

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 81/3

10:00 a.m., January 7, 1981

FILES

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive DirectorsAlternate Executive Directors

M. Abdollahi
J. Anson
A. Buira
S. Y. Cross
J. de Groote
B. J. Drabble

L. D. D. Price

D. E. Syvrud
H. G. Schneider

T. Hirao
J. C. Iarezza
M. B. Jalal
A. Kafka
B. Kharmawan

K. A. Al-Eyd
A. Nagashima

Y. A. Nimatallah
J. R. Gabriel-Peña
V. Supinit
A. K. Mullei, Temporary
G. Winkelmann
C. P. Caranicas
T. Aulagnon
A. Alfidja
V. K. S. Nair, Temporary
T. de Vries
G. Blöndal
G. B. Lind, Temporary
P. L. Mapa, Jr.

G. Laske
G. Lovato
P. Mentré de Loye
S. Nana-Sinkam

J. J. Polak

R. J. Whitelaw
Zhang Z.

L. Van Houtven, Secretary
M. P. Blackwell, Assistant

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Also Present

African Department: J. B. Zulu, Director; C. V. Callender, S. E. Cronquist, I. A. H. Diogo, T. P. McLoughlin, M. Sidibe. Asian Department: P. R. Narvekar, Deputy Director; P. Chabrier, H. P. G. Handy, Y. Noguchi, T. J. Rommel. European Department: M. Dakolias, J. R. Wein. Exchange and Trade Relations Department: D. K. Palmer, Deputy Director; G. Bélanger, S. Kanesa-Thasan, T. M. Reichmann. Fiscal Affairs Department: G. A. Mackenzie. Legal Department: G. P. Nicoletopoulos, Director; Ph. Lachman, J. K. Oh, J. V. Surr. Middle Eastern Department: H. E. Jakubiak. Research Department: W. C. Hood, Economic Counsellor and Director; G. I. Brown, U. R. Gunjal, N. M. Kaibni, G. M. Khatchadourian. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; R. J. Familton, Deputy Treasurer; D. Berthet, K. Boese, D. H. Brown, R. B. Hicks, G. D. Perrett, T. M. Tran. Office of External Relations: A. F. Mohammed, Director. Personal Assistant to the Managing Director: C. M. Watson. Advisors to Executive Directors: S. E. Conrado, A. B. Diao, J. Fajgenbaum, M. A. Janjua, G. Jauregui. Assistants to Executive Directors: E. M. Ainley, M. J. Callaghan, M. V. Carković, A. Halevi, J. U. Holst, J. M. Jones, M. Kusakabe, S.-W. Kwon, J. E. Leimone, J. S. Mair, M. Michelangeli, J. R. Novaes de Almeida, P. D. Peroz, C. N. Pinfield, J. Reddy, M. Shadman, H. Suzuki, O. Uçer, P. Verly, P. Wichert, T. H. Williams.

1. CHAD - PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff's analysis and recommendation with respect to a request by Chad (EBS/80/278, 12/23/80; and Sup. 1, 1/6/81) for a purchase equivalent to SDR 7.1 million under the Decision on Compensatory Financing of Export Fluctuations.

Mr. Price said that he was prepared to accept that the shortfall justifying the request had been beyond the control of the authorities, but it was difficult to be certain of that in view of the recent disturbances in that country. It would be helpful if the staff could give the Executive Board some guidance on how to determine what was actually meant by "beyond the control" of the member. In addition, he had just become aware of a proposed merger between Chad and Libya; he hoped that that news did not mean that the Fund would have to deal with different authorities from those that had initiated the request for a drawing.

Mr. Mullei expressed his support for Chad's request. Could the staff say why the amount requested by the Chad authorities was less than the shortfall calculated by the staff?

Mr. Caranicas inquired whether the news of a merger between Libya and Chad created any legal problem. The request for a purchase transaction was dated January 5, 1981 and the announcement of the merger had been made on January 6, 1981.

The staff representative from the African Department explained that the economy in the south of the country, where most cotton was grown, had been relatively untouched by the civil war, with the exception of a period at the beginning of 1979 when an intensification of hostilities had contributed directly to the distribution problem that was at the root of the shortfall in 1980. That problem had now been solved by the authorities and the distribution of fertilizers and insecticides for the 1980/81 crop had gone ahead as planned. The crop for the coming year should, in fact, be larger than in the shortfall year. During a recent mission to Chad, the authorities had acknowledged that a request for a purchase that would raise the Fund's holdings of Chad's currency beyond 50 per cent of Chad's quota would require a program, the implementation of which would have been difficult under the prevailing circumstances. It was for that reason that the authorities had taken the staff's advice and had limited the requested purchase to SDR 7.1 million.

The staff representative from the Legal Department explained that the staff was unaware of the exact legal arrangements being made between Chad and Libya. The proposed merger could take several forms: one state could be absorbed by the other; the two states could form a federation; or a new state could be created. Whatever arrangements were made, the Legal Department was reasonably confident that under international law any new Chad authorities would assume the obligations entered into by the authorities that had preceded them.

Mr. Nana-Sinkam confirmed the explanation of the staff representative that cotton production was centered in a region that had been little touched by the recent hostilities; if that had not been the case, production would have fallen even more sharply. The authorities had chosen not to request more than SDR 7.1 million because they wished as far as possible to observe a moratorium on the use of Fund resources, and to repay their outstanding drawings as soon as they could. If they had drawn more under the compensatory financing facility than requested at present, they might have created some obstacles to their planned future use of the Fund's resources. With regard to the proposed merger between Chad and Libya, it was too early to draw any conclusions. The merger would result from political decisions taken outside of the Fund and, in fact, might never take place. Finally, he thanked the Executive Board for its comprehension in approving the drawing requested by Chad.

The Executive Board then approved the following decision:

1. The Fund has received a request from the Government of Chad for a purchase of the equivalent of SDR 7.1 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund notes the representation of Chad and approves the purchase in accordance with the request.

Decision No. 6719-(81/3), adopted
January 7, 1981

2. VIET NAM - 1980 ARTICLE IV CONSULTATION, PURCHASE TRANSACTION -
FIRST CREDIT TRANCHE, AND TRUST FUND LOAN

The Executive Directors considered the staff report for the 1980 Article IV consultation with Viet Nam (SM/80/272, 12/15/80), a request from Viet Nam for a purchase in the first credit tranche equivalent to SDR 28.4 million (EBS/80/269, 12/15/80; and Sup. 1, 12/29/80), and a request from Viet Nam for a Trust Fund loan (TR/80/29, 12/15/80). They also had before them a staff paper on recent economic developments in Viet Nam (SM/80/277, 12/23/80).

The staff representative from the Asian Department said that, since the return of the staff mission from Viet Nam, some new information had become available. Monetary statistics indicated that net outstanding domestic credit at the end of October and November 1980 had been within the credit program projections. No new foreign debt had been incurred in the 1-year to 12-year maturities between October and December 1980. The dong had been depreciated, in terms of the U.S. dollar, to 2.38 on November 5, 1980, to 2.39 on December 8, and further to 2.42 on December 15. The 1981 plan and budget had been presented to the National Assembly on December 20. The staff had not yet received the official

documents, but information indicated that the targets and projections remained as described by the authorities during the period of the staff mission. Finally, because the authorities' cost and price study had not yet been completed and because of several uncertainties, in particular as to the amount of future external assistance that would be available the publication of the final draft of the Five-Year Plan, 1981-85, had been postponed until later in the year.

Mr. Kharmawan made the following statement:

Today the Executive Board has before it the staff reports for the 1980 Article IV consultation with Viet Nam (SM/80/272 and SM/80/277), as well as two requests for the use of Fund resources in the form of a first credit tranche drawing (EBS/80/269) and a loan from the Trust Fund (TR/80/29).

On behalf of my authorities I would like to thank the staff for its comprehensive and fair examination of the Vietnamese economic situation. It must have been a difficult task to collect and appraise data related to a country that only relatively recently came out of a long conflict.

When in 1975 peace at long last was achieved, the Government and people of Viet Nam had to reconvert a war economy into a normally functioning one. For that purpose a bold five-year plan covering the period 1976-80 was adopted. One of the objectives was to achieve an average annual rate of growth of 13-14 per cent. The first year of the plan proved to be a success; in 1976 real gross domestic product (GDP) increased by 11 per cent. Thereafter, however, the performance worsened: in 1977 and 1978 the annual rate of growth of real GDP was 2 per cent; and in 1979 and 1980 it was negative at -0.5 per cent and -4.0 per cent, respectively. Industrial and agricultural production--the main components of GDP--after increasing in 1976 by 12.6 per cent and 10.2 per cent, respectively, slowed down considerably in 1977 and thereafter. On the whole, in the period 1976-80 growth of industrial production averaged 2.7 per cent and that of agricultural production averaged 2.5 per cent against plan targets of 16-18 per cent and 8-10 per cent, respectively.

It is obvious that the decline in economic growth after 1976 must be reflected in the performance of the financial sector and the balance of payments.

The overall fiscal deficit increased from D 2.4 billion in 1978 to D 3.2 billion in 1979 and the estimated figure for 1980 is approximately the same as in 1979. Revenue growth was hampered by the stagnation of economic activity. The deficit was financed mainly by external loans and grants (SM/80/272, Table 1) but also by recourse to the State Bank. Over the period 1977-79 cumulative

borrowing from the State Bank amounted to 45 per cent of the increase in the money supply (defined in Viet Nam as cash in circulation plus savings deposits of the nonstate sector).

