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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 74/116

10:00 a.m., September 16, 1974

H. J. Witteveen, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
J. Amuzegar	C. P. Caranicas
P. Åsbrink	K. J. M. Andreassen
L. B. Brand	R. van S. Smit
R. Bryce	G. Reynolds
G. Bueso	F. Suárez
S. Y. Cross	C. R. Harley
	H. G. Schneider
N. Deif	M. Finaish
A. Kafka	B. Martins
K. Kawaguchi	M. Wakatsuki
B. Kharmawan	N. H. Hanh
P. Lieftinck	T. de Vries
C. Massad A.	R. H. Arriazu
	J. B. Zulu, Temporary
F. Palamenghi-Crispi	
P. S. N. Prasad	W. M. Tilakaratna
	P. J. Bull
	L. Fuenfgelt
	G. de Margerie
	J-C. Faure, Temporary
A. W. Yaméogo	

W. L. Hebbard, Secretary
R. Days, Assistant

Also Present

Asian Department: Tun Thin, Director; M. Braulke, P. Chabrier, A. A. Mattera. European Department: A. G. C. Mountford. Exchange and Trade Relations Department: E. Sturc, Director; S. Mookerjee, T. Sweeney. Fiscal Affairs Department: A. Lonnberg. Legal Department: J. Gold, General Counsel and Director; J. G. Evans, Deputy General Counsel; G. Nicoletopoulos, Deputy General Counsel; J. Guardia, P. R. Lachman, S. A. Silard, J. V. Surr. Middle Eastern Department: A. S. Gerakis. Research Department: J. J. Polak, Economic Counsellor and Director; J. M. Fleming, Deputy Director; R. R. Rhomberg. Treasurer's Department: W. O. Habermeier, Treasurer; R. J. Familton, Deputy Treasurer; D. Cutler, A. Watkins. Western Hemisphere Department: J. Del Canto, Director; E. W. Robichek, Deputy Director; F. A. Vera, Deputy Director; O. Albertelli, A. J. Beith, M. Caiola, F. Gaviria, W. Shields, H. J. O. Struckmeyer, E. Williams, E. V. Zayas. Personal Assistant to the Managing Director: D. W. Green. Advisors to Executive Directors: F. K. Hussein, M. S. Nan Nguema, M. Shein. Technical Assistants to Executive Directors: M. Berger, D. C. Chessell, J. A. Crosby, J. A. H. de Beaufort Wijnholds, A. Doizé, B. P. Eap, M. Garadaghipour, F. García-Palacios, G. E. Heyden Q., R. Khonsary, V. N. Mudaliar, A. K. Mullei, C. C. Ozumba, Z. Porath, F. Saccomanni, W. Sanner, T. P. Sweeney, A. Takahashi, M. A. Wasfy.

1. BURMA - SCHEDULE OF REPURCHASES

The Executive Directors considered a request from Burma for a schedule of repurchases, together with the staff analysis and recommendation (EBS/74/278, 8/22/74; and Cor. 1, 8/23/74).

Mr. Kawaguchi voiced his support for Burma's request and said that he believed that the reasons set forth in the staff paper amply justified approval.

Without further discussion, the Executive Directors approved the proposed decision.

The decision was:

> Burma has proposed that repurchase in respect of the purchase equivalent to SDR 6.5 million on September 21, 1971 (Executive Board Decision No. 3418-(71/100), adopted September 17, 1971) under paragraph (5) of the Decision on Compensatory Financing of Export Fluctuations be made in five installments as follows: two installments equivalent to SDR 1.0 million each, not later than April 20 and August 20, 1975, and three installments equivalent to SDR 1.5 million each, not later than December 20, 1975, April 20, 1976, and August 20, 1976. The Fund agrees to the proposal of Burma.
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> Decision No. 4382-(74/116), adopted September 16, 1974

2. BAHAMAS - 1974 ARTICLE VIII CONSULTATION

The Executive Directors considered the staff report for the 1974 Article VIII consultation with the Bahamas (SM/74/215, 8/30/74). They also had before them a report on recent economic developments in the Bahamas (SM/74/216, 9/5/74).

Mr. Bryce thanked the Fund, on behalf of his Bahamian authorities, for the useful consultation reports, and also for the extensive and most helpful technical assistance it had provided in the past few years. The Bahamian economy was quite small, yet dispersed and very open, and it had a long history of booms and recessions caused by everything from wars and piracy, to prohibition and the almost perfect climate. The latest boom during the 1960s had been characterized by a rapid growth in hotel facilities and by the development of financial intermediation, the latter due partly to its tax haven attractions and partly to the privacy accorded banking and trust facilities. Financial intermediation had had little real impact on the economy, but the massive tourist trade had transformed and supported it. The balance of payments figures for 1973, for example, estimated tourism receipts at about US$300 million, whereas domestic exports were estimated at about US$100 million.

The Bahamian authorities, Mr. Bryce continued, had requested him to comment on several points in the staff paper. First, they wished to draw attention to the dominating and depressing effect that the present difficult and uncertain international situation had upon a small and open economy. The revival of private investment, badly needed in terms of current employment as well as future growth, was particularly dependent upon the climate of international opinion. A reasonable level of employment in the construction industry, for instance, depended on having even just a few projects going. Hence, the type of economic stagnation described by the staff could easily be the product of uncertainties on the part of foreign investors. The authorities had taken note of what the staff had said about the macroeconomic targets for growth to provide employment for an additional 1,500 persons each year. While they appreciated the quantitative reassurance, they had commented that unemployment was already at the high level of 13 per cent--on page 8 of the background paper (SM/74/216)--and that there probably was considerable underemployment as well. The labor force was not highly educated or well trained, and the authorities were acutely conscious of the difficulties of finding industries in which Bahamians would be competitive, and the problem was compounded by the high wage levels that had carried over from the boom of the 1960s. The authorities felt that the staff had played down that problem--on page 10 of the staff report (SM/74/215). The Bahamas was facing severe competition from other countries--both large and small--in the fields of tourism and financial intermediation, and there was little prospect of attracting labor-intensive, industrial export industries.

Referring to the quality of the tourism industry, Mr. Bryce remarked that the problem was not now primarily one of overbuilding, or severe competition or a shortage of casinos, but rather one of a decline in the quality of the service offered. Understandably, the staff had made only a guarded comment on that point--page 34 of the background paper (SM/74/216)--but page 43 of the World Bank report was much more explicit on the question; that report drew on the conclusions of a special consultant's study that had been prepared for the authorities in 1973, and it clearly indicated that much needed to be done to improve the quality of tourism-related services. A large amount of capital should not be required to achieve an improvement, although the development of tourism facilities in the out islands, now called the Family Islands, obviously would require substantial capital outlays. To achieve any improvement, it was evident that both the public and private sectors would have to make some hard decisions and to acquire first-rate management techniques. Undoubtedly, the highly controversial immigration issue, as the staff would probably agree, was an important part of the problem. There were many attractions in the Bahamas for tourists and retired persons, as its location and climate were ideal. As overpopulation and pollution increased on the mainland, residents of the United States might easily be attracted to those nearby islands in growing numbers.

