

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/170

3:00 p.m., November 25, 1985

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

Executive Directors

C. H. Dallara

M. Finaish

G. Grosche

J. E. Ismael

M. Massé

E. I. M. Mtei

Y. A. Nimatallah

P. Pérez

J. J. Polak

C. R. Rye

G. Salehkhoul

A. K. Sengupta

S. Zecchini

Alternate Executive Directors

A. R. Ismael, Temporary

M. K. Bush

H. C. Schneider

S. de Forges

T. Alhaimus

M. Sugita

Jaafar A.

J. Hospedales, Temporary

M. Foot

H. Fugmann

L. Leonard

A. Abdallah

C. A. Salinas, Temporary

J. E. Suraisry

J. de Beaufort Wijnholds

A. V. Romuáldez

A. S. Jayawardena

N. Coumbis

Jiang H.

L. Van Houtven, Secretary

K. S. Friedman, Assistant

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Also Present

African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; J. D. Simpson. Asian Department: L. Mendras. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; J. T. Boorman, S. Kanasa-Thanas. Legal Department: G. Nicoletopoulos, Director; F. P. Gianviti, Director Designate; J. G. Evans, Jr., Deputy General Counsel; Ph. Lachman, S. A. Silard. Middle Eastern Department: M. Zavadjil. Secretary's Department: A. P. Bhagwat, G. Djeddaoui. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; T. Leddy, Deputy Treasurer; D. Berthet, J. E. Blalock, J. C. Corr, S. I. Fawzi, D. Gupta, W. E. Hermann, M. F. Melhem, D. V. Pritchett, G. Wittich. Office of the Managing Director: C. P. McCoy. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, G. R. Castellanos, M. B. Chatah, L. P. Ebrill, S. Ganjarerndee, S. M. Hassan, G. Nguyen, P. Péterfalvy, G. W. K. Pickering, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, I. Angeloni, A. Bertuch-Samuels, J. de la Herrán, J. J. Dreizzen, V. Govindarajan, G. D. Hodgson, L. Hubloue, O. Isleifsson, Z. b. Ismail, S. King, H. Kobayashi, M. Lundsager, M. Rasyid, J. Reddy, J. E. Rodríguez, V. Rousset, L. Tornetta, A. J. Tregilgas, H. van der Burg, E. L. Walker, B. D. White.

1. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT  
UNDER RULE K-1

The Executive Directors considered the Managing Director's complaint under K-1, concerning Somalia's overdue financial obligations to the Fund (EBS/85/235, 10/25/85; and Sup. 1, 11/20/85).

Mr. Finaish said that the authorities fully recognized the seriousness with which the Fund viewed overdue financial obligations and the negative implications of such obligations for the Fund's ability to perform its role in assisting members. Moreover, Somalia's record of cooperation with the Fund was good, and the country's keen interest in maintaining that constructive relationship had reinforced the authorities' determination to give priority to dealing with their overdue financial obligations to the Fund. Although the payments made by Somalia over the previous several weeks were only partial, they were a sign of the authorities' eagerness to deal with the problem of Somalia's arrears and should be seen in the context of Somalia's extremely difficult foreign exchange situation of the previous several months.

The shortage of foreign exchange available to the Government had developed partly because of loan disbursement delays and insufficient flexibility in the type of external assistance that had been pledged during the donors' meeting in January 1984, Mr. Finaish continued. Another factor was the shortfall in the Government's receipts of foreign exchange from exports. The authorities had attempted to acquire the necessary foreign exchange from the private market, and foreign exchange purchases had been made, thereby contributing to the significant depreciation of the Somali shilling in the private market. However, the authorities had faced logistical difficulties in making large purchases due to the relatively thin and fragmented nature of the private foreign exchange market in Somalia. That issue, the broader question of the exchange system, and other issues had been discussed by the staff and the authorities at a meeting in Paris earlier in November 1985. During those discussions, understandings had been reached between the authorities and the staff, especially with respect to the date for exchange rate unification, the pace of adjustment of the official rate in the interim period, and the mechanisms that would permit the Government to obtain foreign exchange from the private market, thereby avoiding any further accumulation of arrears.

The authorities had hoped that the discussions of the remaining policy issues could take place in the third week of November 1985, Mr. Finaish went on. However, delays in the preparation of the budget had necessitated a postponement of those discussions for about one month. The authorities still hoped that the discussions with the staff, which were to take place in Mogadishu in the coming several weeks, would result in full agreement on the various policy issues. At the same time, the authorities were seeking bridging finance from commercial sources which would enable them to become current in the Fund. The availability of

such finance would of course be facilitated by, and might depend upon, a proper signal from the Fund, once progress in the discussions reached a point where such a signal could be made.

The authorities were making every effort to become current in their obligations to the Fund, Mr. Finaish concluded. Their efforts would be greatly facilitated by flexibility in the modalities and timing of the disbursement of aid pledged during the consultative group meeting in Paris earlier in November 1985. Somalia had begun a major structural adjustment effort in cooperation with the Fund, and the authorities were anxious to resolve the issue of the overdue obligations to the Fund so that the institution's useful role in support of the adjustment effort could be maintained.

Mr. Nimatallah remarked that Somalia had a good track record with the Fund. The authorities had been trying hard to introduce and maintain appropriate policies over the previous several years, but external factors beyond the control of the authorities had resulted in the accumulation of arrears. The authorities should make every effort to become current in the Fund before the arrears became unmanageable. He was pleased that the staff intended to visit Somalia soon in order to work closely with the authorities in finding a solution to the problem of the arrears.

Continuing, Mr. Nimatallah suggested that the second paragraph of the draft decision should read: "The Fund urges Somalia to become current in its financial obligations to the Fund as soon as possible, and to avoid thereby the need for the Fund to take remedial action." That statement would send an explicit message to Somalia about the need to adopt strong measures in order to become current in the Fund. The original second paragraph of the draft decision should become paragraph 3. A similar format should be used in future decisions on cases like Somalia. In addition, the Managing Director's complaint should be brought back to the Executive Board's agenda in three weeks rather than the usual four weeks. He had an open mind on that particular issue and could go along with the usual four-week period if other Executive Directors preferred it.

The third paragraph--the present draft paragraph 2--could be shortened by eliminating the second sentence, Mr. Nimatallah commented. There was no need to remind the authorities that they would be informed of the Executive Board's decision by rapid means of communication and that the authorities had the right to present their views through an appropriately authorized representative. It would be sufficient instead to amend the first paragraph to read: "Consideration of the complaint in accordance with Rule K-1 particularly affects Somalia, and the procedures set out in EBS/85/235 shall be followed."

The staff representative from the Legal Department said that Mr. Nimatallah's proposed changes in the draft decision were consistent with the Fund's Rules. EBS/85/235 carefully set out the procedures that would have to be followed in accordance with Rule K-1, and the proposed

reference to that paper in paragraph 1 of the decision would obviate the need for the final sentence in paragraph 2 of the proposed decision. The kind of additional paragraph that Mr. Nimatallah had suggested, urging a member to become current in its obligations to the Fund, had not been included in decisions on previous similar cases, but the Managing Director had explicitly made the same point in his communication to each member concerned in which he had described the Executive Board's discussion of the country's overdue financial obligations. Hence, the proposed additional paragraph was appropriate.

Mr. Finaish remarked that immediately after the present discussion on Somalia the Executive Board was scheduled to hold a general examination of overdue financial obligations to the Fund. The proposed changes by Mr. Nimatallah in the draft decision might well give the Somali authorities the impression that they were being treated differently from other members in a similar situation in the recent past.

Mr. Nimatallah said that it was up to the Executive Board to choose the period between the discussions on each member's overdue financial obligations; the Board was not bound to choose any particular period. In the case of Somalia, three weeks before the next discussion seemed sufficient. The additional paragraph he had proposed would merely state explicitly the actions that the Executive Board hoped that the Somali authorities would take in the near future. The authorities would, of course, read the decision carefully, and it would therefore be useful to urge them in the decision to become current in their financial obligations to the Fund. The changes in the text which he had proposed were minor drafting amendments, not substantive alterations.