In view of the recourse by the Government to the State Bank, the Government tightened the extension of credit to state enterprises (amounting to 70 per cent of total outstanding credit). Nevertheless, money supply increased by 11 per cent in 1979 and by 16 per cent in the 12 months ended September 1980 because state enterprises were in a position to draw down their deposits.

The expansion of the money supply on the one hand and the slowdown of the economy on the other intensified pressures on prices (in the free market), which are estimated to have risen by 30 per cent a year over the past two years.

It is clear that the balance of payments must also have weakened. From an average of \$580 million in 1977-78, the current account deficit increased to \$780 million. In 1980, mainly due to a decrease in imports, the current account deficit is estimated to be approximately \$127 million lower than in 1979. The gap was mainly covered by borrowing from the nonconvertible area. Small overall surpluses in both 1979 and 1980 were noted at the expense of imports.

In its examination of the situation, the staff identified five main factors for the unsatisfactory performance of the Vietnamese economy: (1) frequent natural calamities, (2) the slowness of postwar reconstruction, (3) the difficulty of integrating the economies of the North and the South, (4) border tensions, and (5) an inappropriate allocation of resources and policies, including pricing policies which became constraints and disincentives to higher domestic production and exports and to larger mobilization of domestic resources.

To remedy the unsatisfactory situation of the economy, the authorities realized that changes had to be made, especially in the field of economic management. But at the same time, resources--domestic as well as external--were needed. The mobilization of domestic resources is related to the changes of policy. One of the sources of external financing is the Fund, and Viet Nam is therefore requesting a first credit tranche drawing (SDR 28.4 million) and a loan from the Trust Fund (SDR 34.7 million).

It is clear that its balance of payments and reserve position qualify Viet Nam for assistance from the Fund. In the letter of December 6, 1980 from the Vietnamese authorities to the Managing Director, it was mentioned that by October 1980 gross official freely usable foreign exchange reserves amounted to \$80 million or four weeks of 1980 imports, a figure which is disquieting to any government.

But the use of Fund resources has to be paralleled by a program geared toward improving the country's economic situation, including its balance of payments.

The Vietnamese authorities have to be commended for their courage and pragmatism in bringing about substantial changes in policy with a view to making their centrally planned economy more workable and efficient by adopting restrictive demand policies, as well as removing or reducing disincentives, and by introducing incentives in many forms.

The reform of the system is described in SM/80/272 and in the letter of the authorities of December 6, 1980. Changes cover a broad field of economic management.

In the real sphere a shift in priority of investments has been decided. From 1981 onward more resources will be provided for agriculture, forestry, fisheries, the export sector, quickly maturing projects, fertilizer, transport, and energy.

In the financial sphere decisions have been taken in a great number of sectors with one objective in mind: to strengthen responses from the real sphere, i.e., the production side. The measures are impressive in numbers and in scope.

1. Of course fiscal deficit has to be controlled. The 1981 budget, based on some increase in revenues and containment of expenditures, envisages a slight reduction in the overall deficit, which will be fully financed by foreign loans and grant disbursements.

2. As far as monetary policy is concerned, the authorities have agreed with the staff on a limit on net domestic credit which should not exceed D 5,200 million by September 30, 1981 against D 4,712 million on September 30, 1980, representing an increase of 10.4 per cent. As said earlier, no financing of the budget by the State Bank is contemplated. Priority sectors for credit allocation are agriculture, forestry, fisheries, and small-scale industries.

In order to promote private savings, savers are being given priority in the official distribution of certain products; interest rates have been increased as of January 1, 1981; and the banking system is being expanded.

3. On November 5, 1980, the authorities devalued the dong in terms of the SDR by about 15 per cent.

4. External debts will be prudently managed. Viet Nam intends to limit borrowing on commercial terms in convertible currencies to \$250 million during the program period (1-year to 12-year maturities, including a subceiling of \$50 million for 1-year to 5-year maturities).

5. There is also an undertaking not to introduce or intensify restrictions on payments.

If the measures above are more or less of a macroeconomic nature, the Vietnamese authorities have also introduced more specific changes.

6. A number of prices have been adjusted upward related to both consumer goods (kerosene, wax, watches, and footwear) and key inputs (petroleum, diesel, fertilizer, and acrylic fibers).

To alleviate hardship, public sector wages have been increased by 10-20 per cent but the expectation is that this adjustment will be less than the anticipated increase in budget revenues.

7. To stimulate agricultural production, procurement prices of all agricultural products have been increased substantially. Official delivery quotas and agriculture tax contributions are fixed for five years, which means greater certainty for the people concerned. Also, since early 1980 the restrictions on internal movements of goods by private producers and cooperatives have been abolished. Private producers moreover have been allowed greater freedom to sell their goods.

8. State enterprises have been given greater autonomy in taking decisions with regard to management, procurement, sales, and prices.

With the measures taken by the Vietnamese authorities, a comprehensive program has been presented to the Fund in support of their request for the use of Fund resources. The staff has agreed with the program, which will be subject to review in the second quarter of 1981.

I would like to recommend to the Board the approval of Viet Nam's request for a first credit tranche drawing and a loan from the Trust Fund. The balance of payments need requirement is clearly fulfilled. As far as the supporting program is concerned, the main features of which I have tried to describe, it is based on a courageous recognition of what went wrong. Within the framework of the adopted economic and social system, remedial measures are being introduced that are more than adequate and that should eventually result in a better functioning economy, if the required resources are made available.

Mr. Aulagnon noted that the Vietnamese economy had seriously deteriorated and that financial pressures on the external side as well as constraints on the supply side were likely to stand in the way of future economic growth. The deterioration was evident from a study of the

1978/79 program that had been agreed with the Fund. While real GDP had been expected to grow by 12 per cent that year, there had been hardly any real growth. On the external side, exports had actually declined, contrary to expectations of a significant increase, and financial constraints had meant that imports had not increased beyond 1977 levels; in fact, foodstuff shortages had required the postponement of much-needed investment goods imports. Increased expenditures in connection with the rise in defense spending, and the stagnation of revenues had weakened the budgetary situation even further. Those adverse trends had continued over 1980, and GDP had declined by 4 per cent.

The poor performance of the economy raised a number of issues for the immediate and long-term future, Mr. Aulagnon commented. The authorities had become increasingly aware of those issues and had started to address them by recognizing, in particular, the need for adequate incentives to producers. Incentives had been implemented in the agricultural sector and had produced some encouraging results. It was not certain, however, that the present difficulties could be overcome simply by adopting more flexible and realistic pricing policies; additional measures of a structural character would also be required. There was little evidence in the staff report that the authorities were prepared to tackle the problems of insufficient utilization of the production capacity of state enterprises as well as the private sector, or to improve the efficiency of the planning system, which had suffered greatly from the lack of a proper financial accounting system. In short, while some measures were being taken to arrest the process of deterioration, little was being done to bring about the necessary major adjustment. Adjustment could not be delayed much further in view of the external pressures on the economy, which, without a higher level of foreign assistance, could further depress activity levels in 1981.

There seemed to be little possibility for Viet Nam to gain access to the international capital markets as long as its capacity to generate sufficient foreign earnings from productive investments had not been better demonstrated, Mr. Aulagnon observed. The proportion of exports going to convertible currency areas had fallen, and imports in 1981 were not expected to exceed in nominal terms import levels achieved in 1979. There would, therefore, be little relief from the present supply constraints in the short term. He wondered whether the projections for imports took into account the unavoidably sharp increase in the cost of imported energy. The staff papers indicated that Viet Nam had hitherto imported two thirds of its required petroleum products from socialist countries at about one tenth of current world market prices, but that present contracts were in the process of being renegotiated. Could the staff make any comments on the exact cost of energy imports to the Vietnamese economy?

The seriousness of the situation in Viet Nam clearly justified the request for a purchase under the first credit tranche and for a Trust Fund loan, Mr. Aulagnon concluded. The request should, however, be

considered primarily as the exercise of the rights of a member country to benefit from specific facilities provided by the Fund; it was clear that the situation in Viet Nam called for the implementation of an adequate adjustment program as soon as possible.

Mr. Syvrud expressed serious concern at Viet Nam's current use of matériel and manpower resources outside its borders, which was proving a major drain on the economy and a source of pressure on the balance of payments. The country's performance during the period of an earlier first credit tranche program had been disappointing. In fact, during that period output had been stagnant and exports had fallen, partly as a result of a divergence of resources to activities outside Viet Nam's borders. He had serious doubts about Viet Nam's ability to implement the policies needed for adjustment while it continued to expend major resources in the furtherance of its present policies toward its neighbors.

Mr. Price inquired whether Viet Nam was now providing sufficient data for regular inclusion in International Financial Statistics. Was the staff pressing the Vietnamese authorities to move in that direction? In looking at the data that were available, he had noted a number of inconsistencies and had found it difficult to calculate the country's GDP; some clarification by the staff would be welcome. Another problem with the data was that statistics for the Council for Mutual Economic Assistance (CMEA) had been largely excluded from the balance of payments figures. The staff report said little about CMEA relations, although they were obviously of great importance to the Vietnamese economy.