The authorities had noted the staff's comments with respect to the external origin of the country's inflationary spiral, Mr. Bryce said. In fact, in terms of consumer prices, the scale of inflation in the past year was approximately the same as in the United States, a quite understandable similarity in view of the relationship between the two countries that had evolved as a natural consequence of their close proximity. Of importance was the fact that in the Bahamas wage increases in both public and private sectors had been held to reasonably modest rates in the past year or two, contrary to what had transpired in the more southerly Caribbean islands. As he had observed earlier, the boom of the late 1960s and increased wages to a level that made it difficult for the Bahamas to compete; the country's competitive position should be improved as wage levels elsewhere began to overtake them.

On page 30 of the staff paper (SM/74/216), Mr. Bryce noted that optimism had been expressed for equilibrium in the balance of payments situation for 1974 and that the staff had projected a deficit of less than SDR 1 million. That was quite reassuring in a sense, given the state of the world in general, and the sad state of the tourism industry in particular. However, the authorities attributed the favorable balance of payments situation to the country's relatively high unemployment figure and the low level of capital expenditures, and thus in reality it reflected the unsatisfactory situation within the Bahamian economy. As the forecast had been made at mid-point in a year of difficult and uncertain international affairs, the authorities felt the situation required careful watching for the balance of the year; they would wish to go over the situation again with the staff at the time of the Annual Meeting, especially because of its relevance to possible borrowing under the oil facility.

The almost unbelievably high per capital income in the Bahamas, Mr. Bryce added, deserved some special comments. The figure seemed unbelievable because apparently it was slightly higher than that of the United Kingdom for the same approximate period, although, as indicated in the staff report (SM/74/215), the distribution of the income left much to be desired. The World Bank, with which the authorities had discussed the question because of its relevance in terms of the Bank's operation, had reported on the subject in more detail. It would be useful to quote some parts of that report to provide a better understanding of the nature of the income and its relation to the state of development of an economy that only now was coming to the attention of the Fund:

> By exploiting here comparative advantage in tourism, the Bahamas was able to achieve by 1970 a GNP per capita of about B$2,350, among the highest in the Western Hemisphere. However, this is not

particularly meaningful in characterizing the economy of the Bahamas. Some 15 per cent of the population is foreign born, with a large number of expatriates occupying top management positions in banking, insurance, real estate and the tourism business. Foreigners, as a whole, received about 38 per cent of the country's personal disposable income, the balance of 62 per cent going to the Bahamian population. Per capita GNP for the latter group is estimated at US$1,700. Even this figure is somewhat misleading for intercountry comparisons, considering that the price of essential consumer goods is 50 per cent higher in Nassau than in Washington, D.C. A tax system heavily dependent on import duties accounts for the major part of this price differential, and transport costs and high mark-ups may well account for the rest. On this basis, a figure of about US$1,100 would probably reflect more accurately the per capita GNP for the Bahamas in comparison with other countries.

It indeed seemed relevant to stress that great disparity, and to note that there was even disparity in geographic terms; for example, the average disposable earnings in the Freeport area on Grand Bahama island was more than double the national average, which was the approximate rate of the capital on New Providence island.

Referring to tax policy, Mr. Bryce said that he could agree with the staff's broad conclusion that more revenue was needed, but he was less impressed with allegations of extravagance in government expenditures. He was convinced that the need for more revenues eventually would lead to an income tax, thus posing a question about the Bahamas' position as a tax haven. He felt that the benefits derived from the country's tax haven status were greatly exaggerated, both on the corporate and on the personal side; with respect to the latter, much might depend on the outcome of international discussions on the taxation of pensions. The authorities would be faced with serious administrative and policy problems in stepping into the income tax field, and the utmost caution would be required. He understood, for example, that in the Hawksbill Creek Agreement the Government undertook not to impose direct personal, corporate or realty taxes in the Freeport area, precisely where the per capita income was double that of the rest of the country. If that agreement in fact precluded taxing the highest paid persons in the country, it would make any income tax difficult, in political terms. Although he was unaware of the details, he believed there were other similar commitments that compounded the problem of strengthening the tax base. Another type of problem was the fact that government services varied widely, to the point that some of the Family Islands probably received no public services at all; while it perhaps was tolerable to impose indirect taxes payable by all, an entirely different question arose when it came to income tax with little or no government services being received. During the discussions in Nassau, he believed he had heard something about a payroll levy for social security purposes;

perhaps that would be a good start for a program of direct taxation. However, he had seen nothing on the point in the staff papers and he would welcome whatever information the staff might have on the question.

Mr. Bull welcomed the Bahamas to the consultation process, noting that it had become fully independent in 1973 when it assumed the responsibility for external affairs, although it had been independent for many years insofar as domestic management was concerned. In his view, the country's present predicament was partly the result of a long-pursued policy of relying exclusively on economic benefits produced by the tourist industry and the country's special tax haven status, and partly because the authorities had altered the political and even economic direction of the economy as full independence neared reality. A review of the staff papers gave no clear indication that the authorities had yet determined what sort of economic strategy would be best suited for their economy. The staff, however, in the course of the consultation discussions, had posed a series of very cogent questions that, by highlighting many inconsistencies in the present policies, might provide the authorities with guideposts in deciding the course they would wish to pursue. It would be unwise for the authorities to attribute their present difficulties wholly to the generally deteriorated international situation, because many of their problems had been in existence before the onset of the worldwide inflation fever. It would be imprudent for the authorities to believe that their problems would disappear once the world entered a more normal phase, as they had a number of very fundamental problems that needed to be resolved before their economy could thrive.

It did not appear necessary, Mr. Bull continued, to go into great detail with respect to the problems, but one of the prime requirements would be for the authorities to establish and pursue very clear policies that would generate confidence, particularly with respect to investors. As a central banker, he could not fail to agree with the staff about the delicate position of the Central Bank and the importance of avoiding any action that might undermine its position. As a fledgling institution, it was essential that its operations from the very beginning be conducted in a manner that instilled confidence in its effectiveness, as failure to do so would destroy its value for many years to come. Consequently, he hoped the problem of financing the Government's needs would be handled in a fashion that would not be prejudicial to the Central Bank's standing. The staff had made some interesting suggestions that deserved serious consideration, one of which was to transfer the gold tranche to the Central Bank. Another promising possibility that occurred to him was the issuance of local securities, such as treasury bills, and perhaps some longer term government securities that could be offered to the banking system and to other private sector investors. There could well be some investors in the country willing to acquire some government securities if they felt confidence in the Government, and that certainly would be a less inflationary means of financing the Government's deficit than direct borrowing from the Central Bank.

Mr. Yaméogo said he felt that the economic performance of the Bahamas had been quite acceptable in the first year of its independence. Notably, more than one half of the country's GNP was derived from services related to tourism and financial intermediation, something of an achievement considering that its population of 200,000 coped with some 1.5 million tourists annually. In view of the importance of the tourist industry and the fact that a large proportion of the tourists came from developed countries, primarily the United States, the authorities would be well advised to adjust their immigration policies to encourage the entry of first-class professionals to provide the necessary supporting services and to train the local labor force. Perhaps the Bahamas could emulate the example of Hong Kong, provided the authorities were prepared to reduce wages and prices, and import raw or semi-finished products for local processing and subsequent export to the United States, the world's largest market. The country's prospects were not entirely bleak, as, with its relatively low population, its unemployment figure of 13 per cent was not out of line with that of other developing countries.

