a double burden on members eligible for subsidy payments who are already sharing in the burden, like other debtors, through higher charges. Hence the exclusion of the surcharge from the calculations would avoid the additional burden that would result from reduced subsidy payments. I believe that this point should be emphasized to make it clear that the purpose of the exclusion is not to mitigate the burden of one group of the membership. Indeed, our views and the views of others on arbitrary mitigation for members are known. The purpose of this exercise is to avoid imposing a double penalty on a part of the membership. As to the choice between the second and third options outlined in the staff paper, we are strongly in favor of option three for the same reasons given by the staff.

Mr. McCormack made the following statement:

It seems to run counter to the original purpose and spirit that motivated the establishment of the Subsidy Account for application of the existing rules of calculation to result in a loss of subsidies. This point is reinforced by the consideration that recipients are themselves subject to adjustments to ordinary charges in respect of deferred income. As Mr. Lim put it, a form of double jeopardy seems to be involved. We would therefore support some modification of the existing rules.

As to the choice between the second and third options, considerations of simplicity commend the third option, as the staff recommends. Wherever possible, one should avoid decisions that are known in advance to be administratively complicated and cumbersome to implement.

Finally, either the second or third option requires amendment of the Subsidy Account Instrument. This prompts me to ask a technical question. A member does not receive subsidy payments until it is current with respect to charges on purchases made with supplementary financing. However, I understand that as a legal matter it is not possible to refuse subsidy payments to a member which, while current with respect to charges on supplementary financing, is otherwise not current with the Fund. The Fund and the Subsidy Account are legally separate entities. My question is whether it would be possible at this stage, while we are modifying the Instrument to incorporate the third option, to make receipt of subsidy payments conditional on a member being current with the General Department.

Mr. de Groote, Mr. Yamazaki, and Mr. Obame indicated that they shared Mr. Sengupta's views and were in favor of the third option presented in the staff paper.

Mr. Noriega expressed broad agreement with the arguments advanced by the staff in support of the third option. He suggested that a more general discussion of the issue be held in the future because the maximum calculated rate had been set at 3 percent at a time when interest rates had been higher. The differential had narrowed partly because of decisions taken for other reasons, such as to increase the rate of remuneration. Thus, as conditions had changed and particularly as the differential between reference rates had narrowed, it might be necessary to review the arguments for the establishment of that maximum rate of 3 percent and, if judged convenient, to modify it.

Mr. Kabbaj remarked that the staff and Mr. Sengupta had made a good case for the third option, and he thus joined all the previous speakers who had supported that option.

As to the effective floor on the rate of charge, Mr. Kabbaj joined Mr. Finaish in wondering whether, given the recent loss of concessionality of that rate of charge, the Fund should not consider abandoning any reference to the rate of charge for the calculation of the subsidy. As Mr. Noriega had said, it might be preferable for the Board to be presented with the options, including the possibility of providing a subsidy of 3 percent and 1.5 percent, irrespective of the current rate of charge.

Mr. Kyriazidis said that he could go along with the third option, which was the simplest and had many advantages. He had had some questions after seeing Table 2 in EBS/86/276 in which the subsidy payments to members had been detailed. The fact that member countries in quite serious arrears to the Fund could still receive subsidy payments--whether they were disbursed or not--was disquieting. Thus, he thought that Mr. McCormack's point merited serious consideration.

Mr. Fox and Mr. Templeman stated their preference for the third option, and expressed an interest in the answer to Mr. McCormack's question about requiring members to be current with the Fund--not just with SFF charges--before receiving SFF subsidy payments.

Mr. Hospedales, Mr. Jiang, Mr. Feldman, Mr. Puro, and Mr. Pineau expressed their preference for the third option as presented in the staff paper.

The Deputy Treasurer noted that under the present regulations governing the Supplementary Financing Facility Subsidy Account, the Fund had the power to withhold subsidies from any member that was not current in its charges on purchases made with supplementary financing. There was no authority to withhold the subsidy from a member if it was not current in other obligations falling due to the Fund. The current practice followed by the staff was to ask any such member to use the subsidy payment to discharge its other obligations to the Fund. Each member that had been approached in the past on that matter had acceded to the staff's request. Thus, although in fact the issue had never arisen, as a matter of policy the staff would be most supportive of a change in the Subsidy Account Instrument to give the Fund the authority not to discharge subsidies to members that had overdue obligations to the Fund. The legal aspects of the question, of course, would have to be considered by the Legal Department.