It had to be recognized that Viet Nam had a centrally controlled economy and that the role of the private sector was limited, Mr. Price commented. Even so, in a country of 55 million people it was impossible to control everything from the center. Some method of transmitting information was needed, particularly the information needed for guidance in taking decisions on production and consumption patterns. Viet Nam's difficulties had been compounded by the fact that the internal price structure had become unrealistic. The staff had been right in welcoming the move toward more realistic prices, but that move might have more limited effects than appeared at first sight. For instance, the benefits from the decision to allow cooperative and state enterprises to trade production in excess of planned targets at freely determined prices would remain illusory as long as the achievement of planned targets was made impossible by shortages in raw materials and energy. In fact, the amount of transactions taking place at freely determined prices was likely to be very small. In agricultural prices the position was a little different in that prices had been moved close to market prices for sales above quota. Prices for sales within the quota had been at such a derisory level that the authorities had been compelled to raise them to provide some minimal incentive for producers.

On page 9 of SM/80/272, Mr. Price remarked, it was stated that only 12 basic commodities remained under official rationing, and that only two--rice and meat--were still subsidized. It was rather misleading to

refer to "only 12 basic commodities," because those 12 commodities were the only ones that urban dwellers could afford to buy. Other commodities, such as chicken or fish, were far too expensive for average factory workers to buy. With such a distorted price structure, it was difficult to see what the relationship to world prices ought to be. The exchange rate with the convertible area had a very limited role. Transactions outside the country were naturally undertaken in convertible currency and not in dong. There was very little scope for the exchange rate to affect supply or demand in Viet Nam given the internal price structure. As far as could be judged, the exchange rate set by the authorities seemed unrealistically high. The exchange rate was, in fact, probably two and a half times more than it would have been if some sort of free market were available. Thus, despite the program proposed for the first credit tranche drawing and the Trust Fund loan, it was difficult to foresee an improvement in the allocation of resources. As long as the price system continued to give wrong signals to those determining the prices, very high free market prices were bound to endure.

A number of measures were being taken to improve supply in Viet Nam, Mr. Price observed. Greater emphasis was rightly being given to investment in agriculture, forestry, fisheries, consumer goods, and energy. Nevertheless, the authorities still accorded heavy industry a dominant role, a fact that had been enshrined in Article XVI of the new Constitution. The staff had probably been overoptimistic in reporting promising results in oil and gas exploration; he understood that three companies engaged in drilling in Viet Nam were winding up their operations because of poor results.

As Mr. Syvrud had commented, the diversion of human and financial resources to nonproductive sectors had continued, Mr. Price said. As a consequence, industrial production had fallen by 10 per cent in 1980 after a 4.5 per cent fall in 1979. There was no evidence that the Vietnamese authorities were moving to reverse that shift of resources. The resulting shortage of skilled labor had affected the production of coal, cement, and electricity, as well as a number of other products. On the supply side, the uncertain status of land tenure and the abandonment of plantations had been major contributing factors to agricultural decline. The sea-fishing catch had dropped from 600,000 tons in 1976 to about 350,000 tons in 1980, largely as a result of the considerable loss of boats in Viet Nam.

He could accept that the program of the Vietnamese authorities met the requirements for a drawing under the first credit tranche and for a Trust Fund loan, even though it was unlikely to strengthen by very much the balance of payments position, Mr. Price concluded. Debt service would continue to take up a large proportion of convertible currency exports. The Fund's financing would enable Viet Nam to import what it otherwise could not afford on account of its own economic mismanagement. Any further Fund financing could be justified only if substantial measures were taken to assure the reallocation of resources to productive sectors.

Mr. Laske commented that the grim economic situation in Viet Nam could only in part be due to exogenous factors. Misdirected policies appeared to be the root cause of the disappointing developments of recent years. The main problems facing the country were its weak infrastructure, particularly as it affected transportation, its low level of agricultural production despite a large potential, and its comparative cost disadvantage with regard to consumer and export goods. The high priority given to the development of heavy industry had to be considered as a prime source of the misallocation of resources. All of those factors had combined to intensify inflationary and balance of payments problems and to cause a decline in real income.

The most urgent requirements in Viet Nam were for a shift in the allocation of resources and an improvement in the utilization of existing production facilities, Mr. Laske considered. Measures should be taken not only to establish more flexible and realistic producer prices, but also to reduce the budgetary deficit and to restructure public expenditures. Less emphasis should be put on heavy industry and considerably more investment should be directed to agriculture and the production of consumer goods. Steps already taken in that direction were welcome and should be pursued with determination.

He had been somewhat surprised to see that the staff papers had commented so little on the economic cost of military operations in other geographic regions, Mr. Laske said. In his view, Viet Nam's economic prospects could only improve if a larger proportion of resources were to be devoted to civilian use in the future. Finally, he was prepared to approve the requested use of the first credit tranche and the Trust Fund loan, but only with some hesitation, and in the expectation that the authorities would increasingly shift resources to uses holding out promise for genuine economic improvement.

Mr. Nair commented that although Viet Nam's economic performance in 1980 had been disappointing, its authorities had nevertheless adopted several measures introducing more market-oriented criteria into economic management, had introduced improvements in the planning mechanism, and had initiated, however modestly, a decentralization of authority. Those measures represented marked departures from past practices and demonstrated willingness on the part of the authorities to undertake remedial measures. The staff had called for many improvements to be made in Viet Nam's economy, but it should perhaps not be forgotten that experience was the best teacher and that patience and good counsel on the staff's part would eventually bring acceptance of improvements desired.

Viet Nam had reordered its investment priorities in 1980, Mr. Nair continued, and emphasis was now being placed on primary sectors of the economy, consumer goods industries, export-oriented sectors, and on increased energy production. That reordering of priorities should contribute to a better balance in the economy and to the attainment in the medium term of an improvement in the balance of payments both through

savings on food imports and the generation of large export surpluses. He was glad to note that Viet Nam had initiated a more flexible pricing policy designed to provide a framework of appropriate incentives for enhanced production, particularly in the agricultural sector. Such a flexible pricing policy would also secure a more efficient allocation of production resources and would generate larger amounts of budgetary resources. Private savings were to be encouraged through the expansion of banking facilities, through increases in interest rates, and through the provision of other incentives to savers. Budgetary policy would be geared to securing a diminution in the overall deficit and to avoiding recourse to credit from the Central Bank.

Despite a recovery of production, Mr. Nair observed, the Vietnamese balance of payments would remain weak throughout 1981. Even though exports were expected to increase by 22 per cent, the available external resources would be inadequate to permit imports of raw materials and investment goods needed for a resumption of activity in key industrial sectors, so that balance of payments weakness would act as a major constraint on growth. Viet Nam's request for Fund assistance seemed quite justified in that context.

The letter from the Director General of the State Bank of Viet Nam, in EBS/80/269, explained how Viet Nam had suffered as a result of a crop failure that had been beyond its control, Mr. Nair commented. Because of the failure the authorities had had to deploy a larger volume of external resources for imports of foodgrain, and the larger food import bill had necessitated a curtailment of imports of raw materials and investment goods. The scarcity of nonfood imports had in turn affected the country's industrial production and had limited the production of exports. A vicious circle of lower imports leading to lower exports leading in turn to yet lower imports as financing capacity decreased had been established. If the Fund had a food facility it would be able to minimize the chances of countries slipping into such a trap. In conclusion, he considered that the measures taken by the authorities were commendable and that the program presented to the Fund was appropriate and could lead to an improvement in Viet Nam's balance of payments. He, therefore, supported the request before the Executive Board.

Mr. de Groote welcomed the recent improvement in cooperation between Viet Nam and the Fund. The problems now facing the country pointed to the need for further cooperation with the Fund and with the World Bank. Although many of the difficulties Viet Nam faced seemed to be the result of decisions taken in favor of a centralized economy, Viet Nam could not be expected to return to a market economy system. In the Fund's future negotiations with Viet Nam, it would have to make sure that its recommendations were consistent with the country's overall economic philosophy.

Viet Nam was beset with four major problems, Mr. de Groote commented: first, the number of refugees; second, obtaining sufficient foreign assistance; third, the difficulty for state economic enterprises to follow

economic criteria in fixing prices in a highly centralized economy; and fourth, establishing a realistic exchange rate. Those problems would have to be borne in mind as any new program was formulated. It should be acknowledged that the size and magnitude of the program adopted by the Vietnamese authorities went beyond the minimum required to justify a drawing under the first credit tranche and a Trust Fund loan. He supported the proposed decisions and hoped that Viet Nam would in the future be able to justify some further use of the Fund's resources.

Mr. Lind considered that Viet Nam's performance in previous Fund-supported programs had been rather mixed. Some needed policy measures had been implemented, but experience had proved them inadequate. In his view, the authorities had shown a willingness to bring about necessary changes, but had felt that because of the deep distortions prevailing in the economy that it would not be possible to proceed as rapidly as originally planned. In that context, it had to be said that the state of conflict, which had for so long plagued Viet Nam, must have been an obstacle to economic progress and stability. The new program addressed the main structural weakness of the economy--for example, cost-price structures were being changed to promote incentives for producers and employees and for exports--while at the same time taking a stricter stance on fiscal and monetary policies.

While he recognized the difficulties involved in implementing such measures in a country with Viet Nam's political structure, Mr. Lind said, he agreed with the authorities that their program seemed to provide the best way available to them of achieving the overriding goals of increased GDP growth and an improved external position. He could, therefore, support the two requests before the Executive Board.