The ability of the economy to absorb the population increase, Mr. Yaméogo continued, was linked to the fact that internal demand was relatively weak, and that external demand would depend, among other things, upon what the country could do to increase its exports. Table 11 of the background paper (SM/74/216) projected domestic exports in 1974 at slightly more than SDR 70 million, almost double that of 1970; of more relevance was the fact that manufactured goods accounted for more than half the exports in 1970 and were expected to account for over 80 per cent in 1974. There was hope, therefore, that the country could expand its exports still further by importing and processing raw material for subsequent exporting, as he had already mentioned. With respect to the use of the gold tranche to finance the Central Government's debt, he would appreciate further information from the staff about the mechanics of the operation.

Mr. Lieftinck observed that the public finance position of the Bahamas was a cause for concern, as it was deteriorating rapidly. It was his impression that the staff had felt that the solution was to be found more readily in higher income tax policies than from restraint in government expenditures, as the margin for compression was bound to be relatively small. Nevertheless, the generally prevalent public view seemed to be that government expenditure policies verged toward extravagance, according to the final sentence on page 11 of the staff paper (SM/74/215). Given the locally popular presumption that the Government could reduce expenditures, it could be that the staff might have overstressed the smallness of the margin for compression.

With respect to the Central Bank, Mr. Lieftinck said there was a danger that that newly established institution would be called upon to finance government deficits. Parenthetically, was there not a statutory limit to

Central Bank loans to the Government? He supported the transfer of government deposits from private banks to the Central Bank as a wise move. He wondered, however, about the staff suggestion for the transfer of the gold tranche to the Central Bank, a proposal that Mr. Bull had also found attractive. As a matter of principle, central banks should be the repositories of gold tranches, provided, however, that such action was not merely a device to facilitate deficit financing. In the relatively recent past, the Government of the Netherlands had transferred the Fund account to the Central Bank, where the account was blocked precisely in order to forestall its use in connection with deficit financing. With reference to prices, he wondered whether the authorities were well advised in introducing and expanding price ceilings on a number of commodities. It could be that there was not enough competition or that other special circumstances might justify the fixing of maximum prices, rather than introducing a policy of price controls. With regard to the income tax issue, he had fully endorsed the staff point of view until he had heard Mr. Bryce's detailed explanation about the complexities of the situation. Nevertheless, a society free from income tax was an anomaly, and surely the time had come for the authorities to renegotiate agreements that tied their hands in that respect. If there was any real intention to improve income distribution in the country, one of the first steps should be the introduction of an income tax system, even if it had a higher than normal tax-free base, in order to capture a larger proportion of revenue from those in the higher income brackets.

Mr. Cross noted that staff suggestions had focused primarily on the question of a suitable overall development strategy, and that indeed seemed fundamental to the longer term well being of the Bahamian economy. However, after listening to Mr. Bryce, it seemed apparent that the country's progress was not necessarily or strictly related to development in the usual sense, although financing problems were not dissimilar. Broadening the tax base to enhance the Government's financial position was so fraught with complications that it forced a search for other solutions, such as those put forward by Mr. Bull, even though the eventual possibility of an income tax could not be ruled out. Turning to the price ceilings, he shared Mr. Lieftinck's reservations about the adoption of such measures, as they could create distortions in the economy that would be difficult to eliminate.

The staff representative from the Western Hemisphere Department, referring to the balance of payments projections, agreed with Mr. Bryce that the situation would bear close watching. However, on the basis of the available information, there was no reason to amend the projection of approximate equilibrium in the overall balance of payments for 1974. The staff findings had been based on a projected deterioration of about SDR 8 million as against 1973, and the expectation of a deficit of just below SDR 1 million, in turn based on the assumption of a net capital inflow smaller by SDR 10 million than in 1973. On the surface at least, the projections were not unduly optimistic, but that did not necessarily mean the staff would be proven right, because, as Mr. Bryce had noted with respect to the state of world affairs, predictions of capital inflows were very uncertain.

Regarding per capita income, the staff representative said that his view differed slightly from that of the World Bank. The nonresidents were about equally divided between very high and very low income earners in the Bahamas; hence, he was not persuaded that there was any necessity to make any special provision for that category of residents. It was true, however, that the upward bias of the high income earners among nonresidents was apt to be stronger than the downward bias of the lowest income recipients in the same group. In his estimation, the maldistribution of income in the Bahamas was no worse than elsewhere, and the real question seemed to concern the legitimacy of all per capita income calculations. With regard to the absolute price level, one of the elements to be borne in mind was the degree of reliance placed in the Bahamas on indirect taxation. Accordingly, in order to make a fair comparison between prices in Nassau and Washington, D.C., account would have to be taken of federal and state taxes in the United States to offset the peculiarity of the Bahamian tax system.

In connection with the possibility of an income tax for the Bahamas, the staff representative noted that the staff had summarized its views in the last paragraph on page 11 of the staff paper (SM/74/215), the general tenor of which coincided with the thrust of Mr. Bryce's comments. Mr. Bryce had inquired about the prospective payroll levy in connection with the national insurance scheme. Although it seemed that it would be placed in effect shortfly, in fact its status was no different from that described in a previous report (SM/73/281), and consequently it was not mentioned in the present staff papers. He was in complete agreement with Mr. Bull that Bahamian problems were unique to some extent and hence not totally attributable to the generally deteriorated international situation. For that reason, the discussions had centered on the fundamental need of framing an overall development strategy not necessarily related to present international uncertainties. He had noted Mr. Bull's suggestions concerning the possibility of a bill and bond market, but the problem at the moment was that the Central Bank wanted to see a contraction in commercial bank loan and investment portfolios, because it felt the banks were overextended. The feeling of the Governor of the Central Bank was that commercial banks were in need of more liquidity rather than further investment, and that he could maintain better control over government finances by having the Central Bank hold whatever indebtedness with the banking system that the Government had to incur at the present time. With respect to the population increase mentioned by Mr. Yaméogo, the historic increase had been on the order of 4 per cent while there had been heavy immigration. The current increase was between 2 per cent and 2 1/4 per cent because of a reversal in the immigration trend; the staff expected net emigration for a year or two, rather than net immigration, and that was how the addition to the labor force of 1,500 persons had been derived.

Questions about the gold tranche financing, the staff representative said, had been raised by both Mr. Yaméogo and Mr. Lieftinck and he hoped he could clarify the issue. Inasmuch as the Government was in deficit and could not finance a new foreign asset out of current revenues, in effect it had paid for the gold subscription by incurring domestic indebtedness; page 19 of the background paper (SM/74/216) reflected that transaction in the summary of public finances. In suggesting the transfer of the gold tranche to the Central Bank, the staff in no way had intended to encourage deficit financing. After making the conventional analysis of public finances, the staff had concluded that there was a gap of between B$6 million and B$10 million, and it had learned that the Central Bank would prefer to do the financing. Consequently, the staff had felt that the transfer of the gold tranche to the Central Bank was one way of postponing conventional government borrowing from that institution. Like the Executive Directors, the staff felt that the Central Bank was in a particularly vulnerable position at the present time, and if overborrowing by the Government could be postponed for another year, it would give the institution that much more time to consolidate its position. After that, of course, further camouflaging would not be possible if the Government again needed financing, but the staff had felt there were psychological and institutional advantages in transferring the gold tranche to meet the Government's present needs. However, as had been indicated in the staff paper, it was more likely that the authorities would not follow the suggestion because of the possible adverse effects on the Central Bank's earnings.