Mr. Grosche said that he had an open mind on the date to be inserted in paragraph 1 of the proposed decision. In determining the date the Executive Directors would naturally wish to keep Mr. Finaish's opening comments in mind. It would also be helpful to know more about Somalia's likely financing arrangements and adjustment policies. The additional sentence proposed by Mr. Nimatallah was appropriate, although it seemed unnecessary to shorten the text of the existing paragraph 2.

Ms. Bush commented that she had an open mind on the date for the next discussion on Somalia's overdue financial obligations. The additional paragraph suggested by Mr. Nimatallah was acceptable.

The staff representative from the Treasurer's Department said that it might be helpful to say "promptly" instead of "as soon as possible" in the additional paragraph that Mr. Nimatallah had proposed.

The staff representative from the African Department remarked that the staff had held discussions with the authorities during the 1985 Annual Meetings and at a subsequent meeting in Paris in order to complete the review under the stand-by arrangement that had been postponed in June 1985. The stand-by arrangement was due to end in mid-March 1986, and, at the request of the authorities, it was intended to extend the life of the arrangement.

During the discussions at the 1985 Annual Meetings the staff and the authorities had reached an understanding that the stand-by arrangement would be extended and the appropriate economic and financial program would be adopted, the staff representative continued. The staff had felt that as the stand-by arrangement was to be extended, the delayed review discussions should result in an agreement on a fairly detailed description of economic policies for 1986. It was clearly understood that another stand-by arrangement would be requested to follow the present arrangement.

During the discussions in Paris--at the time of the consultative group meeting--the staff and the authorities had reached an understanding on the exchange transactions that would have to be shifted to the official market in order to ensure equilibrium in the exchange market, the staff representative went on. There had also been an understanding on the implications of that switch for the budget targets and a timetable for the unification of the exchange rate in 1986.

The authorities had initially said that they intended to hold discussions within the Government on the 1986 budget and to invite the staff to visit Somalia in November 1985 to complete the discussions on the review under the stand-by arrangement, the staff representative from the African Department explained. However, the authorities had subsequently asked the staff to postpone those discussions for some weeks as they had not yet completed their discussions on the budget. At present, the staff intended to visit Somalia in early January 1986. Unless internal difficulties arose in Somalia, the staff was fairly confident that it would be able to complete the discussions on the review under the stand-by arrangement during its visit in early January 1986.

Mr. Mtei remarked that the authorities were obviously determined to bring their economic and financial program back on track as soon as possible. In considering the Managing Director's report and complaint the Executive Directors should bear in mind the current unfavorable economic conditions in Somalia. The full cooperation of the authorities, donors, and multilateral institutions--especially the Fund and the World Bank--would be needed to help Somalia deal with those conditions.

Mr. Rye and Mr. Pérez said that they preferred to hold the next discussion on Somalia within four weeks.

After a further brief discussion the Executive Board agreed that the Managing Director's report and complaint should be placed on the Executive Board's agenda for December 27, 1985.

The Chairman commented that the second sentence of draft paragraph 2 contained important information that the authorities would wish to be aware of as quickly as possible. A reference merely to the relevant staff paper might not give the authorities sufficient information.

Mr. Finaish remarked that he too preferred to leave draft paragraph 2 as it stood. The various procedures described in EBS/85/235 had to do with matters in addition to those mentioned in the second sentence of draft paragraph 2. He continued to feel that adding the paragraph proposed by Mr. Nimatallah at the present stage--immediately before a general discussion on overdue financial obligations to the Fund--would be inappropriate.

The Chairman commented that the additional paragraph suggested by Mr. Nimatallah made an obvious point--namely, that the Fund urged Somalia to become current in its obligations. That point was indeed at the heart of the complaint under Rule K-1. A similar statement could have usefully been included in similar previous decisions. The additional paragraph did not constitute a substantive innovation in the Executive Board's procedures for handling overdue financial obligations.

Mr. Mtei considered that draft paragraph 2 of the decision under consideration should be the same as the relevant paragraph in previous decisions on overdue financial obligations. The Fund should be certain to inform each member concerned by rapid means of communication of the Executive Board's decision on a member's overdue financial obligations.

The Executive Board then took the following decision:

1. The complaint of the Managing Director dated October 25, 1985 on Somalia, as amended (EBS/85/235; Sup. 2), is noted. It shall be placed on the agenda of the Executive Board for December 27, 1985.

2. The Fund urges Somalia to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule K-1 particularly affects Somalia. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8137-(85/170), adopted  
November 25, 1985

## 2. OVERDUE FINANCIAL OBLIGATIONS - SIX-MONTHLY REPORT

The Executive Directors considered the six-monthly report on overdue financial obligations to the Fund (EBS/85/245, 11/5/85; and Sup. 1, 11/22/85). They also had before them a background note circulated by Mr. Dallara (see Annex).

Mr. Dallara remarked that the staff report once again called attention to the seriousness of the problem of arrears to the Fund. By any standard quantitative measures--the amount and average duration of the



arrears, as well as the number of the countries involved--that problem had been worsening. Outstanding overdue obligations had increased from 0.4 percent of outstanding Fund credit at the end of 1984 to 1.1 percent at the end of September 1985. At the same time, arrears in relation to the Fund's reserves had grown substantially, from 22 percent at end FY 1985 to 40 percent currently.

Earlier in 1985 he had joined other Executive Directors in supporting certain prudential steps to strengthen the Fund's financial position in response to the problem of overdue financial obligations, Mr. Dallara recalled. The Executive Board had agreed to treat certain arrears as non-accrued income and to increase the income target for the current year from 3 percent to 5 percent of reserves. He wondered whether those decisions were still adequate, given the developments that had taken place since their adoption. The substantial increase in arrears in recent months had had a serious impact on the Fund's income position, something that had not been foreseen at the time of the adoption of the decisions that were meant to strengthen the Fund's financial position. The staff had recently projected a net deficit of SDR 32 million in FY 1986, and in his background note he had summarized the possible effect of the deficit on the Fund's income position and the rate of charge. The growth of overdue obligations to the Fund had clearly been a significant factor in the staff's revised projected deficit. On the basis of the scenario described by the staff in its report, which assumed the deferral of SDR 139 million in overdue charges from the Fund's income, the rate of charge would have to be raised to 7.87 percent retroactive to November 1, 1985. On the basis of somewhat pessimistic assumptions about the prospects for reducing the overdue charges, as summarized in Scenario II in his background note, the deficit for FY 1986 could be SDR 148 million, requiring a rate of charge of 8.94 percent retroactive to November 1, 1985 if the income target for FY 1986 were to be met. He was not projecting that outcome, and an increase in the rate of charge above the SDR interest rate would of course require, on the basis of current decisions, the Executive Board to conduct a review of the remuneration coefficient.

The decisions concerning the nonaccrual of charges and the reserve target for FY 1986 might not be sufficient to protect the Fund's financial position, Mr. Dallara commented. Other steps might have to be taken. The external auditors had mentioned the possibility of introducing a loan-loss provision. That proposal was complex and would have to be studied carefully before Executive Directors could appreciate all of its implications and reach a judgment on its appropriateness; however, it clearly deserved the Board's immediate attention. Under Scenario III in his background note a loan-loss provision equal to 20 percent of all current and estimated overdue repurchases through April 1986 by members in arrears for more than one month as of October 31, 1985 would require an increase in the rate of charge to 10.1 percent effective November 1, 1985 in the absence of other financial steps to meet the income target for FY 1986. Some members might feel that at the present stage the Fund need not consider a possible loan-loss provision, and the issue was admittedly closely related to the level of the Fund's reserves. Some of the issues

concerning a loan-loss provision had been discussed on previous occasions, and he hoped that the Executive Board could further examine those issues at an early date; the Fund must face squarely the question of a possible loan-loss provision. The estimates under Scenario III in his background note were not meant to be precise projections; they were intended to illustrate the serious implications that the arrears could have for the Fund.

Despite the efforts over the previous year by many members, the Executive Board, management, and staff to arrest and reverse the trend of arrears and to strengthen the Fund's financial position, the arrears problem had worsened and the Fund's financial position apparently had weakened, Mr. Dallara continued. He agreed with the staff that the financial problems facing the members with arrears to the Fund had to some extent been due to adverse exogenous factors. However, the situation of those members was not significantly or persistently worse than the situation of members that had remained current in their obligations to the Fund. It was important to recognize the efforts of the members that had remained current in their obligations despite the serious strains on their economies.