There were a number of points in the staff papers on which he would appreciate the staff's comments, Mr. Lind stated. First, the authorities had promised that if export targets were exceeded, extra incentives were to be provided in the form of bonuses or vouchers to import machinery or other materials. Would not such a policy encourage planners in individual producing units to estimate their exports on the low side in order to obtain more of those benefits? Furthermore, to distribute the right to import more goods in relation to export performance might not always be the best allocation of scarce foreign resources. Second, the staff's comments on Viet Nam's external debt position were to some extent contradictory. In Viet Nam's earlier program there had been a zero ceiling for borrowing on maturities up to five years in order to improve the debt profile. However, that performance criteria had not been adhered to and during the program period almost 60 per cent of new borrowing in convertible currency had been on shorter terms than five years. On page 6 of EBS/80/269, however, the staff had concluded that "Viet Nam has recently managed to improve the profile of its debt." On page 12 of the same paper, the borrowing allowed under the new program, it was claimed, would result in further improvement. If it was considered prudent a year ago to borrow nothing at all on short terms, why did much larger amounts on

short terms now meet with the staff's approval? Furthermore, the ceiling for external borrowing at all maturities in the new program seemed to be rather high, having increased from \$130 million under the earlier program to \$250 million in the new program. Could the staff comment on the appropriateness of that increase in the light of the worrying debt service burden?

His third comment concerned the presentation of the staff papers, Mr. Lind explained. In introducing both requests for Fund resources, the staff had mentioned that Viet Nam was scheduled to repurchase previous drawings from the Fund amounting to SDR 25 million during the program period. He found such a statement out of place, since it could in no way be regarded by itself as an argument for further use of Fund resources. Moreover, details of the scheduled repurchases were clearly evident in the table summarizing the country's use of Fund resources that generally accompanied all requests for purchases (Table 1, EBS/80/269). In conclusion, he could support both requests. He hoped that the Vietnamese authorities would implement the necessary measures, and that they would have to cope with fewer adverse factors beyond their control during the year ahead. The chance of success was quite reasonable, since the economy had substantial potential.

The staff representative from the Asian Department remarked that the staff felt that the program proposed by the Vietnamese authorities was characterized by a number of strengths, but also by a number of major uncertainties. One strength was that the Vietnamese authorities had committed themselves to changing their policies, and had indeed already introduced some strong measures in 1980. The authorities were moving from a policy of strict controls and rigid planning toward one in which market indicators were given a greater weight. Another strength of the program was that the policies adopted covered a number of sectors of the economy, including interest rates, pricing, investment structuring, the budget deficit, and even exchange rate movements.

As to the uncertainties in the Vietnamese program, the staff representative continued, it was not clear whether the Vietnamese would be able to increase their imports sufficiently to revive economic activity and exports. It had to be said that the prospects for increasing imports from the nonsocialist countries were rather grim. Another major uncertainty arose from the shortage of skilled staff at managerial levels. Such skills would be particularly needed when, as a result of a policy of decentralization, greater autonomy was given at the enterprise level. The overall program aims were only modest but, as indicated in the report, should be seen as laying a sound basis for the adoption of a more comprehensive growth-oriented program at a later stage.

In assessing the results of the measures already taken, the staff representative explained, three developments stood out. First, despite the fall of a half million tons in foodgrain due to a typhoon, food production in 1980 had equaled the 1979 level. Second, despite unchanged

production of foodgrain, the Government through its new pricing policies had managed to procure 16 per cent more foodgrain in 1980 than in 1979. Third, even though the number of people that were excluded from official rations increased substantially in 1980, there had been no increase in the rate of inflation on free markets from 1979 to 1980, which indicated that free market production had picked up substantially. During its last mission the staff had been able to see that the markets were full of vegetables and goods being delivered by farmers or cooperatives. There were, therefore, some signs that the authorities' recent measures were having a positive impact.

Since 1978 defense expenditure had been given priority in Viet Nam, the staff representative observed. There were two categories of defense expenditure: first, locally financed expenditures that were included in the national budget; and second, those expenditures that were financed from abroad and which were secret. The locally financed expenditures had increased by 20 per cent in 1979 to represent 17.5 per cent of expenditure in that year, or over 6 per cent of GDP, against less than 5 per cent of GDP in 1978. Those developments as well as the diversion of human resources to defense had had an adverse impact on the balance of payments. Determining their precise impact on growth was rather difficult. In comparing Viet Nam's growth performance in 1978 with that of neighboring countries, the staff had found that Viet Nam's performance had been negative, whereas growth among its neighbors had ranged between 5 per cent and 7 per cent. It was difficult to say, however, how far the poor growth performance in Viet Nam compared to other countries was due to the diversion of resources to defense. Other factors were also involved, such as natural calamities, poor pricing policies, and misallocation of investment. Some indirect factors, such as the shortage of foreign assistance as a result of Viet Nam's political stance, should also be taken into account in assessing economic performance. On the whole, the staff considered that about half of Viet Nam's shortfall in growth performance vis-à-vis its neighbors could be attributed to a diversion of resources to nonproductive activity. In that context it was worth noting that the share of defense expenditures in both 1980 and 1981 compared to total budget expenditure and compared to estimated GDP would be falling. In terms of total expenditure it would fall from 17.5 per cent in 1979 to 16 per cent in 1981 and in terms of GDP from 6.2 per cent in 1979 to 4.9 per cent in 1981.

The Vietnamese were adopting a policy rather similar to that adopted by the U.S.S.R. in 1965, the staff representative explained. They were moving toward a "softened demand economy." In other words, they were establishing a plan that would compensate for the shortcomings of very rigid planning systems through the use of basically market-oriented mechanisms such as pricing, taxation, interest rates, and exchange rates as well as some other economic regulators. In determining what would be a realistic level for the exchange rate, it had to be remembered that in many socialist economies, the domestic price structure was isolated from world market price developments. Because domestic prices and consumer prices were centrally determined, the supply of exports and the demand

for imports were not directly influenced by the exchange rate of the dong or world market price developments. The surpluses or deficits of the foreign trade companies were reflected in the state budget. Because of that system, changes in world market prices did not necessarily have an impact on production, on domestic demand, or on domestic absorption. However, that isolation had some important indirect effects on budget revenue and expenditures and, in particular, on the profitability of exporting corporations as well as on the subsidization of importing corporations. The authorities' recent greater flexibility in moving the exchange rate had been welcomed by the staff.

Soviet groups drilling in the Red River Delta and the Mekong Delta had found some oil deposits, the staff representative stated. There had been some finds recently and the authorities hoped that by 1985 commercial production could start. As to the pricing of energy, two thirds of Viet Nam's imports of oil came from the U.S.S.R. at transfer prices that were not related to world market prices. If those imports had been bought at world market prices the cost to Viet Nam would have been between \$270 million to \$300 million a year. At present, the Vietnamese authorities were negotiating the prices of oil from the U.S.S.R., and it had been reported that a tenfold increase was being requested by the U.S.S.R. Should that be agreed, payments would be financed by enlarged credit through the CMEA. At the same time, the prices of some export products, such as coal, garments, and rubber, sold to the U.S.S.R. would also be renegotiated so that although there would be a net deterioration in the trade account, part of the deterioration would be offset by renegotiated prices on Vietnamese exports to the CMEA.

Foodgrains and meat were made available with cash subsidies, the staff representative observed. Many other products, although not subject to cash subsidies, were subject to economic subsidies in that their cost assessment was unrealistic.

As to the provision of statistics, the staff was satisfied that progress was being made. Although the Vietnamese authorities were prepared to see some of their statistics published, the statistics were not yet comprehensive or current enough to be published monthly in International Financial Statistics. It was interesting to note in that context that the Vietnamese authorities had recently nominated four officials for the IMF Institute course on balance of payments methodology.

One of the main reasons that the ceiling on external debt had been raised was that the staff believed that unless imports picked up substantially there would be little possibility for reviving economic activity in the country, the staff representative explained. When the ceiling had been set in the previous program, Viet Nam had been expecting aid equivalent to about \$2 billion--more than twice the amount of the country's expected imports. At present there was less than \$1 billion in the aid pipeline. The staff considered that it could be helpful for Viet Nam to borrow some \$50 million with one-year to five-year maturities to alleviate

the shortage of foreign exchange and to help increase nonfood imports. Finally, the inconsistencies in the statistics spotted by Mr. Price arose from the difference between the assessment of investment contained in the budget at constant prices and the investment ratio calculated at current prices compared to GDP. There was no published figure for GDP available in Viet Nam and it was extremely difficult to calculate that figure with any degree of confidence.

Mr. Kharmawan commented that Viet Nam was not alone in having deficiencies in its data; practically all developing countries experienced the same problem. Viet Nam had made great progress in that area over the past five years. For example, much more information was now available concerning the country's debt situation. The Vietnamese authorities would be the first to recognize that much needed to be done to bring prosperity to their people and their country. He hoped that Fund assistance would be available to them and that the Fund would accept that Viet Nam had a political system that was different from those seen in most other Fund members. The Fund would have to develop ideas concerning the recommendations it should make to the authorities of centrally planned economies. The Fund could not, as an international institution, try to convert its members to a different political or economic system. For example, it was not quite appropriate to recommend "market-oriented measures" to a government whose political philosophy was opposed to them. The Fund would need to determine how it should respond to members with economic systems of the type seen in Viet Nam.