It was difficult, the staff representative observed, to judge whether a government's expenditures were extravagant when they were for purchases of goods and services, and it was not surprising that Mr. Lieftinck had questioned the point. A judgment could be made on the quality of government services, and Mr. Bryce had felt that those probably were quite adequate in the main population centers, but quite the opposite elsewhere. The staff had analyzed the Government's wage scale and had come to the conclusion that wage policies had been rather restrained. With regard to the number of government employees, the newly acquired independence offered a plausible justification for the employment of more government workers. Considering all those factors, the staff did feel that the allegations concerning government extravagance were somewhat exaggerated. In regard to the matter of price ceilings, up to and including the period of consultation there had been no indication that the Government was in any way resisting market forces. However, the staff had been surprised to learn that among the price ceilings established after the consultation, the one set on fuel oil clearly intimated that market forces were not being allowed free play. Mr. Lieftinck's question on the institutional limits of government borrowing involved a highly complicated formula that was described in paragraph (d) on page 21 of the staff paper (SM/74/216).

The Executive Directors concluded their discussion of the report for the 1974 Article VIII consultation with the Bahamas.

3. HONDURAS - 1974 ARTICLE VIII CONSULTATION

The Executive Directors considered the staff report for the 1974 Article VIII consultation with Honduras (SM/74/199, 8/13/74; Cor. 1, 8/26/74; and Cor. 2, 9/16/74). They also had before them a report on recent economic developments in Honduras (SM/74/209, 8/23/74).

Mr. Bueso made the following statement:

> I wish to express my appreciation to the staff for its brief and comprehensive report on the 1974 Article VIII consultation with Honduras.
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> Even though the rate of growth was moderate in 1973 and is expected to be only slightly higher in 1974--4.5 per cent and 5 per cent respectively--the Honduran economy has been experiencing what is to it a new phenomenon of fast increases in domestic prices, as well as the more familiar one of a deteriorating balance of payments. At the consumer level, prices increased by 5.5 per cent during 1973 and have accelerated to an annual rate of 10 per cent in the first 6 months of this year, compared with a traditional rate of between 2 and 3 per cent. During 1973 the price increase was influenced by a reduction in the supply of food staples due to drought conditions, by the pressures from international prices, and also by the liberal credit policies to the private sector that were followed by the authorities. The latter were taken as a means to compensate for the decline in investment of the public sector.
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> The balance of payments outlook for 1974 is one of a substantial overall deficit, notwithstanding an increase in exports and inflows of private capital. The agreement reached with the banana producing companies with reference to the new tax on production and the payment of income tax at the same rate as national corporations, has dispelled the uncertainties of a possible slowdown in shipments of this product. On the other hand, although the centralization of lumber exports has initially meant a lower level of production and exports, the foreign exchange inflow from this source is bound to increase, as private companies are no longer in a position to leave part of the proceeds abroad.

Imports increased at the extraordinary annual rate of 65 per cent during the first 4 months of 1974. In spite of the fact that the increase in the price of fuel allowed by the authorities appears to have reduced consumption by about 15 per cent this year, the increased oil payments will represent more than $40 million in 1974. A large component of the imports rise, however, can be attributed to speculative stock building, which has been facilitated during the first semester by the liberal credit policy, as well as to the re-establishment of substantial free trade with the Central American Common Market.

In view of this situation, the authorities have seen the need to tighten the monetary stance and, to this effect, they have adopted several measures designed to eliminate certain minor deficiencies in the legal reserve system, limit the external indebtedness of the banking system and reduce the level of Central Bank credit. These measures should restrain credit expansion to the private sector to the same level for the year as a whole as the one registered in 1973. Additionally, the authorities have reinforced their use of portfolio ceilings as a means of influencing the direction of credit and, concurrently, last week they introduced a substantial upward modification of the interest rate structure.

Even with the implementation of these measures, the price increase forecast for 1974 is still of the order of 14 per cent, and the balance of payments will show an estimated deficit of SDR 15 million. However, this will be somewhat offset by the increased foreign exchange tax payments of the banana sector which, according to the estimates of the authorities, will represent about 10 per cent of current government revenues on an annual basis. Furthermore, the proceeds of the new tax will ensure the financing of the investment program on a sound footing. The authorities are firmly committed to a tax reform program but, as government revenues have already increased substantially, the timing of the tax reform is now being made to coincide with the beginning of the development program.

In the meantime, as the staff points out, the operations of the Central Government have been strengthened and the fiscal deficit appears to be well under control in the sense that it has not been a factor in the recent inflationary pressures. On the other hand, although wages have been moderately rising in the private sector, wages and salaries of the public sector have been successfully controlled by the authorities. Demand for salary increases has been postponed until 1975 on the understanding that the Government will not grant sectoral wage increases but will follow a policy of granting an overall increase of about 10-12 per cent in 1975.

Concerning the development policy, Mr. Bueso continued, he had to admit that the efforts might indeed appear rather slow, particularly when it was considered that there had been a reduced rate of public investment in 1973. In part, that could be explained by the fact that the authorities had reshuffled priorities. On the other hand, however, substantial progress had been achieved in discussions with an acceptance by the various sectors involved in the Government's development strategy, including the sensitive area of agrarian reform; the basic aim was a redistribution of income parallel to the increase in public sector investment efforts. With respect to the staff paper (SM/74/199), the first page incorrectly referred to Honduras as the largest country in Central America; in fact it was the second largest. Also, the geographic setting described in the next sentence was not quite accurate.

He had received specific instructions, Mr. Bueso remarked, to make known certain views held by his authorities. They had always considered that they benefited from consultations with the Fund; the present one was particularly beneficial, as they had timed it to coincide with the anticipated mid-year review of monetary and fiscal policy. But after reading the staff paper (SM/74/199), his authorities desired that he express their dissatisfaction with the unwarranted and highly subjective judgments that appeared throughout the paper, especially on page 12. Those subjective evaluations did not add to the analysis of the economic situation, but instead served to detract from its value, and caused his authorities to feel that future consultations with the Fund might well be inhibited.

Mr. Martins noted that the staff analysis seemed to be centered on the shift from an ambitious financial program to an active stabilization plan that had been necessitated by the rapid deterioration of the Honduran balance of payments. Indeed, the value of imports had increased substantially due to the high level of aggregate demand and rising world prices, resulting in external and internal financial imbalances. The energy crisis created further difficulties in an economy that depended almost exclusively upon imports to meet energy needs, and the rate of price increases had accelerated to the abnormally high level of 18 per cent. That exceptional rate was the consequence of internal and external shortfalls of foodstuffs and raw materials, acting in combination with the effect of the devaluation of the lempira. As the fiscal postion was expected to remain strong, the authorities had decided to review their financial program and to implement a package of monetary measures in an effort to cope with those imbalances. Fortunately, as wage pressures had not been an important factor in 1974, they should not hinder implementation of the new monetary measures. In that connection, he applauded the decision to enforce legal reserve requirements, as well as the limits established on the external indebtedness of commercial banks. With regard to interest rates, he agreed with the staff on the importance of attracting more private savings to the banking system, and on the need to moderate credit demands.