In its report the staff had noted that the Fund had taken preventive and corrective steps to deal with the problem of arrears, Mr. Dallara remarked. He welcomed the increasing attention given by the staff to the need for members to shape their balance of payments, reserve, and debt management policies in a way that would increase their ability to repay the Fund. Article IV consultations were helpful in that regard. Article V, Section 3 stated that "the Fund shall adopt policies on the use of its general resources...that will assist members to solve their balance of payments problems...and that will establish adequate safeguards for the temporary use of the general resources of the Fund." It was incumbent upon the Executive Board to review and consider thoroughly a member's ability to repay the Fund when the Board considered any request by a member to use the Fund's resources. Accordingly, the staff should include in papers containing requests by members to use the Fund's resources, a section analyzing the member's ability to repay the Fund. Such analysis was particularly important in view of the revolving character of the Fund's resources, which the Board must keep foremost in mind to protect the Fund's long-term financial strength. The analysis that he had in mind had occasionally been made--often indirectly--in some staff papers. A uniform analysis in all staff papers would complement the staff's medium-term balance of payments projections, which helped Executive Directors to judge a member's medium-term financial position.

The analysis of a member's ability to repay the Fund was closely related to the issue of the access to Fund resources that should be provided to each member, Mr. Dallara said. The staff had mentioned that in cases in which a relatively long time seemed to be needed for a member to achieve a sustainable balance of payments position, the Fund's role had been largely that of a catalyst of other resources. That approach was welcome. The application of the Fund's access policies in the current circumstances should be particularly cautious; even when a relatively moderate amount of the Fund's resources was requested by a member, the Fund must feel confident that the member could repay it.

The most fundamental way of preventing arrears to the Fund was the formulation by members of sound economic policies, Mr. Dallara continued. Such policies could contribute to the achievement of sustainable balance of payments positions, improve a member's creditworthiness in private markets, and increase confidence among donors, which would help to generate needed additional financing. During the 1985 Annual Meetings, Treasury Secretary Baker had outlined a broad approach to the possible use of Trust Fund reflows, perhaps in combination with other sources of financing, in support of comprehensive economic programs for low-income developing countries. That approach should support members' efforts to encourage domestic policy actions that would prevent the emergence of further arrears. During the 1985 Annual Meetings Secretary Baker had also outlined a strategy for achieving sustained economic growth which was based on the implementation of comprehensive economic programs supported by additional financing from commercial banks and on an enhanced financial role for the multilateral development banks as well as a continuation of the Fund's central role. Once comprehensive economic programs were in place, bilateral donors might also feel encouraged to lend active support to those programs. Secretary Baker's initiatives would involve concerted efforts by all the parties concerned to meet the domestic economic and external financing needs of members in the coming period, thereby improving the prospects for avoiding arrears in the future.

The staff had usefully discussed the appropriate corrective actions for cases in which preventive action either had not been taken or had been inadequate, Mr. Dallara remarked. The question of the timing of the Executive Board's consideration of individual cases of overdue obligations was complex. The staff had argued convincingly in support of its conclusion that the present period of five months between the emergence of an overdue obligation and the Board's substantive consideration of the Managing Director's report and complaint concerning that obligation might permit the buildup of arrears to become nearly intractable; moreover, some countries might have viewed that period as something akin to a grace period. Hence, that five-month period should be reduced to three months.

Review periods after the substantive consideration of the Managing Director's complaint concerning a member's arrears should be tailored more closely than hitherto to the member's actual performance, although such periods should not exceed three months, Mr. Dallara continued. However, the Executive Board should avoid placing too much emphasis on the need for flexibility in establishing review periods, as attempts to be flexible could appear to be arbitrary. He agreed with the staff that following a declaration of a member's ineligibility to use the Fund's general resources, the Executive Board should not necessarily wait until the next Article IV consultation with the member to review the country's situation. The Board should review such cases at intervals not exceeding three months. Moreover, the Executive Board should examine the possibility of eventually expelling members with outstanding arrears. For example, the procedures resulting in expulsion could be started six months after the Executive Board's declaration of a member's ineligibility to use the

Fund's resources. The staff should prepare a short note on the legal steps in the expulsion process and the steps that an expelled country could take to be reinstated after it had become current in its financial obligations to the Fund.

Other possible corrective actions warranted further examination by the Executive Board, Mr. Dallara continued. For example, a member in arrears to the Fund could be prohibited from using any new SDRs acquired from any source. Consideration also should be given to a special charge, perhaps designed initially to recover costs associated with overdue payments but which could be expanded to provide a penalty charge. In addition, his authorities intended to consider a member's creditworthiness and its financial position in the Fund when examining the proposed use by the member of resources of other multilateral institutions. Special consideration should be given to procedures that might be needed to deal with members that had indicated their intention not to meet their financial obligations to the Fund in a timely manner. The Fund could not and should not tolerate such behavior by any member. In those cases, the Executive Board could accelerate its procedures for considering and taking action with respect to overdue obligations, including, perhaps, the imposition at an early stage of penalty charges. His authorities had not yet fully developed their position on such an approach, and he looked forward to hearing other Executive Directors' views on it.

Arrears to the Fund were posing an increasingly difficult dilemma for the Fund and its members, Mr. Dallara concluded. Members must work together to reverse and eliminate the current rising trend in arrears. Otherwise, the Fund's financial integrity could be undermined.

Mr. Nimatallah remarked that the staff report clearly showed that the situation with respect to overdue obligations had continued to deteriorate: the list of members with overdue obligations had grown, and the total amount of such obligations had increased. The rapid rise in the magnitude of the arrears was reflected in the fact that arrears were already equivalent to about 40 percent of the Fund's reserves. The problem had worsened even though the Fund had adopted a range of policies and procedures aimed at containing and solving the problem. There was an obvious need to take another careful look at the problem at the present stage. The arrears situation involved many issues and had a number of implications for the Executive Board, for the Fund as a cooperative financial organization, for members with arrears, and for other users of the Fund's resources which had remained current in their obligations to the institution.

The Executive Board had the responsibility to maintain a balance between its efforts to help members in arrears and its efforts to reduce those arrears as quickly as possible, Mr. Nimatallah continued. In the process, the number of Executive Board meetings on overdue financial obligations had increased markedly. The Executive Board already faced a significant increase in its work load, including longer agendas for Board meetings.

The Fund was suffering from a loss of income, and from a deterioration in its liquidity and, possibly, its credibility, Mr. Nimatallah said. The members in arrears were suffering from impaired relations with the Fund: they were no longer able to initiate adjustment programs with the Fund's assistance and were therefore unable to obtain financial help from other sources. Moreover, as long as the problem of overdue payments to the Fund persisted, the borrowers and potential borrowers that remained current in their obligations to the Fund would face the threat of higher charges, tighter conditionality, and a reduction in the availability of Fund resources; the Fund might find it more difficult in the future than hitherto to obtain additional ordinary and borrowed resources.

In attempting to handle the growing problem of arrears, the Executive Board should try to reduce the frequency of meetings to review cases of overdue obligations and the period between the Board's noting of the Managing Director's complaint concerning a member's arrears and the Board's declaration of the member's ineligibility to use the Fund's resources, Mr. Nimatallah considered. The timetable for reporting to, and action by, the Executive Board must be advanced to ensure that substantive discussion by the Executive Board of a member's arrears would take place within three months--rather than five months--after the emergence of the arrears.

Furthermore; each case should be dealt with on its own merits to avoid the possibility of having extensions given by the Executive Board being taken as grace periods, Mr. Nimatallah continued. The principle of the uniform treatment of members was important, but each case of overdue obligations was different, and it should be left to the Executive Board to decide whether or when to review each case. By emphasizing the individuality of each case of overdue obligations, the Executive Board would dispel any presumption that its procedures for handling such cases were mechanical and automatic. Whenever possible the Executive Board should reduce the period between the first substantive discussion of a member's arrears and the declaration of the member's ineligibility to use the Fund's resources. That approach would send a signal that the Executive Board had strengthened its resolve to deal vigorously with the problem of arrears. The declaration of ineligibility should be deferred only in a case in which a member was making a serious effort to repay the Fund. In the absence of such an effort, the member should be declared ineligible to ensure that all of the parties concerned would be aware of the situation. The Executive Board should review a member's overdue obligations within six months of a declaration of the country's ineligibility to use the Fund's resources; that review should be designed to consider other, more serious steps.