The program submitted by the Vietnamese authorities, even when compared with those submitted by the authorities of other countries, was more than adequate to justify the request they had made, Mr. Kharmawan observed. It would be a challenge for the staff to work out with the Vietnamese authorities a program to justify drawings under the higher credit tranches. Such drawings should be made possible in the future within the context of the country's centrally planned economy. The Fund could quite well encourage a country like Viet Nam to increase its supply, because the possibility of selling excess supply at a better price would have the same encouraging effect there as in other types of countries.

Mr. Syvrud commented that in studying the papers on Viet Nam, the most positive element that he had perceived had been the introduction of more market-oriented criteria in the country's economic management. Indeed, Mr. Kharmawan in his opening statement had pointed out that decisions had been taken in the financial sphere with the one objective in mind of strengthening the responses from the industrial sector. Almost all of the significant measures taken recently by the Vietnamese authorities had involved using the price mechanism to improve the efficiency of the economy. In his view, it was important for the Fund to continue to persuade its members to use the pricing mechanism to improve the efficiency of an economy.

Mr. Kharmawan responded that the difference between himself and Mr. Syvrud was mainly a matter of semantics; there was no real difference of opinion between them. What he had attempted to stress in his last intervention was that it was important for the Fund not to create the impression that it was trying to convert a socialist economy into a capitalist economy. Improving efficiency should be recommended to all countries.

The Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that while external factors had played a large role, the disappointing economic performance of recent years, in which there had been practically no real economic growth, was in substantial part the result of policies that were geared insufficiently to higher production and generation of domestic savings. Pricing policies had been unduly rigid and the concentration of investment on heavy industry had been at the expense of the agricultural and export sectors. Declining exports, high levels of foodgrain imports, and the mounting burden of external debt servicing had seriously weakened the country's balance of payments, and the resulting constraint on essential imports had further depressed economic activity.

Executive Directors noted that measures had been taken during 1980 to improve the growth performance and strengthen the balance of payments over the medium term. The decision to concentrate development efforts on the primary sector, the consumer goods industry, and the production of exportables was appropriate. The higher incentives to agricultural producers already in place, the relaxation of controls on internal production and trade, and the increases to more realistic levels of consumer prices should lead to higher productivity and help contain the rapidly growing budgetary subsidies. While Directors were glad to recognize that the measures recently taken constituted a clear departure from policies pursued in recent years, they stressed, nevertheless, the overriding need for the introduction and implementation of a stronger and more comprehensive stabilization program. The role of interest rate policy in mobilizing savings and allocating them efficiently was stressed. The depreciation of the dong in 1980 and the higher export incentives went in the right direction, but, in the light of the extreme weakness of the balance of payments and of the structural problems faced by the economy, the Directors felt that further major changes would have to be introduced if Viet Nam were to move toward lasting improvements in its economic performance.

The Executive Board then took the following decisions:

Decision Concluding 1980 Article XIV Consultation

1. The Fund takes this decision in concluding the 1980 Article XIV consultation with the Socialist Republic of Viet Nam, in the light of the 1980 Article IV consultation with the Socialist Republic of Viet Nam conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Viet Nam maintains restrictions on payments and transfers for current international transactions as described in SM/80/272 and in SM/80/277. The Fund hopes that these restrictions and the multiple currency practice can be removed as soon as possible. Moreover, the Fund notes with satisfaction that the authorities have terminated two bilateral payments arrangements and urges the authorities to terminate the remaining five arrangements with other members of the Fund.

Decision No. 6720-(81/3), adopted
January 7, 1981

Purchase Transaction - First Credit Tranche

1. Viet Nam has requested a purchase in its first credit tranche equivalent to SDR 28.4 million.

2. The Fund notes the objectives and policies stated by the Government of Viet Nam in the letter attached to EBS/80/269. To support these objectives and policies the Fund approves the purchase in accordance with the request.

Decision No. 6721-(81/3), adopted
January 7, 1981

Trust Fund Loan

1. In a communication dated December 6, 1980, the Government of Viet Nam has requested a loan under the Instrument to Establish the Trust Fund ("Instrument") annexed to Executive Board Decision No. 5069-(76/72) TR, adopted May 5, 1976, as amended by Decisions No. 5563-(77/150) TR, adopted October 28, 1977, No. 6202(79/121) TR, adopted July 23, 1979, and No. 6676-(80/168) TR, adopted November 19, 1980, from the Trust Fund in respect of the second period mentioned in Section II, paragraph 1 of the Instrument.

2. The Fund as Trustee finds that Viet Nam is qualified for the loan requested in accordance with the requirements of Section II, paragraph 3 of the Instrument, and the Managing Director is authorized

to inform Viet Nam that the Trustee has approved a loan for Viet Nam on the basis of the request, on terms and conditions set forth in the letters annexed to Executive Board Decision No. 5195-(76/134) TR, adopted September 8, 1976.

Decision No. 6722-(81/3) TR, adopted
January 7, 1981

3. CHARGES - REVIEW

The Executive Directors considered a staff paper reviewing the level and structure of the Fund's charges (SM/80/282, 12/24/80).

The Deputy Treasurer explained that the rate of interest for the SDR for the quarter beginning January 1, 1981 was 10.875 per cent and that the rate of remuneration, at 90 per cent of that rate, was 9.785 per cent. Those rates were appreciably above those assumed in the earlier estimates of the Fund's income position for the financial years 1981 and 1982. The staff had originally forecast net income for the Fund of SDR 60 million for FY 1981 and a deficit of as much as SDR 75 million for FY 1982. Those estimates had been based on a set of assumptions including the standard assumption that the SDR interest rate and rate of remuneration at the time of the estimate would remain in effect throughout the period until April 30, 1982. The assumed rates were an SDR interest rate of 8.5 per cent and a rate of remuneration of 7.6 per cent. Some indication had been given in EBS/80/254 (11/25/80) of the financial consequences of changes upward or downward in those rates. In the present staff paper some calculations had been made based on higher rates of interest; for example, Table 7 contained simulations based on a combined market rate of interest of 11.25 per cent, and Table 9 indicated the consequences for the rate of remuneration of a combined market rate of 12.75 per cent. The fact that the actual combined market rate had reached 13.59 per cent meant that Tables 7, 8, and 9 needed revision.

The Fund's income for FY 1981 had originally been estimated at SDR 60 million, had been revised to SDR 57 million in Table 7, and should now be further revised to SDR 46 million, the Deputy Treasurer remarked. The deficit originally estimated at SDR 75 million for FY 1982 had been revised to SDR 104 million in Table 7, and should now be further revised to SDR 211 million, on the assumption that the present SDR interest rate and the rate of remuneration were not changed before April 30, 1982. Because many of the calculations in the staff paper needed revision, the staff would issue a short supplementary paper with revised figures for FY 1981 and FY 1982. The revised figures would not change the conclusions or proposals presented in the staff paper; however, the worsening of the Fund's estimated income position would affect the extent of any adjustment of charges that might be agreed on.

The Executive Directors addressed their remarks particularly to Section VII, paragraph 8, subparagraphs (a) through (j) of the staff paper, which specified the staff's proposals for consideration.

Mr. Kafka expressed agreement with the points made in paragraphs 8(a) and 8(b). With regard to paragraph 8(c), he recalled from EBM/80/187 and EBM/80/188 (12/19/80) that the consensus of the Executive Board had been against any integration of charges; the Executive Board should not commit itself to a re-examination of that question. As to paragraph 8(d), it made good economic sense to abolish the rise of charges over time now that the Fund had an early repurchase policy. He wondered, however, whether the existence of an early repurchase policy--which undoubtedly reduced the economic need for raising charges--could create an abnormal situation that would counterbalance the statement in Article V, Section 8(b) that "the rates of charge normally shall rise at intervals." The Fund should certainly avoid giving the impression that it was riding roughshod over its own constitution.

A second question raised in paragraph 8(d) was whether charges should vary with the degree of conditionality, and, specifically, whether higher charges should be applied to drawings under the compensatory financing facility and under the buffer stock financing facility, Mr. Kafka noted. In his view, the low degree of conditionality applied to those facilities was appropriate, because the problems they had been set up to deal with were problems that were outside the control of the countries concerned. He would not favor imposing higher charges on countries already hard pressed by events outside their control. He agreed with the principle expressed in paragraph 8(d); normally, the Fund should not be too concerned if it made losses. Indeed, if all the Fund's member countries were in balance of payments equilibrium at all times, the Fund would have achieved its objectives but would incur constant losses. At present, as the Fund prepared to borrow in the markets, any reasonable measures to enhance its creditworthiness should be taken, as long as the costs were reasonable and charges did not have to become excessively burdensome. He wondered why the staff had suggested, in paragraph 8(e), that the Fund's ideal annual income objective should be the equivalent of 3 per cent of its reserves. Before adopting that or any other figure, would it not be useful to consider more carefully the effect that such a decision might have on charges? He wondered also whether it might not be wise to change the present policy of charging all capital expenditures to the current account rather than charging them over a reasonable amortization period; changing that policy could be particularly helpful over the coming two years as the annex to the Fund's building was constructed. Would it make sense to raise charges in order to meet the expenditure involved on the new building? Or would it be better to debit those expenditures to the current account over an amortization period of some 20-25 years?