Mr. Massad said that the Honduran authorities should be commended for their consistently successful pursuit of stabilization policies. Between 1966 and 1973, prices had risen by about 20 per cent, or an average of less than 3 per cent per year, a rather outstanding accomplishment. The present difficulties seemed to stem from three main sources--the events of 1969-70 and the ensuing integration difficulties, external pressures on the balance of payments, and external pressures on the domestic price level. On the matter of integration, it was encouraging to note from Mr. Bueso's statement that substantial free trade with the Central American Common Market had been re-established, a positive development that should enhance the rate of growth. With respect to the balance of payments, it was very difficult to bring about adjustment through demand management when disequilibrium was due to one particular product for which demand was inelastic. Global domestic demand restrictions could cause unemployment without eliminating the balance of payments disequilibrium. Perhaps the authorities could do something about the apparent outflow of capital, and the recent adjustment of interest rates that had been mentioned by Mr. Bueso should be helpful in that respect. However, a proper judgment about the flight of capital could not be made unless more was known about the causes. There were hints throughout the staff paper about uncertainties in some sectors of the economy, with agriculture mentioned at one point and lumber exports at another. If factors of that nature were responsible for capital outflows, adjustments to interest rates, while probably of some help, could not be expected to have any real impact on the situation.

Referring to fiscal policy, Mr. Massad indicated that it would be well for the authorities to anticipate a relatively difficult inflationary period, even though induced by external circumstances, and to adopt policies accordingly. For example, they might consider shifting to a pay-as-you-go basis for income tax in order to minimize inflationary losses in real tax collection. Balance of payments prospects for the current account did not appear promising in the short run, another condition brought about by circumstances over which the authorities had little control. If some part of increased imports in fact corresponded to stock buildup, then that part of the increase would not be of a recurring nature and some alleviation of pressures on the balance of payments could be expected. However, the current account would probably remain under pressure in the near term, a worrisome prospect given the situation of world financial markets. The authorities perhaps might profit from a careful analysis of the capital account to see what could be done to achieve balance of payments equilibrium. External assistance, of course, would probably play a very important role in filling the external gap while also contributing to the successful implementation of the new and comprehensive development program in the context of the Central American Common Market.

Of particular interest, Mr. Massad continued, were the figures on the flow of funds in the Honduran economy. Table 1 in the statistical appendix of the report on recent economic developments (SM/74/209) indicated a loss of net international reserves for 1974 of L36 million (about SDR 15 million), a figure repeated in other parts of the same staff paper. However, it was curious that different figures were shown on page 12 of the staff report (SM/74/199), and that those figures had prompted the staff to make stern comments on the economy. The latter figures were shown as SDR 25 million in the absence of corrective measures, or SDR 8-12 million under a revised balance of payments target. He was grateful to Mr. Bueso for having mentioned the figure of SDR 15 million in his statement, as that was consistent with the figure shown in the table on the flow of funds. With respect to domestic monetary policy, he was pleased to learn that the authorities had already adopted measures that sought to avoid additional pressures from that source. However, because of the influence of external factors, he was afraid that Honduras could not expect as much stability as had been possible in the past. On the other hand, if Honduras' rate of inflation was not higher than that of its main trading partners, there would be no real reason for great discouragement or for much criticism.

The staff representative from the Western Hemisphere Department, referring to Mr. Massad's comments about the discrepancy in figures, said that throughout the report on recent economic developments (SM/74/199), the balance of payments loss for 1974 was estimated at SDR 15 million; the discussion on monetary projections on page 11 of that paper specifically mentioned SDR 15 million. Quite inadvertently, page 12 of the paper had shown the wrong amount, but that had been rectified by the recent issuance of a correction (SM/74/199, Cor. 2), changing the figure from SDR 8-12 million to SDR 15 million. Capital movements in Honduras, a question t touched on by Mr. Massad, were greatly influenced by internal political developments, and the authorities were well aware of the problem, particularly as they concerned the agricultural and industrial sectors. For that reason, the authorities attached great importance to the development plan and that explained why its formulation had taken so long; they were particularly anxious to restore a climate of investor confidence in the agricultural and industrial fields. The authorities likewise were conscious of the fact that some of the measures contemplated might be misinterpreted initially, such as had occurred in connection with the recent measures in the agricultural sector that affected the lumber industry and agrarian reform. They were hopeful that, once the measures had been implemented, the public would view them as sensible steps in the right direction and thus result in a bolstering of investor confidence. Meanwhile, of course, they had just revised the interest rates and to some extent that step should serve to attract domestic capital.

The Executive Directors then concluded their discussion of the report for the 1974 Article VIII consultation with Honduras.

4. DRAFT AMENDMENTS - PROVISIONS OF ARTICLE XXV ON OPERATIONS AND TRANSACTIONS IN SPECIAL DRAWING RIGHTS

The Executive Directors considered draft amendments of the provisions of Article XXV on operations and transactions in special drawing rights as proposed by the staff in DAA/74/11 (8/16/74).

The General Counsel recalled that one of the requests emanating from the Committee of Twenty concerned an improvement in the characteristics of the SDR in order to broaden its scope and use. Although other improvements would be found in the draft amendments, the fundamental changes proposed in DAA/74/11 went to the heart of the improvements that had been requested. As would be seen by the listing on page 1, the staff paper covered five basic topics, all relevant to any effort at improving the characteristics of the SDR. Two of the topics--(a) transactions by agreement; and (c) relaxation of the requirement of need--were particularly intricate and hard to keep a grip on at all times, as even staff members had found. He hoped that a brief explanation of both of those topics as they related to the proposed amendments would be found useful.

With reference to designation, the General Counsel said that, within four specific categories of transactions, the present provisions of the Articles allowed participants to use their SDRs by agreement with the issuer of a currency in circumstances in which the issuer was redeeming its currency. The Fund, of course, prescribed the transactions that fell within those four categories, and those categories were basic to the sound operation of the scheme as originally conceived. Incidentally, one of those categories concerned reconstitution and there now appeared to be widespread agreement that the obligation of reconstitution should not be perpetuated. The prescription of a transaction that fell within any of those four categories required a decision by the Executive Directors, but the Board of Governors, by an 85 per cent majority, could extend the list of transactions or categories of transactions that could be entered into by agreement and without designation. Hence, there was some latitude to depart from the principle of designation, provided the Board of Governors were to act in the manner he had described. With regard to the expectation of need, the criterion that a member must need to use reserves when it used SDRs was likewise subject to exemptions, but always within the same four categories that he had mentioned. It was particularly in connection with the restrictions on the use of SDRs by agreement and with the requirement of need that suggestions were being made for the liberalization of the scheme, and he would attempt to clarify how the amendments sought an easing of the restrictions.

The provisions shown under alternative A, the General Counsel continued, had been designed to enable the Fund to prescribe transactions by agreement without limitation, and unfettered by the need of a high majority for decisions by the Board of Governors. In exercising that authority, the Fund would be empowered to waive the requirement of need with respect to those or other transactions. It was understood, of course, that the Fund would be able to exercise the power in relation to particular transactions or categories of transactions. Thus, alternative A amendments would give the Fund complete and direct freedom to permit transactions by agreement and to permit them in the absence of need, and that in turn afforded members a higher degree of freedom. The proposals under alternative B were basically identical, except that they eliminated the need for prescription by the Fund, thereby giving members complete and direct freedom to act.

It would be perfectly feasible, the General Counsel commented, to derive variants by combining some features of each of the alternatives. One possibility was suggested by the note that appeared on page 4 of the staff paper, for example, to permit the Fund to prescribe transactions to be entered into by agreement by participants with the automatic consequence that the participants would be free of the requirement of need. In a sense, that would confer a broader freedom on both the Fund and participants, and it would be difficult to say which of them carried more direct freedom in the first instance.