Two members had already been declared ineligible to use the Fund's resources, Mr. Nimatallah noted. More than six months had passed since those declarations had been made, and the time had come for the Executive Board to review those cases. In dealing with members that proved to be recalcitrant, the Board should consider the possibility of imposing ad hoc financial sanctions or of initiating procedures leading to the obligatory withdrawal of the members concerned.

He welcomed the significant accounting measures that had already been introduced to strengthen the Fund's financial position, Mr. Nimatallah commented. Following an Executive Board decision in March 1985, the Fund no longer included in its current income charges that were overdue by six months or more. Furthermore, the Fund's reserve position had been strengthened by raising the annual net income target from 3 percent of reserves to 5 percent. At the present stage, however, as the external auditors had suggested, the Fund should seriously consider whether some of the arrears might never be repaid, and the Fund should examine the possibility of making provisions against such losses. The staff should study that option in the light of the length of time that the arrears in question had been outstanding and the period that had elapsed since the declaration of ineligibility of the countries concerned to use the Fund's resources.

The strengthening of any financial institution involved some combination of an increase in net worth--which was comprised mainly of capital and reserves--and an improvement in the quality of the institution's assets, Mr. Nimatallah commented. He doubted whether it would be easy to strengthen the Fund's capital base. The Fund probably would have to start strengthening its reserve position and improving the quality of its loans. In his summing up at the conclusion of the discussion on overdue financial obligations in December 1985, the Chairman had stated that "the Fund is not a creditor like other creditors.... The Fund must preserve its credibility; and if it is considered desirable for the institution to continue to assist member countries that are facing structural weaknesses and difficulties, it must be demonstrated that Fund loans are indeed serviceable and repayable in a timely way." Therefore, he was pleased that the staff intended to continue to give due emphasis to the fulfillment of obligations to the Fund in designing programs.

The only viable option for members with arrears was to adopt comprehensive adjustment policies to bring their economies back onto the path of sustainable growth, Mr. Nimatallah said. The alternative was further deterioration in their economic situation and further delays in settling their overdue obligations to the Fund. He hoped that the Trust Fund reflows and perhaps other additional financial assistance could provide more resources for those members. However, those members must show that they were interested in making a greater effort to implement appropriate policies to deal effectively with their economic problems.

Borrowing members that settled their obligations on time could participate in concerted efforts with other, nonborrowing members to encourage members with arrears to make every effort to repay the Fund, Mr. Nimatallah remarked. All members should realize that it was unfair for members that remained current in the Fund to incur higher charges and tighter conditionality because of actions by members with arrears. In addition, the entire membership should resist the adverse effects of negative publicity about the Fund. There was a tendency for those who were hostile to the Fund to encourage some members not to settle their obligations to the Fund. To preserve the integrity and strength of the

Fund, those hostile voices should be ignored; they seemed to favor the very destruction of the Fund, something that obviously would not be in the best interest of members. The Fund had been very helpful to members, and they should help to keep it viable and strong.

Mr. Grosche commented that the discussion at the present and previous meetings on three members with arrears to the Fund clearly showed that the situation with respect to overdue obligations had deteriorated in recent months. It was regrettable that some members apparently did not understand that the Fund was a lender of last resort and a lifeline to the restoration of net credit inflows in the future; once severed, that lifeline was difficult to restore. His authorities attached great importance to the problem of overdue obligations. In their view, no effort should be spared to strengthen the policies designed to prevent a further worsening of the arrears situation.

In its report the staff had identified three major areas in which progress should be made--namely, the strengthening of the Fund's financial position, the procedures for dealing with overdue obligations, and the measures to prevent arrears from arising, Mr. Grosche continued. He would not comment at length on possible means of strengthening the Fund's financial position; Executive Directors would have an opportunity to deal with that subject in detail during the coming review of the Fund's income position. However, it was important to bear in mind during the present discussion that actual developments in the Fund's income position in the first half of FY 1986 had been less favorable than the staff had initially projected: a deficit of SDR 20 million was expected, mainly because a larger amount of overdue payments had had to be treated as deferred income. Unless a substantial amount of overdue obligations were settled soon, the Executive Board would have to decide on December 11, 1985 on additional steps to reach the income target for FY 1986. That prospect underscored the importance of devising ways of helping members to settle quickly their overdue obligations and to remain current in the Fund while making every effort to prevent the emergence of new arrears. If no significant progress in those areas could be made, the need to consider introducing loan-loss provisions would become even more urgent. He wondered when the staff's examination of such provisions could be completed and brought to the Executive Board's agenda.

In the area of corrective actions to deal with arrears, the staff had already made commendable efforts to help countries to devise adjustment measures to eliminate their serious economic imbalances and to attract non-Fund sources of finance, Mr. Grosche remarked. At the same time, the staff and the Executive Board had shown considerable flexibility in dealing with individual cases of arrears. That approach should be continued. He hoped that the efforts that were being made would solve the arrears problem in members where discussions between the staff and the authorities had led to the adoption of adjustment measures.

He agreed with the staff that the present timetable for considering cases of overdue obligations to the Fund caused certain problems, Mr. Grosche commented. A significant buildup of arrears could occur before the Executive Board gave substantive consideration to the Managing Director's complaint concerning a member's arrears. In addition, the present timetable for considering individual cases of arrears apparently had led some members to regard the period between Executive Board discussions on a country's arrears as a kind of grace period. At the same time, the Executive Board's regular schedule for considering individual cases of arrears had not prevented a number of members from repeatedly being late in making payments to the Fund.

The periods between Executive Board discussions on a member's arrears were clearly intended to be used by members to take steps to eliminate their arrears; the periods were not meant to provide any form of relief for the members concerned, Mr. Grosche continued. Although the staff had appropriately cautioned against introducing undue rigidities in the scheduling of Executive Board meetings on individual cases of arrears, there should be a further tightening of the general timetable. The staff proposal to leave that timetable unchanged might have some drawbacks; for example, it would be difficult for the staff to initiate reductions in the periods between various Executive Board discussions on arrears. It should be up to the member concerned to make a case for extending the regular period between Executive Board discussions of its arrears. That approach would not necessarily make the Executive Board inflexible. In cases in which there was reason to believe that the member was doing its best to eliminate its arrears, the Executive Board could extend a review period until further action were taken; the Board had used that approach in some cases.

An important aspect of the Executive Board's procedures for handling cases of arrears was the Board's policies and procedures following the declaration of a member's ineligibility to use the Fund's resources, Mr. Grosche said. At present, the Executive Board's only opportunity to monitor developments in a country following its declaration of ineligibility was the annual Article IV consultation with the country. He agreed with the staff that that situation was not fully satisfactory, and he supported the suggestion to hold more regular reviews of such arrears cases; a period of six months would be acceptable, but he was open to other suggestions. Such regular reviews would serve to keep the Executive Board abreast of the progress--or lack of progress--a member was making in becoming current in the Fund, and they would give the Executive Directors a chance to discuss whether additional measures by the Executive Board might be appropriate.

As to possible preventive actions, the staff, in its discussions with members and in the design of programs, had been paying increasing attention to ensuring that a member using the Fund's resources would be in a position to remain current in its obligations to the Fund in the future, Mr. Grosche remarked. That effort was reflected in the suggestion by the staff of the level of access for the countries concerned, the



staff's increased use of medium-term balance of payments scenarios, the setting of reserve targets, and the assistance provided by the staff in establishing appropriate debt management policies in the countries concerned. All those measures were in the right direction and should continue to be applied in the coming period. Moreover, he agreed with Mr. Dallara that future papers on members' requests to use the Fund's resources should contain a section describing the member's ability to repay the Fund. Most members with substantial overdue obligations to the Fund and a number of other countries that had managed to remain or become current in the Fund faced protracted structural problems, the solution of which would require more time than was usually provided under programs supported by the Fund. Although the Fund would still have an important role to play in assisting such countries, it would be prudent to place increasing emphasis on the institution's role in formulating urgently needed comprehensive economic programs and in catalyzing financial support on highly concessional terms.