Recalling that some Directors had raised the issue of whether the Fund should not pay a subsidy of 3 percent or 1.5 percent to eligible members irrespective of the differential between the rate of charge on supplementary financing and the basic rate of charge, the Deputy Treasurer said that such a policy would give rise to a number of difficulties. In that connection, mention had been made of the considerable reduction in concessionality in the use of ordinary resources. By far the most important element in the reduction of concessionality over the past few years had been the substantial fall in the rate of interest on borrowing

to finance the supplementary financing facility itself. The interest rate on that borrowing was a U.S. dollar interest rate, not an SDR rate, calculated on the basis of a constant five-year maturity in the New York market for U.S. government securities. That rate had fallen from a high of 11 percent about three years earlier to 7.05 percent as of end-December 1986. Such a large change in the medium-term rate of interest had itself altered substantially the relationship with the rate of charge on the use of ordinary resources.

It was also true that the rate of charge on the use of the Fund's ordinary resources had fluctuated, the Deputy Treasurer observed. It was currently 6 percent, but had been as high as 7.5 percent and as low as 5.5 percent, and that rate had also been influenced by changes in short-term market rates, as well as by other factors. In view of the changing relationship between the cost of borrowed resources and the rate of charge, it would be difficult to justify a fixed rate of subsidy because it could result in the use of supplementary financing or being at a lower cost than the use of ordinary resources. When the Instrument had been established, the Board had intended specifically that the subsidized cost of supplementary financing should not fall below the rate of charge on ordinary resources, namely, that there should not be a lower rate of charge for borrowed resources than for the use of ordinary resources, partly to discourage the use of borrowed resources. In addition, there was a much longer maturity of supplementary financing--five to seven years--than for ordinary resources--three to five years. Those two points were still relevant to the present discussion. Setting a fixed rate of subsidy, irrespective of the relationship between the rate on borrowed resources and the rate on ordinary resources, would reverse the intent that had led to the establishment of the Supplementary Financing Facility Subsidy Account.

The staff representative from the Legal Department, commenting on the use of SFF subsidy payments to offset a member's overdue obligations in another department, indicated that two questions needed to be distinguished in that context. First, could the Fund use amounts to be paid under the SFF Subsidy Account to offset a member's overdue payments under other instruments or accounts, such as the General Resources Account? Second, could the Fund withhold payment of SFF subsidies in order to induce a member to make payments under other instruments or accounts?

It was useful to note some indications contained in the Subsidy Account Instrument, established in December 1980 by Decision No. 6683-(80/185) G/TR, in order to respond to those questions, the staff representative continued. The Subsidy Account Instrument stated in Section 11 that the Fund was to act as a trustee. Moreover, in Section 12, it was noted that the resources of the Account were to be held separately from the resources of all other accounts of the Fund. Thus there was a separation of assets between the General Resources Account and the Subsidy Account, and it would be contrary to that separation of assets to use the Subsidy Account resources for repayment through the setoff of obligations under the General Resources Account.

Finally another issue was related to Section 1 of the Subsidy Account Instrument, in which it was indicated that the purpose of the Account was to reduce the cost to eligible developing members of using the Fund's resources, the staff representative from the Legal Department explained. That statement of purpose in Section 1 could not be amended by the Executive Board, but would need a decision by members to change the Instrument itself. The Legal Department would look further into the issues arising from the current discussion, but it was useful to recall that a linkage between subsidy payments and other overdue obligations in other accounts through setoff or withholding could not be established by an amendment of the Subsidy Account Instrument by the Fund.

The Deputy Treasurer indicated that a decision would be prepared for approval on a lapse of time basis by the Executive Board, whereby Section 10 of the Subsidy Account Instrument--Amount of Subsidy--would be amended to reflect the Directors' agreement that the calculation of the SFF subsidies would not be influenced by the Fund's deferred income situation, and to provide additional subsidy payments for eligible members. It was expected that that decision could be prepared without delay so that the payments could be made to members as quickly as possible. The broader issues that had been raised during the discussion would require more extensive staff preparation and would be handled separately.