He had no problems with paragraphs 8(f), 8(g), and 8(h), Mr. Kafka stated. He welcomed the proposal made under paragraph 8(i), which, if implemented, would accentuate the reserve character of the reserve tranche. He had no comments on paragraph 8(j). Finally, he would be prepared to

contemplate some sales of the Fund's gold in order to increase the degree of concessionality on the use of the Fund's resources, if the Executive Board thought it appropriate. It would be interesting if the staff could make known the degree of concessionality that had been applied to the use of its resources in the years prior to 1972 when market interest rates had risen markedly in the United States.

Mr. Anson considered that the review of the Fund's charges was timely for three reasons: first, it was clear that if charges were not raised the Fund's income would be insufficient; second, the agreement in principle to raise the SDR interest rate had implications for all other interest rates fixed by the Fund; and third, and perhaps most important, at a time when the Fund was contemplating market borrowing, its balance sheet and operating accounts would be critically examined by outside parties. Clearly, the Executive Board had to take measures to safeguard the Fund's income position and to enable the Fund to realize an adequate surplus to build up its reserves. At the same time, the Board should guarantee the maintenance of a concessional element attached to the use of the Fund's ordinary resources. Any change in the rates of charge should not be so abrupt that members would be discouraged from timely resort to the Fund. He agreed with the staff that a strong case could be made for a simpler and more systematic approach to charges.

He would like to make some preliminary remarks about the staff proposals outlined in Section VII, paragraph 8, Mr. Anson remarked. With regard to paragraph 8(a), he believed that reserve tranche purchases should continue to be free of any service charge for the time being. The question might need to be re-examined later, if the net use of unremunerated reserve tranche positions was considerably larger than foreseen at present. Some study of the service charge, and of commitment charges for stand-by and extended arrangements would be useful. It could well be that an increase in service charges would provide an appropriate means of increasing the Fund's income. That possibility and the possibility of abolishing the commitment fee and substituting a higher service charge should be examined.

He had no difficulty with paragraph 8(b), Mr. Anson continued. He had no major difficulty with paragraph 8(c) either, although he believed that the phrase "in the same manner as charges for use of the supplementary financing facility" should be made clearer. It did not follow that charges on future borrowed resources would be linked to U.S. Government bond yields in the way that charges on supplementary financing facility drawings were. As to the progression of charges, he favored some simplification; he wondered, however, whether it would be appropriate to abandon the last in, first out principle altogether. In that context, could the staff say how the word "normally" in Article V, Section 8(b) should be interpreted? A case could perhaps be made for distinguishing between the use of the ordinary credit tranches and stand-by arrangements on the one hand, and extended arrangements on the other. It might be useful to examine ways of concentrating concessionality on short-term to medium-term use of the Fund's resources, and to have a simpler form of progression;

for example, a first increase in charges could be made after five years, and if there were continuous use beyond ten years, charges could be increased again and brought to a level that was the same as, or close to, the rate of remuneration. That suggestion might be relevant if it proved impossible to abolish progression altogether without altering the Articles of Agreement.

There were arguments for and against linking the rates of charge to the degree of conditionality attached to a drawing, Mr. Anson observed. There seemed to be some merit in applying a higher level of charges for drawings under the compensatory and buffer stock financing facilities than for more conditional drawings. Admittedly, however, there would be difficulties in implementing such a principle in the face of the diversity of problems members faced. If charges were to be linked to conditionality, the practice should not be seen as punitive, but as a means of concentrating concessionality in the areas where it was most needed. If it was felt that it would be too complicated to link the main structure of charges to conditionality, some of the same objectives could be met by establishing different rates of service charge for different kinds of drawings.

With regard to paragraph 8(e), Mr. Anson agreed that the calculation of the rates of charge should be based on a net income objective framed in terms of a five-year average. Could the staff explain its recommendation that the Fund's target for average annual net income should be an amount equivalent to about 3 per cent of its reserves? That figure seemed rather low, given the present need for a greater level of income during a period when the Fund would be resorting to borrowing. Of course, the figure should not be set too high, since the Fund was essentially intended to act as a cooperative organization. It would be interesting to know how the market would react to such a modest figure. Would potential lenders compare unfavorably the Fund's annual income of about SDR 25 million with the income of \$209 million to \$588 million that the World Bank had achieved over the past seven years? In practical terms, he could accept the establishment of an automatic adjustment procedure for the rate of charges, although he would expect the Executive Board to take a view on the action required on each occasion. If there was to be an automatic adjustment procedure, it should perhaps be triggered only by a shortfall in the Fund's projected income, leaving any excess to be taken up in the five-year averaging process. Some guideline would have to be established that would enable the Executive Board to decide when the Fund's performance was leading to a substantial departure from its income target. It might perhaps be desirable to review the Fund's income position on a quarterly basis with a more thorough review taking place at the end of each year. He had no difficulty with paragraphs 8(g) and 8(j) and endorsed the suggestion that a decision should be taken and implemented from May 1981.

It seemed inevitable that the Fund's income position would remain precarious as long as the rate of remuneration was linked to the SDR interest rate and, therefore, to market interest rates, while charges

remained concessional, Mr. Anson commented. One way of overcoming that problem would be to break the link between the rate of remuneration and market interest rates. It could be argued that the role of the SDR was sufficiently distinct from the role of the reserve tranche as an asset to allow that link to be broken. However, breaking the link would probably require an amendment to the Articles of Agreement and might not, therefore, be practical. If that were the case, it would probably be necessary, when the SDR interest rate was raised to market levels, to lower the rate of remuneration in relation to the SDR from its present level of 90 per cent. His inclination would be to fix it at perhaps 85 per cent rather than 80 per cent of the SDR interest rate. Finally, the proposal in paragraph 8(i) should be the subject of further examination in a separate staff paper. The staff should study the effects on the Fund's income and on its liquidity of leaving a greater proportion of reserve tranche positions undrawn.

Mr. Drabble explained that his remarks on the staff paper would be of a preliminary nature. Clearly there was a need for a general adjustment of the rates of charge, in the light of both the projected deterioration of the Fund's income position in the period ahead and the decision in principle for an adjustment of the SDR rate of interest with its consequential effects on the rate of remuneration. When the SDR interest rate was eventually increased to the average market rate, he would be quite willing to consider reducing the rate of remuneration from the present level of 90 per cent of the SDR interest rate to 85 per cent or perhaps even to 80 per cent. Ireland at present had a remunerated position, but was willing to join with the other members of his constituency in considering a decrease in the rate of remuneration. In the case of the SDR interest rate, the Fund was concerned that measures should be taken to allow the SDR to stand as an attractive alternative reserve asset. In the case of the rate of remuneration, however, those members in creditor positions should, in a spirit of cooperation, be prepared to accept something less than the full market rate on their remunerated reserve position in the Fund.

The approach to the rate of charges traditionally taken by the Fund had been established in a noninflationary period when international interest rates had been much lower and more stable than at present, Mr. Drabble observed. In recent years the modest increases in the Fund's rates of charges had been overshadowed by the sharp swings in market rates of interest. Some major innovative changes to the present system of charges were, therefore, warranted by the very difficult financial climate that prevailed in the world. The possibility of linking charges to the rate of remuneration should be considered, even though it would mean abandoning for the time being the traditional relative stability of the rates of charge. It could be argued that linking the rates of charge to the rate of remuneration would at least assure a constant level of concessionality. Such a link could well prove more acceptable to the Fund's membership in present circumstances, because the great majority of countries using the Fund's resources were also engaged in borrowing from the markets at floating rates of interest. Indeed a simple floating rate of charges

might be more readily understandable than some of the other complicated formulas involving a progression of charges that prevailed under present policies. Some approximate calculations that he had made suggested that if a rate of charges was fixed at 70 per cent of the rate of remuneration, and if the rate of remuneration was set at 80 per cent of market interest rates, the Fund would still be able to offer significant concessionality while giving greater protection to its income position.

He was not convinced that the alternative approach outlined by the staff would ensure greater stability, Mr. Drabble commented. If a five-year moving average were to be used, on any occasion when the year to be dropped had been one of sizable net income and the one to be added was one of sizable deficit, a sizable adjustment might be required. Another disadvantage to that approach was that adjustments to the rates of charge would be divorced from the movement of interest rates in the market.

He could agree with most of the staff proposals listed in the paper, Mr. Drabble said. He agreed that the service charges for stand-by and extended arrangements should remain unchanged and that the rate of charge, where borrowed resources were involved, should be such as to ensure a modest income for the Fund. There should be a review from time to time of the five-year moving average approach, if it were adopted, and particularly of the targets for Fund income that were envisaged. The target for annual income of 3 per cent of reserves mentioned by the staff appeared reasonable.

He could see some merit in linking the rates of charge to conditionality of drawings for the same reasons mentioned by Mr. Anson, Mr. Drabble remarked. If the rates of charge were to be linked to the rate of remuneration, then conceivably the rate of charge on drawings under the compensatory and buffer stock financing facilities could be set at 80 per cent or 90 per cent of the rate of remuneration, while the rate of charges on drawings under the normal conditional tranches could be set somewhat lower, perhaps even at 65 per cent or 60 per cent of the rate of remuneration. Alternatively, it would be possible to envisage some differential between the various rates of charge or to link only some of the rates to the rate of remuneration. What was important was to provide countries with the greatest amount of concessionality when major adjustment efforts had to be taken. Under present policies, programs involving major adjustment were often financed only partially from the Fund's internal resources with the balance provided by resources borrowed at market rates of interest. That argued for the Fund making every effort to keep the charges on its ordinary resources as low as possible in such cases so that the overall cost of the member's borrowing retained some concessional element.