He agreed with the staff that the proper use of Trust Fund reflows could be helpful, Mr. Grosche said. In several cases in the past, involving members with large projected debt service payments and for which financing on highly concessional terms had been strongly recommended by management and Executive Directors, the Executive Board had nevertheless approved substantial drawings under a stand-by arrangement because the authorities' determination to implement appropriate adjustment policies was considered worthy of the Fund's financial support. In his view, in similar cases in the future the availability of Trust Fund reflows would provide a welcome means of extending Fund financial assistance without heavily increasing the members' future debt service burden to the Fund.

Mr. Pérez said that recent developments in, as well as the prospects for, overdue financial obligations to the Fund were a cause for great concern. The staff paper clearly showed that the situation with respect to arrears was worsening: the amount of outstanding overdue obligations was increasing, and there was no indication that the upward trend could be reversed. Indeed, the number of countries that were accumulating arrears to the Fund was much higher than the number of members that were becoming current in their obligations to the institution. In addition, repurchases falling due greatly exceeded payments of arrears. The bleak arrears situation and the even bleaker prospects for solving the problem cast doubt on the effectiveness of the current procedures for dealing with arrears.

The staff considered that recent experience warranted shortening the time between the Managing Director's report on an overdue obligation and action on the matter by the Executive Board, and reducing the periods between the Executive Board's reviews of a member's arrears, Mr. Pérez went on. The staff believed that those proposals would eliminate the weaknesses in the present procedures for dealing with arrears. However, there was no evidence in the staff paper that the upward trend in overdue obligations to the Fund was due to such weaknesses. Indeed, the evidence

suggested that the number of successfully handled cases of arrears had decreased in line with the increasing rigidity in the Fund's procedures for dealing with arrears.

In analyzing the problem of arrears the Executive Directors should bear in mind the circumstances under which the problem had emerged, Mr. Pérez considered. The rising overdue payments had been a consequence of the problems facing most countries in the wake of the prolonged recession that had given rise to the accumulation of debt; it had not been due to a change in members' basic perception of the importance of their remaining current in the Fund.

The Fund's present procedures were designed to encourage members to pay the Fund on time but disregarded the fact that in some countries internal and external factors had resulted in a scarcity of foreign reserves, Mr. Pérez went on. The Fund's lack of flexibility and options in dealing with members that faced a shortage of foreign reserves had not helped to solve the problem of arrears. The Fund should distinguish between cases in which a member was unable to repay the Fund and cases in which a member was unwilling to repay. That distinction was difficult to make in practice; a member that was ready to agree on an appropriate adjustment program should be deemed willing to repay the Fund. The Fund's policies should be more flexible, so that the Fund could adopt measures that were based on the particular merits of each case of arrears. To that end, careful thought should be given to the particular Articles that might permit a widening of the range of policies concerning arrears. The Fund's claims on members should not be rescheduled, but the Articles might permit other means of postponing repayment in specific circumstances. For example, Article V, Section 7(g) and Section 8(e) might permit a member to postpone repurchases if the payment on the due date would result in an exceptional hardship for the country, and the Fund might permit a member to pay charges in its own currency in exceptional circumstances.

Such options should be applied only in an arrangement with the Fund supported by an appropriate adjustment program, Mr. Pérez said. The program should in the Fund's view be designed to restore a viable external position that in turn would enable the Fund to decrease its exposure in the country at the end of the program period. That approach might result in the transformation of the problem of arrears into a problem of prolonged use of Fund resources, but he doubted whether a better choice was available. He looked forward to discussing possible means of solving the problem of prolonged use during a future discussion on collaboration between the Fund and the World Bank.

Mr. de Forges remarked that there was a close relationship between the problem of overdue obligations to the Fund, the financial and non-financial relations between the Fund and members with arrears, and the Fund's income position, which was significantly affected by the arrears. The trend in the arrears to the Fund was a cause for great concern, and Executive Directors should examine at the present meeting the most useful nonfinancial means of encouraging members to eliminate those arrears.

The Fund had already implemented certain measures designed to reduce the arrears; those measures had had a positive effect, but there were also certain weaknesses, and he agreed with most of the modifications that the staff had proposed.

The present procedures for dealing with members that had been declared ineligible to use the Fund's resources were not satisfactory, Mr. de Forges continued. A way must be found to maintain pressure on such members to pay the Fund; the countries must understand that a declaration of ineligibility did not excuse them from meeting their obligations to the Fund. The Executive Board should hold six-monthly reviews of each case of arrears by a member that had been declared ineligible to use the Fund's resources. However, he hoped that such reviews would not increase the Fund's work load and that staff reports for the reviews should not require travel to the countries concerned; the reports should be based on information available at headquarters. Such reviews should be combined with Article IV consultations; there would then be two reviews per country each year.

The Fund should obviously maintain close and regular contact with members that had overdue obligations but that had not been declared ineligible to use the Fund's resources, Mr. de Forges said. The staff's proposal to accelerate the timetable for reporting to, and action by, the Executive Board concerning the arrears of such members were worth examining. However, a general tightening of the present procedures would not always be the most productive approach; some flexibility should be maintained. He preferred to leave the present timetable unchanged while introducing the possibility of issuing complaints at an earlier stage than hitherto and of shortening review periods in certain cases. The staff had argued that a large buildup of arrears might occur in the present five-month period between the notification of a member's overdue obligations and the Executive Board's substantive consideration of the managing Director's report and complaint concerning those arrears. In that connection, the staff should include in its first paper describing a member's overdue obligations a table summarizing the country's obligations--in absolute terms and as a percentage of quota--that would fall due to the Fund in the coming 12 months and a brief description of the country's economic situation including, at the least, a balance of payments forecast. Such information would enable the Executive Directors to assess the structural aspects of a member's position which might justify an acceleration of the application of the procedures for dealing with arrears.

According to his rough calculations, experience showed that in the five months following the appearance of arrears by a member the accumulation of arrears could range from 12-48 percent of quota, Mr. de Forges remarked. The shortening of the timetable for Executive Board consideration of a member's arrears should be linked to the potential increase in those arrears as a proportion of quota. For example, the timetable could be accelerated if it was estimated that in the five months following the appearance of arrears a member would accumulate arrears exceeding

20 percent of quota; at that rate, the member would accumulate arrears of 50 percent of quota for the whole year assuming that the member had used Fund resources equivalent to approximately 200 percent of quota. In such cases the Executive Board's substantive consideration of the Managing Director's report and complaint concerning the arrears should take place within three months of the notification to the Executive Board that the member was in arrears to the Fund. Such a trigger mechanism would ensure equal treatment among members and would provide an objective basis on which to accelerate the present timetable for handling individual cases of arrears.

Mr. Schneider said that the rapid increase in the amount of overdue financial obligations in general, and the amount of obligations that had been overdue for extended periods in particular, was a cause for great concern. In addition, there was a rising trend in the number of countries with arrears. Those developments suggested that the Fund should approach the problem of arrears in a medium-term perspective. It was in the interest of all members to take decisive action to prevent the emergence of arrears to the Fund and to adopt corrective measures as soon as arrears occurred. Experience showed that members with arrears to the Fund were usually caught in a vicious circle that deprived them of further access to Fund resources and of the financial support of other creditors, thereby making it all the more difficult for the countries to implement corrective adjustment measures and repay the Fund. Overdue obligations had a negative effect on the Fund's reserves and on its financial integrity, as arrears were a legitimate cause for concern by the Fund's creditors, whose claims on the Fund were a part of their official reserves. Furthermore, overdue obligations could make some members reluctant to contribute further to the Fund's liquidity either during the next quota review or through new lending to the Fund.

The actions that the Fund had taken thus far to deal with the problem of arrears were by and large adequate, Mr. Schneider continued. Every effort should be made to prevent the emergence of overdue obligations; however, when arrears occurred, a constructive dialog should be maintained with the member concerned in order to encourage the authorities to devise adjustment policies that would permit a return to normal conditions. In addition, adequate prudential measures should be introduced to protect the Fund's financial integrity.