Mr. Kafka said that he understood the reform proposed under alternative A and it seemed to be a desirable one. However, it seemed that alternative B in fact would be opening the door to purely speculative transactions in SDRs, as in essence it appeared to encourage countries to switch SDRs against currencies, and he wondered whether the Fund really wanted to move in that direction.

The General Counsel stated that in formulating the proposals under alternative B, the staff certainly had had no intention of precipitating undesirable consequences nor, of course, of appearing to espouse a policy that encouraged speculation. Admittedly, the effect of alternative B tended toward greater freedom, perhaps more than was desired. He recalled that at the time the original provisions were drafted, one view was that there should be the utmost leeway for consensual transactions, precisely as had been contemplated in alternative B. One safeguard against adverse effects would be available under Article XXVIII, in which it was stipulated that, in addition to obligations assumed with respect to SDRs, each participant undertook to collaborate with the Fund and other participants to facilitate the effective functioning of the Special Drawing Account and the proper use of SDRs. That provision, deliberately couched in general terms, had been designed originally to enable the Fund to take action ranging from mere representations to more severe measures if it concluded that members were subverting the scheme. Obviously, views might differ about the efficacy of that provision, but it should be remembered that it was based on Section 4(a) of Article IV, a provision that had come into increasing use.

The Treasurer, referring to the possibility of speculation, said that each transaction in fact represented a merging of the interests of each of the participating parties. Therefore, if there were to be a speculative agreement, each of the parties would have its own view of the outcome; otherwise the agreement would not have been made. For example, one participant might wish to unload SDRs, while the other might wish to accumulate them, and it was not clear that the transaction could be regarded as speculative. On the other hand, if it was found that there might be a general speculative tendency to get rid of SDRs, it should be remembered that unloading could only occur through the designation process and not through a system based on mutually satisfactory bilateral agreements. Moreover, if there were to be a general tendency toward speculation in SDRs relative to currencies, instruments were available to the Fund, such as the interest rate or the value of the SDR, to make the SDR more competitive with those other assets.

The Deputy Director of the Research Department stated that it might be a little risky to assert that there was no danger of speculation of any kind. However, so long as the principle of equal value was maintained, the possibility of speculation would be greatly diminished. It was not beyond the realm of possibility that a group of countries might cooperate to keep as many SDRs as they could among themselves or, conversely, to get rid of them. On the other hand, if SDRs became very attractive, then it was conceivable that countries that had to use them would seek to make arrangements to keep them within a given circle. In his view, that appeared to be the only danger, but he did not feel that it would constitute a serious threat to the system.

Mr. Cross said he interpreted the replies to Mr. Kafka's very pertinent question to mean that the transactions were between "consenting adults," as it were, and that speculation could occur only if both participants were so inclined. He could visualize, however, all sorts of situations that could arise. For instance, country A could agree to take certain actions helpful to country B but only if the latter would agree to provide the former with some of its SDRs. Another situation could develop where country A might be in deficit and be expected to provide SDRs under the Fund's normal procedures to country B, but in order to avoid doing so, it would pass its SDRs to a third country with which it had a special relationship. Were contingencies of that nature covered in the present amendments?

The General Counsel remarked that the point raised by Mr. Cross was difficult, but lay at the heart of the matter. He would not venture an opinion on the degree of suspicion with which the operation of a liberalized scheme should be viewed. Tight procedures and heavy safeguards could be imposed, as had been done originally. However, the trend of present policy appeared to call for liberalization, with <u>ex post facto</u> application of pressures if those seemed indicated by events.

The Treasurer, referring to Mr. Cross' point about the possibility of a parallel understanding in exchange for an SDR transaction, commented that if the understanding were financial in nature, it would presumably contravene the equal value principle. The Executive Directors had been concerned with one situation of that type in theory, but the issue had not yet been confronted in practice. Furthermore, when the agreement was concluded with the Bank for International Settlements (BIS) as an Other Holder of SDRs, one of the major concerns was that over a period of time there could be an undue concentration of SDRs in the hands of the BIS. The decision was not to limit transactions between participants and the BIS. The agreement, however, included several clauses providing for consultation, review and cooperation between the BIS and the Fund for the purpose of preserving the efficiency and satisfactory working of the SDR scheme as a whole.

Mr. Bryce indicated that he preferred the second format of alternative B appearing on pages 18 and 19 of the staff paper. Besides being logical and cohesive, that proposal seemed best to meet what he and his constituency had envisaged as a result of lengthy discussions in meetings of the Committee of Twenty. There should be as much freedom as possible for transactions between participants, but such operations were not to be conducted in private. Instead, they would be open to public view with the expectation that they would be scrutinized by an expert staff well aware of the reasons for critical examinations. It was true, however, that those voluntary transactions could be speculative in nature, as Mr. Kafka had said, but that did not appear to represent any real harm. If some people took the view that the SDR was a better asset than the dollar, and others took the opposite view, there was no reason why that preference could not be reflected in reserve situations. Obviously, the price of the dollar in terms of the SDR could not affect the market, but at least voluntary transactions should be allowed to go as far as desired in adjusting holdings in accordance with preferences.

Turning to the proposal for Article XXV, Section 2(d) on page 19, Mr. Bryce noted that it provided for the Fund to prescribe the terms and conditions under which participants would be authorized to engage in operations and transactions other than those permitted under paragraphs (a) and (b) immediately preceding it. However, those other transactions were not described, although he presumed that in some way they would involve the use of SDRs. It would seem advisable to clarify Section 2(d) so that its meaning would not have to be derived by inference. In looking at the following paragraph, Section 3(a), he wondered what was meant by the phrase "...or in the light of developments in its official holdings of gold, foreign exchange, and special drawing rights, and its reserve position in the Fund... ." No doubt there might be good reasons for that wording, but when it was combined with the remaining portion of the paragraph, he was at a loss to know what it was intended to allow or prevent. It did seem that the composition of reserves could be taken into account, but not for the sole purpose of changing the ratio of SDRs in relation to the other holdings. He would appreciate further information on that point.

The new formulation of Section 3(c) on page 20, Mr. Bryce continued, simplified the original version by deleting the first phrase and references to promoting reconstitution. However, the use of the word "waive" brought to mind the fact that that word had not appeared in the original Articles and its use at the top of page 3 of the staff paper--"...participants are expected to use SDRs only when they have a need to do so, but the Fund, by a majority of the votes cast, may waive this expectation within four specific categories, which are the same as those specified in Section 2(b)"--caused him some slight concern. He had thought that the circumstances in fact would lead to the judgment that there would not be a need to fulfill the expectation, and not that a waiver would have to be granted. That seemed appropriate, as participants who were giving up SDRs were doing so because of another participant's needs, and were not merely satisfying their own needs. He therefore felt justified in preferring alternative B, as it eliminated the test of need for voluntary transactions. But if the use of designation were to be continued, then the test of need should be retained, and perhaps in that context the word "waive" could be employed because of the reliance placed on compulsory powers, as opposed to powers of agreement, to achieve the desired objectives insofar as SDR recipients were concerned. Consequently, he did not object to the new phrasing for Section 3(c), provided the word "waive" did not in fact apply to that paragraph.