Mr. Buira commented that the apparent deterioration in the Fund's income position and the recent decisions on the SDR rate of interest and on the Fund's resort to borrowing made the present discussion extremely timely. He was in broad agreement with the staff's proposals for simplifying the system of charges. He agreed also with previous speakers that

greater consideration should be given to the possibility of reducing the rate of remuneration to 80 per cent of the SDR rate, in the light of the very high rates of interest that were now prevailing and of the cooperative nature of the Fund.

He favored considering a more systematic approach for determining the level and structure of charges than was at present being followed, Mr. Buira said. The approach should recognize the continuing need for concessionality, the need for the Fund to recover its interest costs on its borrowed resources, and the need to obtain a small amount of new income over a number of years. It seemed quite reasonable, therefore, to assess the income position of the Fund at the end of each year on the basis of actual results over, say, the four past years and the outcome estimated for the current year. He wondered, however, whether such a procedure would make redundant the other suggestion that when the actual results of a 12-month period showed a deficit or a net income rather less than would be required to increase reserves by a certain percentage, charges should be automatically adjusted to the extent necessary to produce that target amount of income. Perhaps the staff could provide some additional explanation of how those two approaches interrelated.

He could go along with the suggestion that the rates of charge should be adjusted to changes in the Fund's income position rather than to changes in the rate of remuneration, Mr. Buira indicated. However, he had been interested in Mr. Drabble's suggestion of linking charges to the rate of remuneration so as to ensure a constant level of concessionality; the idea was attractive and should be further explored. He favored the suggestion that there should be a single rate of charge on the Fund's resources, thus eliminating the progression used at present. He would prefer that the rate should be the same for all users of Fund resources that had not been financed by borrowing.

Like Mr. Kafka, Mr. Buira continued, he did not favor a high rate of charge on drawings under the compensatory and buffer stock financing facilities. Those drawings had low conditionality because they related to problems that were beyond the members' control. He could see no reason to justify a higher rate of charge in such circumstances. He wondered whether a single rate of charge would be legally permissible under Article V, Section 8(b).

He agreed with the staff suggestion that the use of the reserve tranche position should be free of charge so as to maintain the reserve character of those resources, Mr. Buira remarked. He also agreed that the charges for drawings under the supplementary financing facility should continue to be calculated as at present. He saw no reason to examine the possibilities of integrating charges on drawings under the supplementary financing facility and drawings financed by resources borrowed by the Fund. With regard to the target annual income figure that the Fund should pursue, he wondered what had led to the suggestion for a level equivalent to 3 per cent of the Fund's reserves. Perhaps it would be best to establish a target level for reserves and then to

discuss the rate of reserve accumulation over the target period. It would probably not be necessary to continue accumulating reserves beyond some absolute level. If that argument could be accepted, it would be consistent with the cooperative character of the Fund and would avoid any inequities being suffered by present users of the Fund's resources, who would effectively be subsidizing future users if an excessive amount of reserves were being accumulated. It might be convenient each year to determine the amount by which the Fund's reserves should be increased and at the same time to determine the level of charges and to some extent the degree of conditionality. A staff paper explaining how each one of those elements tied together would be useful. The paper could also contain the information requested by Mr. Kafka on how the level of concessionality and the use of Fund resources had changed over time, taking into account the level of the service and commitment charges that had been paid.

Use of the reserve tranche should not be necessary as a prior condition of the use of the credit tranches, Mr. Buira argued. Leaving the reserve tranche untouched would preserve its reserve character and could well result in a higher net income for the Fund.

Mr. Iarezza welcomed the staff's effort to simplify matters connected with the rates of charge. In approaching the subject the most important principle to bear in mind was the need for concessionality in the use of the Fund's resources. He supported the proposal to base the rate of charges on a five-year averaging period and the proposal to set a positive target of net income, even though the Fund was not a profit-seeking institution. He was open-minded with regard to the proposal that the target for annual income should be set at 3 per cent of reserves.

The rates of charge should continue to contain a concessional element and should be reasonably stable, Mr. Iarezza suggested. The Fund's income position was affected greatly by changes in market interest rates. A change of 1 per cent in the SDR rate of interest and a 0.9 per cent change in the rate of remuneration would increase the estimated deficit by about SDR 57 million. Given the large volatility of interest rates over the past month, perhaps, as Mr. Drabble had suggested, a better way to avoid sharp changes in the rates of charge might be to fix those rates as a percentage of the rate of remuneration. In that way, the rates of charge would move in line with market interest rates, the rate of remuneration, and the SDR interest rate. Moreover, the income position of the Fund would become more stable. In consequence, he preferred the approach outlined in Section III,1(b),(3) of the staff paper.

He supported the elimination of a progressive rate of charges, but like some previous speakers wondered whether such a change was legally feasible, Mr. Iarezza stated. He agreed with the proposal that, for the time being, the charges on drawings financed by resources borrowed by the Fund should be such as to ensure for the Fund some net income. A unification of all rates of charge would require more in-depth analysis. He would prefer to maintain a uniform charge on drawings under the Fund's

regular facilities, including those under the compensatory and buffer stock financing facilities. Members drawing under the compensatory financing facility were often drawing under the credit tranches as well, and so were subject to Fund conditionality. He could agree that the use of the reserve tranche should not be specified as a necessary prerequisite for the use of the credit tranches.

There were firm grounds justifying the maintenance of a distinction between the SDR and a remunerated position in the Fund, Mr. Iarezza remarked. With the SDR interest rate fixed at 12.75 per cent, the single rate of charge necessary to attain a net income for the Fund of 3 per cent of its reserves for a five-year period would be 6.9 per cent if the rate of remuneration was fixed at 80 per cent of the SDR interest rate. In other words, rates of charge would need to be increased by more than 30 per cent in order to provide enough resources to resolve the present problems affecting the Fund's income position and to finance a rate of remuneration rising from 72 per cent to 80 per cent of market interest rates. If the rate of remuneration was to be fixed at 90 per cent of the new SDR interest rate, charges would have to be increased by more than 50 per cent. Moreover, if actual drawings under the remunerated reserve tranches were higher than those included in the simulation in Table 9 of the staff paper, the rate of charges would have to be raised even further. Finally, he supported an increase in the rate of remuneration, but not beyond a level of 80 per cent of the combined market rate.

Mr. Laske considered that a reform of the Fund's system of charges was overdue for a number of reasons. First, the present system was complicated; a simplification would diminish the administrative burden borne by the Fund, and would enable members to have a clearer idea of the potential cost of drawings from the Fund. Second, the system of charges had become outdated as the Fund had established new facilities requiring little or no conditionality. Third, in present circumstances, any increase in the Fund's lending activity would threaten it with an increase in its operational deficit. Finally, by borrowing resources at market-related rates a new element had been added to the Fund's interest rate structure. The agreement in principle to raise the rate of interest on SDR holdings to the full combined market rate made an examination of the level of charges inescapable.

In considering any reform, Mr. Laske continued, the Fund should ensure first of all that it would have sufficient income to cover its operational costs and to be able to add adequate amounts to its reserves. The charges related to the use of Fund resources should be different according to whether the drawings had been from the Fund's own resources or from its borrowed resources. The cost of the borrowed resources should be fully passed on to users. If such resources were obtained in the future at differing interest rates, then an appropriate combined rate would have to be calculated, which would assure full compensation of the Fund for its costs. The charges for the use of the Fund's regular resources should continue to contain a concessional element that would

provide an incentive for members to seek Fund assistance. Some differentiation in the levels of charges for various Fund facilities should not be excluded; for example, higher charges for the use of the compensatory and buffer stock financing facilities would not be inappropriate in view of the low conditional character of those two facilities. Adjustments to the rates of charge should be made in such a way that sufficient operational income was earned from the Fund's credit operations. Indeed, it might be appropriate to fix charges so that income from them covered the cost incurred by the Fund in paying remuneration on reserve positions. However, given the considerable amount of interest-free resources at the Fund's disposal, and the fact that the Fund derived income from its substantial SDR holdings, such a tight relationship might not be necessary.

If an adjustment of charges was required in order to safeguard the Fund's financial position, Mr. Laske observed, it should take place promptly. It might be advisable to provide for an emergency clause, which would ensure an automatic adjustment in the event that the Fund experienced an operational deficit and the Executive Board was not able to establish a consensus on what should be done. In principle, such an emergency clause would be similar to the automatic adjustment provided by the present rules. The substantive difference between the two approaches would be that under the new approach the rates of charge would not be tied to the rate of remuneration, but would be triggered by an operational deficit of the Fund.

The difference between the rate of interest on the SDR and the rate of remuneration should not be too wide, Mr. Laske recommended. Setting the rate of remuneration at about 90 per cent of the SDR interest rate would probably be appropriate, even after the SDR rate of interest had been moved up to the full combined market rate.