However, the persistence of the problem of overdue financial obligations and the rapid accumulation of arrears by several countries forced the Executive Board to consider means of further reinforcing existing policies and procedures for dealing with arrears, Mr. Schneider considered. The staff's emphasis on the need for preventive action was appropriate, and he supported the steps that were planned or had already been taken to tailor the design of Fund-supported programs and the phasing of members' purchases to their future obligations to the Fund.

Experience with overdue obligations provided a fairly reliable profile of the countries in which arrears to the Fund were most likely to emerge, Mr. Schneider continued. Members incurring arrears to the Fund had typically suffered from balance of payments problems for a long time and, through their prolonged use of Fund resources, had built up relatively high levels of indebtedness to the Fund. Since the access of those countries to private market borrowing was usually limited or nonexistent, their access to Fund resources constituted a significant part of the financing available to cover their external deficit. The combination of large indebtedness to the Fund and great dependency on Fund resources could quickly produce arrears to the Fund when an ongoing Fund-supported program was interrupted owing to the country's nonobservance of the program's performance criteria. That lesson from experience should help the Fund to detect potential problems at an early stage; as soon as a Fund-supported program went off track, the Fund should contact the authorities concerned in order to assess the country's financial situation in the light of the member's prospective obligations to the Fund.

He basically agreed with the intention behind the staff's proposals aimed at increasing the efficiency of the corrective actions to be taken once obligations to the Fund had become overdue; those actions were designed to ensure the Executive Board's timely and close involvement in the relevant cases, Mr. Schneider said. He shared the staff's concern that some members seemed to look upon the interval between Executive Board reviews of cases of overdue obligations as a kind of grace period. However, the Executive Board should bear in mind that before it examined and reviewed cases of arrears, the staff and the member concerned should have sufficient time to examine and assess thoroughly a country's situation and if possible to make some progress in formulating and implementing corrective measures. Hence, he did not necessarily favor a further tightening of the present timetable for reporting to and action by the Executive Board. The present timetable enabled management and staff to assess the seriousness of each case and to collect all the relevant information required for a thorough Executive Board examination of the case. Of course, the timetable should be applied flexibly; the Managing Director should be able to call for relatively early Executive Board consideration of cases in which arrears were accumulating rapidly or the member was not in a position to introduce corrective measures. It was reasonable to maintain the standard three-month interval between Executive Board discussions on a member's arrears after the substantive consideration of the Managing Director's report and complaint concerning the arrears.

The issue of the further steps that should be taken in handling members that had been declared ineligible to use the Fund's resources was a delicate one, Mr. Schneider commented. Such members typically had great difficulty in adopting corrective measures, and it would therefore not seem useful to re-examine their cases as frequently as once every three months. It would be more realistic to review such cases on an ad hoc basis, whenever there was evidence of a change in a member's attitude toward the Fund and, in any event, on the occasion of the member's annual

Article IV consultation. During that consultation, the Executive Board could consider whether further steps to deal with the country's arrears might be appropriate. For the present, the staff should give some indication of the further steps--financial and nonfinancial--that the staff had in mind for the period after a declaration of ineligibility. It seemed inappropriate in the present circumstances merely to apply the provisions of Article XXVI, Section 2, which dealt with compulsory withdrawal by a member.

The financial policies that the Fund could adopt to deal with the consequences of overdue obligations were to be discussed in detail during the Executive Board's consideration of special charges and the Fund's income position in the near future, Mr. Schneider noted. He attached importance to the ongoing examination of possible loan-loss provisions for use in cases in which members had failed to complete repurchases on time. At first glance, it seemed that such provisions need merely conform with the normal relevant commercial banking practice. However, there might be a danger that such provisions could be misunderstood by some members, as the use of the provisions would appear to place the Fund in a position to be able to write off its claims on those countries, a step that would weaken the members' willingness to normalize their financial relations with the Fund. The complex issue of loan-loss provisions required careful examination; its implications went beyond the scope merely of bookkeeping practices.

He hoped that the few cases in which a solution to a member's overdue obligations and the adoption of adequate adjustment policies seemed imminent could be dealt with successfully, Mr. Schneider concluded. That outcome would provide good examples for other members and could increase the willingness of official donors to support members that had a reasonable chance of reversing their present adverse situation in a durable fashion.

Mr. Foot commented that the present discussion was a suitable prelude to the coming examination of various aspects of the Fund's financial position and the terms of its relations with borrowers and lenders. The situation with respect to overdue obligations was serious: it posed dangers for the financial position of the Fund, the institution's fundamental role as an agent of adjustment, and the members with the arrears.

The picture of the arrears situation painted by the staff could be clearer if the paper had included a table that distinguished between the categories of overdue obligations--namely, overdue charges and delayed repurchases--for recent and coming fiscal years, Mr. Foot said. That information would help Executive Directors in their assessment of the Fund's income position.

The seriousness of the arrears problem raised a number of questions, Mr. Foot commented. For example, was the Fund making a sufficient effort with individual debtors to contain arrears? The answer seemed to be in the affirmative. He endorsed the Fund's efforts to keep open all lines of communication with such countries and to assist them in implementing

needed adjustment measures and in presenting those policies to donors and creditors. Another question was whether the Executive Board's procedures were sufficiently supportive of the effort to contain arrears. The answer to that question was clearly in the negative, although he recognized that no mechanical tightening of the procedures would be helpful, given the diversity of the cases to which the procedures were applied. Nevertheless, there should be a general presumption that substantive Executive Board consideration of any case of arrears should be within three months--rather than five months--of the notification of those arrears to the Board. A period exceeding three months would be appropriate only if there were sufficient evidence that the member was making progress in becoming current in the Fund. However, the more time the Fund gave a member to act, the more the Fund should expect the member to do. In addition, the Executive Board should shorten the period of its reviews following its substantive consideration of the Managing Director's complaint concerning overdue obligations; the outside limit should be three months.

The staff should circulate its updated summary of overdue obligations every two or three months to improve the flow of information to the Board, Mr. Foot went on, although a discussion of the situation need be held no more frequently than at present--every six months.

There was a need for a review procedure--over and above Article IV consultations--applicable once a member had become ineligible to use the Fund's resources, Mr. Foot said. A periodic review every few months of the cases of all ineligible members--preferably taken together at a single Executive Board meeting--could be helpful. The Executive Board should discuss only those cases in which some progress in handling the arrears problem had been made.

The most difficult question was whether the Fund's sanctions on members with arrears were sufficient, Mr. Foot remarked. The Executive Board was scheduled to discuss in the coming days the possibility of imposing a special charge on members with arrears. He favored a system of special charges that would broadly recoup the direct costs to the Fund of arrears and which would provide for penal charges if such were found to be appropriate at some future time. Penal charges would be especially useful in discouraging members that were capable of repaying the Fund from accumulating arrears as a means of obtaining temporary cheap credit. In difficult cases of arrears, in which a declaration of ineligibility to use the Fund's resources was likely, special charges of any sort were rarely likely to make any difference. Special charges were not sufficient by themselves to solve the problem of arrears.

One option was to impose additional financial penalties on members that had become ineligible to use the Fund's resources or to regard a declaration of ineligibility as a step toward requiring a defaulting member to withdraw from the Fund, Mr. Foot continued. At the present stage, however, those measures were unlikely to prove to be productive.

Another possibility was to seek to increase the Fund's leverage on members with arrears through means other than penalty charges, Mr. Foot continued. The declaration of a member's ineligibility to use the Fund's resources would send a signal that would likely damage the country's reputation; accordingly, a member would have some reason to pause before taking a course that was likely to lead to a declaration of its ineligibility to use the Fund's resources. Potential access to Trust Fund reflows could provide a more obvious lever for the Fund's use. For the time being, the Fund had not yet found an adequate set of measures to discourage members from falling into arrears.

Recent experience clearly showed that it was no easier to forecast the level of the Fund's arrears than, say, the level of the U.S. dollar, Mr. Foot commented. The basic trend in arrears could perhaps be foreseen, but the precise extent and timing of any changes in the trend could only be guessed at. In the circumstances, it was important for the Fund to be prudent in forecasting future arrears. Furthermore, the Executive Board should consider the difficult subject of the financial implications for the Fund of arrears on repurchases as well as the particular kinds of arrears with which the Fund had already come to grips in an accounting sense by deciding that those arrears should not be treated as deferred income. In that context, the more progress that could be made at an early stage, the better.