Mr. Sengupta suggested that when the staff considered the broader issues that had been discussed, and perhaps prepared a paper on the subject, it would be appropriate for the staff to include a discussion of the point made by Mr. Finaish and Mr. Kabbaj, namely, to maintain the maximum rate of subsidy at 3 percent and 1.5 percent for eligible members, irrespective of the rate of charge on ordinary resources. That issue merited careful examination by the staff in a paper prepared for the Board's consideration.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/13 (1/21/87) and EBM/87/14 (1/23/87).

4. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 86/72 and 86/73 are approved. (EBD/87/7, 1/14/87)

Adopted January 21, 1987

b. The minutes of Executive Board Meetings 86/74 through 86/76 are approved. (EBD/87/16, 1/15/87)

Adopted January 22, 1987

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/87/12 (1/20/87) is approved.

APPROVED: September 4, 1987

LEO VAN HOUTVEN
Secretary

Statement by the Acting Managing Director

There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their January 6, 1987 discussion in Committee of the Whole of a paper entitled "Zambia - Medium-Term Economic and Financial Policy Framework (January 1987-December 1989)."

1. The Executive Directors of the Bank and IDA discussed, in a meeting of the Committee of the Whole, the paper entitled "Zambia - Medium-Term Economic and Financial Policy Framework (January 1987-December 1989)."

2. The Zambia Policy Framework Paper was introduced against the background of the recent Consultative Group meeting. While there was appreciation at that meeting of Zambia's adjustment effort, concern was also expressed at some of the recent policy decisions by the Government, and at the continued suspension of the IMF program. Commitments made, although larger than those of the previous year, fell short of the amounts needed to close the financing gap.

3. Directors expressed broad support for the adjustment program outlined in the paper, although it was recognized that both adverse external circumstances and implementation problems had arisen. Concern was expressed that the pace of reform might prove too great for the country to sustain in terms of management capacity and social impact. The discussion recognized that staff shortages, the extent of adjustment required, and the scarcity of resources all combined to strain Zambia's implementation capacity. The social impact of the program was also a matter of concern, which would require careful monitoring. However, options available to the country were limited and despite the difficult measures that the adjustment program involved, the Government was urged to maintain effective implementation. No quick turnaround could be expected but there were early indications of a good supply response in agriculture, private industry, and nontraditional exports.

4. Several speakers noted with appreciation both the determination of the Government to carry through its reform efforts and, in particular, the improved operations of the auction system for foreign exchange. However, it was also noted that more vigorous action would be desirable in such areas as civil service reform, parastatal rationalization, monetary management, budget discipline, and expenditure restructuring. Steps had been initiated in all these areas and in some, such as the daily auction of treasury bills, progress was significant.

5. Concern was expressed at the disturbances created by the change in the maize price and whether this indicated that the pace of reform was excessive. The discussion suggested that in changing the maize price it was planned to maintain a subsidy on the type of maize meal used by the

lower income groups but the Government failed to put this subsidy mechanism in place in time. Consequently, the millers produced only the higher quality, higher-priced meal. It was stated that it was this implementation failure rather than the policy change, with its associated safeguard for low-income groups, that caused the problem. With a budget deficit at 30 percent of GNP in 1986, the reduction of subsidies was an essential element of restoring a sustainable balance. Nonetheless, several speakers stressed the importance of the Bank being very sensitive to the social impact of proposed reforms and to the limited implementation capacity of many of the sub-Saharan African countries. The Bank should continue to seek effective means of cushioning the impact of adjustment on the poor.

6. There was extended discussion of the link between the debt payments, new aid commitments, and the adequacy of the growth aspects of the adjustment program. It was generally agreed that the present program was underfunded--the pace of adjustment could be faster, the social impact lessened, and growth accelerated if additional concessional resources were made available. In addition, in Zambia, as in some other countries, attention needed to be given to special debt relief measures. In that connection, the designation of Zambia as a least developed country would enable donors to convert some outstanding loans to grants. But additional measures would be necessary, since a 75 percent debt service ratio, after available rescheduling, was neither sustainable nor consistent with an effort to restore growth.

7. The meeting recognized that successful restructuring of a bi-polar, mineral-dependent economy such as Zambia's would inevitably be a long-term process with considerable uncertainty and risk. There were no guarantees of success but there was every reason to continue to work together with the Government to develop, implement and modify, as conditions changed, the adjustment strategy.