He agreed with the proposal in paragraph 8(a) that the service charge and the charges for stand-by and extended arrangements should remain unchanged, and that use of reserve tranche positions should continue for the time being to be free of charge. He also agreed with the view expressed in paragraph 8(b) that there should be no change in the periodic charges for the use of the oil facility and the supplementary financing facility, and that the Fund should continue to derive a small margin of income from the operation of those facilities. With regard to paragraph 8(c), he believed that the cost of future borrowing should be fully passed on to users. He wondered whether it would be technically feasible to implement the proposal that income derived from the temporary investment of borrowed resources should be taken into account in determining the level of charges. Would it not be easier to add such potential investment income to the Fund's regular operational income? The amounts involved might well be marginal and separate treatment of them not worth the administrative complications involved.

With regard to paragraph 8(d), he could agree to some simplification of the system of charges by the elimination of progression, Mr. Laske commented. Like other Executive Directors, however, he would be interested to hear whether that would be possible from a legal point of view.

The replacement of progression by a uniform rate would provide a welcome simplification. It should certainly be possible to allow for a discontinuation of the last in, first out principle. In his view, there should be some provision for making the charges on purchases under extended arrangements with their longer maturities rather higher than those for purchases under the credit tranches and for stand-by arrangements. It would not be inappropriate to have a higher rate of charges for drawings under the compensatory financing facility and under the buffer stock financing facility, perhaps set at a certain discount--for example 10 per cent--from the SDR interest rate. The level should, in any event, not be lower than the rate of remuneration. For the rarer cases of a member failing to make repurchases at a due date, a penalty rate could well be introduced by adding a surcharge to the otherwise applicable periodic charge.

In relation to paragraph 8(e), Mr. Laske continued, he agreed with the proposal to aim for a 3 per cent increase in the Fund's reserves annually as an average over a five-year period. At a time when the Fund's activities were expanding, and when it was embarking on a substantial borrowing program in the market, it was necessary to strengthen the Fund's equity position. An average annual increase of 3 per cent was not exorbitantly large. Like other Directors, he would be grateful if the staff could explain why a rate of 3 per cent had been considered most appropriate.

The formula proposed in paragraph 8(f) for the automatic adjustment of charges seemed to be feasible, Mr. Laske observed. However, would the phrase "should the Board not decide otherwise" mean that the present situation of possible inactivity in the face of a threatening deterioration in the Fund's financial position would be continued? He would strongly prefer automatic adjustment of charges, which would not require prior approval or involvement by the Executive Board. As to the periodic review of charges in the light of developments, he would not object to a somewhat shorter period than 12 months. In the present volatile world conditions, reviews after 6 months might be appropriate.

He could go along with the proposals in paragraphs 8(g) and 8(h), Mr. Laske stated. He could also go along with the proposals in paragraph 8(i) that would make the reserve tranche float with regard to the credit tranches. Several times in the past it had been argued that the reserve tranche position should be regarded as a country's reserves, at the unrestricted disposal of the authorities; he would not wish to disagree with that view.

Mr. de Groote expressed broad agreement with the staff proposals. It would be appropriate to set the rates of charge at levels that would guarantee the Fund an annual income equivalent to about 3 per cent of its reserves, while at the same time maintaining an element of concessionality. He welcomed the proposal to eliminate the progression of charges over time; that elimination would enable members to calculate

for themselves the cost of using Fund resources and it would also help to bring to an end the paradoxical situation in which the Fund's income position deteriorated as its lending increased.

The idea that there should be a higher rate of charge on drawings under the compensatory financing facility and under the buffer stock financing facility because of their low conditionality seemed reasonable, Mr. de Groote remarked. However, if that principle were accepted, the Fund might also be obliged to establish a higher rate of charge on drawings under the first credit tranche; that would be a significant departure from present policies as the first credit tranche was supposed to form part of a country's reserves. Members would probably find it difficult to accept that their access to the first credit tranche should be made more difficult. He suggested that the question be left in abeyance for the time being and that the proposed simplification of the Fund's system of charges should not be delayed by long negotiations concerning the possible linking of charges and conditionality.

He agreed with several previous speakers that charges on drawings financed by the Fund's borrowed resources should be set at a level that would cover the interest cost and include an element of income for the Fund, Mr. de Groote stated. He had, however, some misgivings about the phrase "for the time being" in Section VII, paragraph 3(c). Those words should not be read as implying that the Fund was moving toward a permanent system of borrowing and a permanent mix between ordinary charges and charges based on the cost of borrowing. The envisaged borrowing should only be necessary during the present transitory phase of the Fund's history, while a sufficient increase in quotas, a notable adjustment of the world economy with regard to oil producing countries, and, perhaps, the adoption of a new approach to the link were awaited.

He could see some merit to the staff proposal described in paragraph 8(i), Mr. de Groote said. Some members of the Fund had reserve positions that they might wish to retain; it would obviously be a great advantage in financial terms to those members if their first drawings from the Fund could be from the credit tranches. On that point, he would be in favor of any decision taken by a majority of Executive Directors that would not hold up early agreement on the main features of the new system. He hoped that after the present discussion the staff would be able to prepare rapidly a draft decision setting up a new system for determining the rate of charge and the rate of remuneration. With regard to the rate of remuneration, most of the members in his constituency were in favor of an upward adjustment. It would be possible to adjust the rate upward while still allowing for a concessional element in the level of charges. Finally, he agreed with Mr. Kafka's suggestion of amortizing the cost of the building extension, and perhaps some other capital expenses.

Mr. Lovato remarked that if the problems connected with the Fund's rates of charge were not resolved, the Fund could be seriously hindered in its efforts to fulfill its objectives. Any review of the Fund's charges should take into account the general principles underlying those objectives.

The Fund had a basic responsibility to encourage its members to adopt adjustment measures and, therefore, needed to be able to subsidize charges on the use of the conditional resources it made available, Mr. Lovato said. On the other hand, the Fund had a basic responsibility to ensure that its rates of charge were such that its income position would be in equilibrium or even show a modest surplus. That second principle was particularly important at present as the Fund prepared to borrow from the market. He would prefer to maintain the rates of charge on the Fund's ordinary resources as stable as possible; he could see no justification for different rates of remuneration being paid on members' reserve positions and on borrowed funds. Therefore, taking into account the cooperative nature of the Fund, member countries with strong balance of payments positions should be ready to lend at a yield close to the rate of remuneration.

The income position of the Fund was extremely sensitive to short-term factors, Mr. Lovato noted. For that reason, instead of the complicated system of charges described in the staff paper, he would prefer to see the Fund adopt a more pragmatic approach and to adjust charges on an ex post basis, according to developments in the Fund's income position. In the case of no consensus on new charges, he would side with those favoring the abolition of the present rule governing the modification of the rates of charge. That rule could lead to excessive results and should be replaced by another, also automatic, which could assure, in the same case of no consensus on new charges, the equilibrium of the Fund's income position.

There should continue to be a concessional element in the Fund's charges for use of its ordinary resources so as to encourage members to adopt adjustment programs, Mr. Lovato recommended. He could, however, favor an increase in charges on use of the Fund's nonconditional resources, such as drawings under the compensatory financing facility and under the buffer stock financing facility, so that lower charges could continue to be applied to the Fund's conditional resources and so as to improve the Fund's income position. He favored a uniform rate on the use of conditional resources. Charging a higher rate on drawings under the supplementary financing facility or other borrowed resources would represent in itself a progression in the rate of charges.

With regard to the proposals in Section VII, paragraph 8, Mr. Lovato concluded, he could agree with the proposals outlined in paragraphs 8(a), 8(b), 8(c), 8(d), 8(g), and 8(h). As to paragraph 8(i), he doubted whether it would be possible to treat all holdings resulting from credit tranche purchases as being acquired under a policy which was the subject of an exclusion under Article XXX(c). Such treatment could have some advantages for the Fund's income position but they would probably be modest and insufficient to compensate for the negative effects on the enforcement of the Fund's policies. Finally, with regard to paragraph 8(j), he believed that questions related to the rate of remuneration could only be answered in the context of a wider study of the Fund's indebtedness.

The Executive Directors agreed to continue 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/81/2 (1/5/81) and EBM/81/3 (1/7/81).

4. DJIBOUTI - 1980 ARTICLE IV CONSULTATION - FURTHER POSTPONEMENT

The Executive Board notes the request contained in EBD/80/327, Supplement 1, and agrees to delay until not later than January 16, 1981 its consideration of the staff report on the 1980 Article IV consultation with Djibouti. (EBD/80/327, Sup. 1, 12/30/80)

Decision No. 6723-(81/3), adopted
January 5, 1981

5. ITALY - EXCHANGE SYSTEM

The Fund approves the restriction on the availability of foreign exchange for tourist travel referred to in EBD/80/347 (12/29/80) until the completion of the 1981 Article IV consultation with Italy, or December 31, 1981, whichever is the earlier. (EBD/80/347, 12/29/80)

Decision No. 6724-(81/3), adopted
January 5, 1981

6. KENYA - TECHNICAL ASSISTANCE

In response to a request from Kenya for technical assistance, the Executive Board approves the proposal set forth in EBD/80/344 (12/29/80).

Adopted January 6, 1981

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 80/89 and 80/90 are approved. (EBD/80/346, 12/29/80)

Adopted January 6, 1981

8. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director, as set forth in EBAP/80/380 (12/31/80), is approved.

APPROVED: June 2, 1981

LEO VAN HOUTVEN
Secretary