Mr. Massé said that the staff paper clearly showed that the problem of overdue obligations to the Fund was serious and growing. The volume of arrears had nearly doubled since March 1985, and the accelerating growth in arrears was an even greater cause for concern; overdue payments as a percentage of all payments had increased between January 1983 and September 1985 from 5.7 percent to 14.3 percent in amount and from 17.9 percent to 30.9 percent in number. It was important to remember, however, that Sudan and Zambia accounted for some 55 percent of total arrears, that the Fund had received indications from those countries that they were prepared to introduce strong and comprehensive measures to deal with their serious economic problems, and that an adequate response by donors could at least give those two countries a chance to meet their large obligations to the Fund.

The purpose of the present discussion was to find better ways of convincing members with arrears that meeting their obligations to the Fund was in their own best interest as well as that of the Fund, Mr. Massé continued. To that end, the Executive Board had adopted a number of important decisions, and the staff had made changes in some procedures over the previous year.

On page 11 the staff had concluded that "the present total of overdue obligations is not of a size that is considered to have a direct, material impact on the Fund's liquidity position," Mr. Massé noted. Even though arrears totaled SDR 426 million on September 30, 1985, the staff had judged that for the time being, the Fund was not seriously threatened by the arrears. However, the staff had also said that additional arrears,



or a weaker liquidity position, might well create damaging perceptions about the Fund's effectiveness and integrity. He agreed with both those statements: the arrears problem had not reached the crisis stage and could be managed as long as resources were provided by donors; however, any further arrears could damage the Fund's liquidity position and tarnish its image. Any steps that the Executive Board could take to impress further upon members the seriousness of arrears to the Fund would certainly be justified.

The Executive Board had an important role to play in underscoring the seriousness of arrears to the Fund, Mr. Massé considered. The procedures for dealing with arrears had occasionally produced the desired results, but a good case could be made for further tightening the procedures. The close relationship between payments received by the Fund and the timing of reviews of members' arrears suggested that a more active Executive Board role might encourage a more rapid elimination of arrears. Therefore, as a general rule, the period between the emergence of a member's arrears and the Executive Board's initial discussion of the Managing Director's report and complaint concerning these arrears should be reduced; a period of three months might be appropriate. That step need not reduce the Executive Board's flexibility in dealing with individual cases of arrears, since the Board could always give due consideration to a member's special circumstances in determining the period between the initial emergence of the country's arrears and the Executive Board's first discussion of the Managing Director's report and complaint.

Shortening the period between the Executive Board's initial consideration of a complaint and subsequent reviews of the member's arrears would not necessarily be productive, Mr. Massé said. A shorter period might be acceptable in special cases in which management felt that significant progress toward eliminating the arrears was not being made, but the Executive Board must continue to be--and must be seen to be--evenhanded in its treatment of members.

He doubted whether more frequent reviews than at present of the arrears of members that had been declared ineligible to use the Fund's resources would be productive, Mr. Massé commented. Article IV consultations alone did not provide sufficient contact with those countries. A six-month review period would continue to be appropriate.

The staff had mentioned the potential role of Trust Fund reflows in preventing arrears, Mr. Massé commented. Such reflows should not be used by members to reduce their arrears to the Fund, as that use of the reflows would provide merely temporary relief to the delinquent countries. However, Trust Fund reflows might be useful in catalyzing other resources that could be used to reduce arrears to the Fund.

Speaking on a personal basis, Mr. Massé said that he felt uncomfortable with the staff's presentation of the problem of arrears. There was clearly an even more fundamental problem than the staff had mentioned--namely, the actual capacity of a number of members to repay their arrears

on a timely basis. He harbored some doubt about the usefulness of declaring a member with arrears ineligible to use the Fund's resources. The possibility of making such a declaration certainly gave the Fund some leverage, but once the declaration was made, the leverage seemed to be lost. As a matter of good strategy the Fund understandably wished to use the possibility for declaration of ineligibility as a means of encouraging members to repay the Fund. In actually making such a declaration, however, the Fund seemed merely to create considerable difficulties for the members concerned and did not help those countries to make further repayments, at least in the short run.

He also harbored some doubt about the proposals to tighten the Fund's procedures for handling cases of arrears, Mr. Massé continued. Having a number of members with arrears naturally led Executive Directors to wonder whether the Fund's policies and procedures relating to arrears and the Fund's assessment of the risks involved might have been lax. He was reluctant to draw that conclusion. After all, in assessing risks associated with its lending the Fund was not in the same position as a commercial bank. A more detailed discussion of the question of risk assessment would be helpful. In the future, the Fund should make a more careful assessment of a member's ability to repay the Fund. However, when the Executive Board considered a member's request to use the Fund's resources, it should be remembered that the member's repayment ability depended on the capacity of the authorities--working in their current political environment--to make the right decisions about their comprehensive adjustment program management, rather than on the country's record of repayment to the Fund. A change in government in a country might well be an indication that the Executive Board should give the country another chance to make an effort to repay, rather than refuse to give the country financial assistance because of its repayment record. Indeed, in some cases the Fund's only hope to receive repayments might be for the institution to give the government concerned such a second chance.

Mr. Dallara's comments had underscored the usefulness of considering the Fund's policies concerning arrears in a longer-term perspective, Mr. Massé remarked. The Fund admittedly must increase the cost to members of falling into arrears to the Fund, and policies regarding charges or the length of review periods should be designed to avoid giving members any impression that a review period was equivalent to a grace period. However, if a country was already in arrears and was unlikely to be able to eliminate them soon, the application of more stringent policies and procedures by the Fund probably would not be helpful. In those cases, the members' various donors, including the multilateral development banks, should help the authorities to formulate and implement an adjustment program; that effort would be an appropriate test of the political will of the recipient countries to take steps that would eventually place them in a position to eliminate their arrears. The Fund had to walk a narrow line between pressuring a country to repay on time and pushing the country to such an extent that it would in fact have no incentive to introduce the politically difficult economic adjustment measures needed to place the member in a position to repay the Fund.

Mr. Sengupta commented that Mr. Massé's personal comments were consistent with the position of the Group of Twenty-Four. The increase in overdue obligations to the Fund in recent months was clearly a cause for serious concern not only because of the implications for the Fund but also because of the effects on charges paid by members that used the Fund's resources. Members should make every effort to eliminate their arrears to the Fund, which had decided to exclude from accrued income payments of charges that were overdue by six months or more. It was necessary to examine what the Board could do to eliminate the overdues problem.

Overdue obligations to the Fund had been accumulated by a fairly limited number--17--of members thus far, Mr. Sengupta noted. Those members had been unable to shake off the adverse effects of the deep and prolonged recession and debt problems; they had not benefited adequately from the economic recovery in industrial countries in 1984-85. Of the SDR 547 million in total overdue obligations, SDR 103 million was accounted for by Viet Nam and Guinea--which had recently been declared ineligible to use the Fund's resources--and the Democratic Republic of Kampuchea, which had been in arrears to the Fund since 1975. In addition, Sudan, Zambia, and Liberia accounted for SDR 316 million in arrears. Together, those six countries accounted for 84 percent of total arrears. The amount of overdue obligations of all the other countries concerned were small. In assessing the general problem of arrears, Executive Directors should note the significant differentiation between the particular problem of members with large arrears and the minor problem of members with smaller arrears. The problem of how to deal with members that had been declared ineligible to use the Fund's resources should be dealt with separately.