The General Counsel, replying to Mr. Bryce's first question about the scope of Section 2(d), indicated that the paragraph was common to all versions of the drafts. It empowered the Fund to permit by prescription operations and transactions other than those to be found in the specific provisions of the Articles. He recalled that, even at the time when the original provisions were being drafted, there had been some feeling that there might well be other types of transactions that would be appropriate, both in terms of policy and in the interest of improving the SDR, and a provision along those lines had been considered. Although it came close to being accepted, it finally was decided that it was too venturesome to incorporate in the fledgling scheme. The present draft amendment did not seek to stipulate in advance what those operations and transactions might be. In the explanatory comments of the staff paper several examples of the possible types of transactions had been given, such as grants, loans, pledges and the direct settlement of obligations. Indeed, there might be others, such as swaps, and no one could say in advance whether any transactions would always be desirable or undesirable. The provision merely made it possible to permit new types of transactions when the circumstances were deemed appropriate.

One of the possible safeguards, the General Counsel noted, was that of a higher majority, as indicated in the square-bracketed portion of Section 2(d). Insistence on a higher majority would depend upon the extent to which it was felt that a provision of that nature should or should not constitute a normal feature of the scheme in operation. The other safeguard, of course, would be in the prescription of terms and conditions under the general criterion that they must be consistent with the effective functioning of the scheme as a whole. There had been occasions on which the prescription of some of those transactions would have been useful. For example, it would have been useful for a participant to use SDRs in the direct settlement of obligations. It should be understood that the provision did not relate in any way to the SDR as a unit of account, as that was neither an operation nor a transaction in itself, and anyone could use the unit even now without violating the Articles.

In his second question, the General Counsel continued, Mr. Bryce had asked about the meaning of a portion of Section 3(a) on page 19. That same question, incidentally, had been the subject of discussion in the report forwarded by the Executive Directors to the Board of Governors when the original amendments had been proposed. The topic had been much discussed. It was his understanding that the provision permitted the use of SDRs when there was a need to use reserves, including redemption by a member of its own currency. Even when the provision was observed, there were circumstances that could bring about a change in the composition of reserves, and for that reason there was the added provision that if a member had a need to use reserves it could bring about a change in the composition of its reserves.

With respect to Section 3(c) on page 20, the General Counsel said that exemptions by prescriptions were in effect "waivers" even now. The point was a verbal one only and did not affect the substance of Section 3(c), as Mr. Bryce himself had surmised.

The Treasurer, referring to Section 2(d) on page 19, said that the present Articles permitted the use of the SDR as a unit of account. That use should be continued in the future, as he did not feel that members should be enjoined from using the SDR as a unit of account. With regard to Mr. Bryce's question on Section 3(a), the first three lines of that paragraph did not cover only a situation where a balance of payments deficit was reflected in a decline of gross reserves. It also had been intended to cover the situation of reserve currency countries in buying back balances of their own currency, thus reducing their official short-term liabilities, under the present provisions of Section 2(b) and subject to the requirement of need. He had not found the question easy to explain to participants when they had questioned him about it, nor was he certain that his explanation was entirely correct, inasmuch as the Executive Directors had never agreed on an interpretation of the issue.

The Deputy Director of the Research Department expressed the opinion that all concerned would agree that Section 3(a) indeed was not perspicuous. He had always thought that the second clause--"in the light of developments..."--was not an explanation of meeting a balance of payments need, but merely an example. A balance of payments need might manifest itself in a decline of gross reserves, or in a rise in reserve liabilities in the case of a reserve center, and either of those would constitute a legitimate reason for using SDRs. The middle and last parts of the paragraph in effect meant that SDRs could be used to the extent required to prevent a decline in other reserves, but not to the extent of creating a rise in other reserves; that would alter the composition of total reserves and the ratio between SDRs and other reserves.

Mr. Bryce said it was somewhat disturbing that the phrasing of that particular paragraph had required such elaborate explanations on the part of the staff. That circumstance certainly led to the conclusion that a reader of the section could not be expected to understand precisely what it was intended to convey. Clearly, there should be no question about redrafting the paragraph so that most readers would understand what was meant by balance of payments needs. If he had correctly understood the explanations, the sense of the paragraph was that when a country had used up some of the other types of its reserves in meeting a deficit, it would subsequently be allowed to use SDRs to restore the composition of its reserves to the position prevailing two or three months earlier. When Canada lost reserves, for example, it lost them in terms of U.S. dollars on a daily and even weekly basis. If Canada chose to use its SDRs, either by designation or voluntary transactions, it would be doing so for the purpose of changing the composition of its reserves because of the losses suffered. Based upon explanations he had heard previously as well as during the present meeting, that sort of action seemed to be entirely appropriate. If that was the intent, surely it could be expressed in much clearer language.

The General Counsel noted that the language of Section 3(a) of the draft amendment in fact was the original language, and he recalled that it had resulted only after many sessions, and that the use of SDRs by reserve currency countries had been considered a major problem. When the scheme went into effect, the staff had made efforts to give precision to the provision but, as the Treasurer had stated, the Executive Directors had been unwilling to adopt firm criteria. That attitude stemmed partly from the desire to have as flexible a scheme as possible; and firm criteria, particularly with respect to need, clearly would limit the usability of SDRs.

Mr. Yaméogo inquired what the effect would be of deleting the last portion of Section 3(a), from the words "and not" in the fifth line.

The General Counsel remarked that the phrase "and not for the sole purpose" had been deemed desirable as a means of extending, rather than curtailing, the usability of SDRs. Therefore, from the operational point of view, it was regarded as a liberalizing provision. The topic could be studied and a paper could be prepared for discussion. The concept was a difficult one. For example, what was the relationship between the concepts of need in the two Accounts?

The Deputy Director of the Research Department, referring to Mr. Bryce's earlier question, said that the provision about not changing the composition of reserves had never been interpreted as applying on a day-to-day basis, but rather over a period of time. Consequently, if it were to be made more precise, it would necessitate specifying a particular period in the past, a rather difficult undertaking. With respect to the concept of the requirement of need, if the entire question was to be reconsidered, there would be a case for taking some account of reserve levels in addition to the flow of reserves. In other words, if a country had an extremely low level of reserves, it would seem reasonable to apply a different test. Indeed, such a change seemed logical, as the level of reserves was taken into account at the higher end of the scale when SDR designation was involved.

Mr. Yaméogo asked whether, in addition to the suggestion made by the Deputy Director of the Research Department, consideration also could be given to current account needs, as that was the most important criterion with regard to the oil facility. A country could have a deficit in its current account, for instance, which could be offset by long-term capital inflows that would not necessarily increase its disposable reserves.

The General Counsel stated that the present text of the provision certainly did not refer exclusively to the current account. Although originally there had been heavy and almost exclusive emphasis on the use of the General Account in connection with deficits on current account, that view had been liberalized as time progressed. With respect to the General Account, it would not be correct to maintain that the Fund's resources were usable solely for deficits attributable to the current account. For that reason, there appeared to be no justification for narrowing the language of Section 3(a).

The Treasurer observed that the SDR was available for covering any balance of payments need, irrespective of the origin of that need, because the SDR had the nature of a reserve asset.

