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January 29, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Final Minutes of Executive Board Meeting 86/57

The following correction has been made in the final minutes of EBM/86/57 (3/28/86):

Page 23, para. 3, line 4: for "SM/79/74 (6/22/79)"
read "SM/79/74 (3/15/79)"

A corrected page is attached.

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Department Heads

The present discussion did not need to include a detailed examination of the specific technical characteristics of an interest cost facility, Mr. Nebbia considered. The main objective of the present discussion should be to seek the political consensus needed to create such a facility. The specific features of a new facility could be examined at a latter stage.

His authorities strongly believed that there was an urgent need to establish a new facility or to expand the compensatory financing facility in order to alleviate the debt service burden caused by increased interest rates, Mr. Nebbia commented. The facility could become an important safety net to ensure the viability of adjustment programs: access to the facility would enable countries that were implementing adjustment programs and faced a major increase in interest costs to continue their adjustment efforts without experiencing a deterioration in investment, export, and economic growth capacity.

Before the adoption of the decision modifying the compensatory financing facility in August 1979, the Executive Board had held several discussions on possible changes in the facility, Mr. Nebbia recalled. SM/79/74 (3/15/79) summarized the agreement that had been reached during those discussions:

> In earlier Board discussion on possible improvements of the compensatory financing facility, there was general agreement on the principle that major services should, if possible, be included in the calculation of export shortfalls.... Two types of service items had been singled out for consideration in the calculation of export shortfalls, namely, travel and workers' remittances. Attention has been focused on these types for several reasons. In particular, they are known to be quantitatively important for a number of countries, they can be especially subject to short-term fluctuations, and they are in principle measurable with a reasonable degree of adequacy.

Those three requirements were met by interest costs on external debts of capital-importing countries, which constituted a particular type of service. In addition, changes in interest rates were attributable to circumstances beyond the control of a member.

The Executive Board could decide either to create an independent interest cost facility or to integrate such a facility into the compensatory financing facility, Mr. Nebbia commented. If the latter course were chosen, the experience with the decision on cereal imports might be useful. Under that decision there were separate access limits for export shortfalls and import excesses, and a joint limit for total purchases under the compensatory financing facility. Under either of the possibilities that he had mentioned, it would be necessary to establish limits for access that were compatible with the order of magnitude of the likely demand to use the new facility.

A major increase in interest rates could threaten to destabilize the gradual foundation on which current international financial arrangements were based, Mr. Nebbia said. As the stability of the international monetary and financial system was at stake, the Fund should intervene in a flexible and rapid manner. A new facility might serve as a useful device or safety net. He agreed with the staff's conclusion on page 12 that when debtors were faced with rising interest costs, the likelihood was that that condition would be a reflection of inflation in the world, particularly in the creditor countries, and that the fundamental approach should be to attack the problem at its root rather than to develop palliatives. However, it had taken nearly four years of effort to reduce interest rates somewhat, and an interest cost facility would be helpful to debtor countries while further efforts were made to attack the root causes of inflation and the associated high interest rates.

An interest cost facility could play an important role in assisting debtor developing countries, especially those that were implementing strong adjustment policies, Mr. Nebbia concluded. His authorities were confident that, in a spirit of international cooperation, the Executive Directors would agree to move ahead toward the creation of a new facility, and that an examination of its specific features could be started in the near future.

Mr. Nimatallah said that he fully understood the concern of the debtor countries about the interest costs that they faced in servicing their debt. In many countries the debt servicing difficulties associated with those costs had occasionally been exacerbated by a decline in their foreign exchange earnings. He greatly sympathized with the authorities who wished to reduce interest costs.

However, no convincing case had been made for creating an interest cost facility, Mr. Nimatallah went on. The issues involved in the possible creation of such a facility were complex. The staff paper and previous speakers had noted the many difficulties involved in the proposal. He was particularly concerned about the possibility that an interest cost facility could impair the functioning of interest rates as an instrument for allocating financial resources and might encourage banks to lend more and countries to borrow more than would otherwise be the case. In addition, he wondered how large such a facility would have to be if interest rate increases recurred frequently and a large number of countries wished to use the facility. If a large facility was thought to be necessary, he wondered where the resources to finance it would come from. They could conceivably be accumulated by diverting some ordinary Fund resources, or they could come from additional resources, or a combination of the two. He doubted whether there was sufficient resolve in the world community to provide such a potentially large amount of resources required for such a facility.

On previous occasions his authorities had stated that they would be willing to participate in an interest cost facility, Mr. Nimatallah commented. But his authorities had had in mind cases in which overdue