Mr. Schneider, speaking in a more general sense, said that the mandate (Outline, Part II, paragraph 41) from the Committee of Twenty in reality afforded leeway for either of two courses to be pursued. The first would be to limit amendments to an adaptation of the present Articles to provide for the Fund's orderly functioning under present circumstances. The other course would be to initiate the evolutionary process of reforming the Articles along the lines of the reformed world monetary order as set forth in Part I of the Outline. If the latter course were to be followed, it would be a matter of judgment about how far the reform would be taken. Considering the courses of action that were open, he believed that his authorities were rather reluctant to move too quickly at the present time, and they were not yet prepared to go beyond a somewhat limited scope of amendments. For example, and merely as an example, his understanding of a limited scope would be to consider some of the proposals to broaden the use of SDRs, together with changes in other areas of the Articles that would flow from a broadening of the use of SDRs. In brief, his authorities were inclined to limit the exercise to changes that undoubtedly were necessary and useful, and to changes to which the term "housecleaning" had been applied in the past.

It was not inconceivable, Mr. Schneider continued, that his authorities might change their position, but it did seem that more discussions were needed at the political level before proceeding further. A convenient occasion for those discussions would be during the forthcoming Annual Meeting, and it would be very useful if the Managing Director's opening address could include an outline of the possible scope of the amendments and an evaluation of their effect on the members as well as on the Fund. With respect to the staff paper under discussion, and for the reasons he had mentioned earlier, he considered proposals like eliminating the acceptance limit as well as the opting out provision as premature and not appropriate under present circumstances. It was also not clear what consequences the proposed simplification of the concept of currency convertible in fact might have, if in that way the number of currencies convertible in fact was broadened considerably. In any event, he doubted that the limited time available would permit a thorough examination of the complexities of all the amendments, and the making of proposals to the Board of Governors for their adoption, assuming, of course they could be agreed upon in the first place.

The General Counsel remarked that Mr. Schneider had raised questions of policy, and he would not disagree with the opinion that eventually political decisions would have to be taken. The staff, however, as he had indicated on other occasions, had as its term of reference the list put forward by the Committee of Twenty, and the scope of action prescribed therein had not been exceeded. It was not up to the staff, on its own initiative, to pare that list in any way.

Mr. Lieftinck indicated that his Netherlands authorities shared the views expressed by Mr. Schneider, but that would not prevent him from participating in the discussions, even though on a personal basis. In his opinion, the present provisions of the Articles that dealt with agreed transactions and expectation of need were somewhat restrictive and should be liberalized. He would concentrate, however, on liberalizing the Fund's authority rather than the participants' freedom of action, and therefore he preferred the proposals under alternative A. At the present stage of relationship between the SDR and the monetary system, it would be important to preserve certain principles that had been embodied in the original amendments. For example, the SDR system would be ill served by a concentration of SDR holdings among a few members, as compared with a wide dispersion of SDRs. Accordingly, he favored continuance of the concept of designation and prescription of permissible transactions for the foreseeable future. He preferred maintaining the expectation of need provision, even with the present volume of SDRs--which would be increased by new allocations or by the substitution provision if it became operative--because otherwise it could precipitate disequilibrating reserve movements, a contingency that should be guarded against.

Under the existing Articles, Mr. Lieftinck continued, permissible transactions had already resulted in lack of harmonization in the distribution of SDRs among participants. It had been the designation process that had borne the full burden of seeking to establish a certain amount of harmonization. Consequently, he would be in favor of allowing the Fund to prescribe transactions by a simple majority, despite the danger of conflicting with the harmonization principle, if it was felt that such transactions would be conducive to the usage of SDRs in the international monetary system.

Mr. Palamenghi-Crispi noted that on previous occasions several Executive Directors, Mr. Bull in particular, had requested the preparation of a comprehensive paper outlining the general philosophy of the amendment exercise to permit a better understanding of the implications and ramifications of the reform. Such a paper would be useful and in fact he saw the need for one on the SDR amendment covering all of the suggestions that had any bearing on the operation of the Special Drawing Account. It seemed clear that the SDR was going to be the main reserve asset of the system, both in the interim period and for the long run, as no one really knew how long the interim period would last. The paper should indicate the extent to which the legal framework of the SDR could be reformed, and set forth more wide-ranging solutions, describing the lines along which the SDR system could or should evolve. Quite candidly, it would seem desirable to avoid creating a situation that would involve further amendments in the near future. Therefore, current amendments should contain a sufficient degree of flexibility to permit adaptation to changing circumstances without formal amendment action.

Pending a more general paper on the Special Drawing Account, Mr. Palamenghi-Crispi said that his comments on the paper under discussion should be regarded as preliminary. He had always favored a greater degree of freedom in the use of SDRs than that allowed under the existing Articles, as that seemed the best means of promoting the SDR as the main reserve asset of the monetary system. Additionally, more flexible rules for SDR operations and transactions would, he hoped, overcome the reluctance of certain member countries to participate in the Special Drawing Account, thereby making the SDR acceptable to the Fund's entire membership. In that context, he therefore preferred alternative B on pages 18 and 19 of the staff paper, as it gave participants complete freedom to engage in agreed transactions and eliminated the need for prescription action on the part of the Fund. As it would be a natural consequence of that greater freedom, he would also support the abolition of the expectation of need for agreed transactions, a requirement he had always viewed as constituting a major impediment to the general acceptability of the SDR as a true reserve asset, particularly by chronically surplus countries.

Referring to Section 3(c) on page 20, Mr. Palamenghi-Crispi wondered why it was necessary to repeat the listing from paragraph (a). The explanatory note on page 4 mentioned that the list was retained only in relation to designated transactions to enable the Fund to waive the expectation of need for that category of transactions. However, it would seem that the same paragraph under alternative A on page 7 accomplished the identical purpose much more succinctly and, if his presumption was correct, he would change his preference to alternative B for Section 2, which was common to both alternatives, as it would enhance the flexibility of the Special Drawing Account. He would not, however, make those transactions subject to a qualified majority of the total voting power, as the provision that enabled the Fund to prescribe terms and conditions for those transactions was enough of a safeguard to insure the proper functioning of the SDR account.

In a more general sense, Mr. Palamenghi-Crispi said, referring to a distinction made earlier by the General Counsel, it would be better not to burden the SDR scheme with too many limitations and constraints, so long as the Fund retained powers to intervene if anything went wrong. Although the SDR was a young asset, in Mr. Cross' words it would be used only by "consenting adults" and there was justification for a presumption of good behavior. With respect to Section 4, he had always favored the abolition of the acceptance limit in order to confer upon the SDR the same reserve status applicable to other assets. He preferred the alternative A version of Section 4(a) on page 21. He could also endorse the proposed change to Section 8 that would enable the Fund to take ad hoc decisions on exchange rates applicable to special cases covered by Section 2(d).

The General Counsel indicated that while he would want to consider Mr. Palamenghi-Crispi's statement in more detail to see what other issues he had raised, one point stood out in reference to the redraft of Section 3(c) on page 20. That provision was desirable in connection with designation because the freedom that would be introduced under the scheme, regardless of which alternative might be preferred, applied to transactions entered into by agreement. There remained the question whether it was useful in connection with designated transactions to exempt the transferors of SDRs from the requirement of need.

The Executive Directors agreed to resume in the afternoon their discussion of the draft amendments on provisions of Article XXV on operations and transactions in special drawing rights.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Directors without meeting in the period between EBM/74/115 (9/13/74) and EBM/74/116 (9/16/74).

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/74/216, Supplement 1 (9/12/74) and EBAP/74/228 (9/12/74) is approved.

APPROVED BY THE EXECUTIVE BOARD:
Meeting 75/8, January 31, 1975

WILLIAM B. DALE
Acting Chairman

ROGER V. ANDERSON
Acting Secretary