The staff report could have usefully included a detailed analysis of the reasons why some countries had fallen into arrears, why the arrears had persisted in those countries, and the adjustment policies needed to ensure the elimination of the arrears and the attainment of a viable external payments position over the long run, Mr. Sengupta said. Such an analysis would yield different conclusions for different members. However, it was important to stress the staff's conclusion on page 5 that almost without exception, the countries subject to complaints and action by the Executive Board, as well as some others that had fallen into arrears intermittently, had faced protracted problems of economic management that had been a source of concern to the Fund before the recession and widespread debt difficulties; in several of those cases, payments problems had persisted despite repeated adjustment programs and the prolonged use of Fund resources. The staff had concluded that in countries with arrears economic management had not helped to achieve a balanced external position even when the members had repeatedly adopted adjustment programs. Tanzania had had a stand-by arrangement from September 15, 1980 to June 30, 1982 for SDR 179.6 million, but had actually used only SDR 25 million under the arrangement. Other members with arrears had had three or more stand-by or extended arrangements with the Fund, but the amounts purchased had not always equaled the amounts approved under the arrangements, as the programs had not always been fully implemented. Sudan, however, had made

all the purchases under its stand-by arrangement in 1983-84 except the final one, and a program had been approved in 1984, shortly after which the country had fallen into arrears. Apparently Sudan had followed the Fund's policy prescription but had still been unable to avoid falling into arrears. He doubted whether it was fair to conclude that countries with arrears had not introduced many of the adjustment policies suggested by the Fund. He wondered whether it had been feasible to expect all the suggested policies to be implemented within the program period and whether the difficulty members had had in implementing all the policies as scheduled would not explain the emergence of the overdue obligations to the Fund.

The problem of arrears to the Fund could not be tackled successfully unless more were known about why a particular member incurred arrears and whether anything could have been done to avoid the arrears, Mr. Sengupta continued. There was no universal solution to the problem that could be applied to every case of overdue obligations. Apparently management had reached the same conclusion. However, it would be easy to slip from the present, preferred case-by-case approach into a simple ad hoc approach. On a recent occasion Mr. Nimatallah had correctly been concerned that a decision on Liberia's overdue obligations should be so worded that it would not become a precedent for a number of future cases. In his view, a decision on an individual case need not set a precedent. However, the Executive Board should avoid an ad hoc strategy under which it applied the applicable Rules one way in handling a certain case and the opposite way in handling another case.

Members that had a Fund-supported adjustment program must try to be current in all their obligations to the Fund, Mr. Sengupta stated. The Group of Twenty-Four had recently stressed that the Fund must safeguard the revolving character of its resources, and that repayment obligations to the Fund must be settled on time. In his summing up of the discussion on overdue obligations at EBM/84/167 (11/19/84) the Chairman had usefully remarked that "I have always taken the view that we would stand ready to assist all members including those which have severe structural difficulties; but this can only be done if they understand that the continuation of Fund support in the years to come is very much dependent upon their meeting their obligations to the Fund." He sympathized with the Chairman, who had also mentioned in that summing up that repayment to the Fund should be given higher priority than other types of payments because of the systemic implications of overdue obligations to the Fund. As he understood it, the Chairman had implied that the discipline of repaying the Fund must be maintained even by countries facing serious problems in order to enable the Fund to help them to solve those problems. He attached considerable importance to maintaining the financial discipline mentioned by the Chairman, and that effort was strengthened when the Fund helped to catalyze resources for countries in great difficulty or, in extreme cases, provided the necessary assistance from the Fund's own resources.

Ideally the Fund should encourage the creation of conditions that would enable a member to remain current without facing dire consequences as a result, Mr. Sengupta went on. A country could always repay the Fund or any other external creditor if that was the country's sole policy goal; expenditure or absorption capacity could be reduced in order to generate a sufficient payments surplus to repay external obligations. However, that approach obviously would be unacceptable to both the country concerned and the Fund, both of which wished to see the country successfully undertake viable balance of payments adjustments. Accordingly, the Fund should maintain a flexible approach to cases of arrears on the basis of the current conditions in each country and of the factors that had caused a country to fall into arrears.

There were three categories of members with arrears, Mr. Sengupta remarked. The first consisted of countries with little financial discipline in which political and other considerations prevented adjustment assistance from being used as intended. If such cases could be identified by the staff, the only way of dealing with them was by imposing strict financial discipline upon the countries. The second category consisted of countries that were trying to make adjustments in their economies through the introduction of appropriate policies, most of which had been formulated in consultation with the Fund and were consistent with the optimum utilization of resources subject to existing structural and resource constraints. Those members could encounter problems and fall into arrears because of external factors beyond their control such as drought, cyclones, famine; or such as a sudden fall in commodity prices, an increase in interest rates, or an appreciation of key currencies. If the staff's assessment clearly showed that external factors were the main reason for the country's inability to implement an adjustment program or remain current in the Fund, the Fund's response should be different from its response to members under the first category that he had described. The third category consisted of members that were trying to implement appropriate policies under a Fund-supported program but still accumulated arrears because the program was not capable of producing viable payments adjustment.

It was clear that the Fund could not know for certain how a country's level of income would be affected by various policies or how a change in the rate of absorption through monetary or fiscal policy could generate a sustainable balance of payments surplus without reducing the level of income, Mr. Sengupta said. The implementation of a Fund-supported program did not necessarily result in viable balance of payments adjustment that was precisely commensurate with the rigorousness of the program.

Most cases of overdue obligations involved countries that had features of the second and third categories that he had mentioned, Mr. Sengupta said. Those cases should not be treated in the same manner as members in the first category. Before considering expelling a country from the Fund or even declaring a member ineligible to use the Fund's resources, the Fund must be certain that the arrears had been caused by the member's lack of discipline and not by exogenous factors over which the country

had no control. If a country's arrears problem could not be solved in two or three years despite the adoption of all the policies called for under a Fund-supported program, a declaration by the Fund of the member's ineligibility to use the Fund's resources or expulsion from the Fund would not place the member in a viable payments position. That conclusion was clearly applicable to Viet Nam and Guyana, and he suspected that it would be applicable to most cases of arrears. It was for that reason that the Group of Twenty Four had recently concluded that in cases in which a country's balance of payments situation had been hurt by exogenous factors, making it practically impossible for a country to repay according to a fixed schedule, the mechanical application of sanctions available under the Articles would be self-defeating and it might be necessary for the Fund to be more flexible in the application of Article V, Section 7(g), which provided for postponement of the discharge of obligations because discharge on the due date would result in exceptional hardship for the member. However, to help such countries to become current in their obligations to the Fund, new mechanisms should be developed, in collaboration with the World Bank and regional development institutions, to provide longer-term assistance for orderly adjustment.

Users of Fund resources should make every effort to repay the Fund on time so that the Fund could continue to assist all members, Mr. Sengupta concluded. The Fund should mobilize the financing that countries with arrears needed to implement an adjustment program, the design of which would depend upon the nature of the problems facing a particular country; additional extended arrangements and more concessional assistance might be required in the coming period. If a member seemed likely to fall into arrears, the matter should be brought to the Executive Board at an early date, and the reasons for the possible accumulation of arrears should be clearly identified by the staff. The Fund should attempt to assist those countries, unless they lacked the needed financial discipline or had not complied with appropriate adjustment programs. A mechanism should be established, with the World Bank, regional institutions, and bilateral donors to assist those members that were making appropriate efforts to avoid falling into arrears or accumulating additional arrears to the Fund.

Mr. J. E. Ismael recalled that during an earlier discussion on overdue obligations, when only a few members had had arrears to the Fund, he had said that the growing incidence of arrears was symptomatic of wider problems affecting developing countries. That conclusion seemed more valid than ever, as many developing countries had not benefited from the recovery in the industrial countries over the previous several years. In addition, the operation of the mechanisms governing trade and financial flows had not benefited the developing countries. As a result, a number of countries lacked the financial resources to meet their obligations to their creditors, including the Fund. The central issue at hand was how to recover debts from countries where conditions were very difficult. Should the Fund insist on immediate repayment and in the process cause further hardships for the countries or should it give the members more time to implement adjustment measures so that they could eventually find themselves in a better position to repay the Fund?

The primary goal of the present discussion was the eventual elimination of members' overdue obligations to the Fund, Mr. Ismael continued. Experience showed that it was unproductive to pressure a member to make repayments when the member did not have the means to do so. In his view, the best approach in such cases was to persuade the member to adopt Fund-supported programs in return for a rescheduling of its arrears to the Fund. That approach would be a constructive way of improving the external position of the countries concerned, would increase the chances of repayment to the Fund, and would be consistent with the Articles and current practice.

He welcomed Mr. Pérez's reference to the applicability of Article V to the handling of cases of arrears, Mr. Ismael remarked. There were numerous examples of prolonged use of Fund resources. Each year the amounts purchased by prolonged users were roughly equivalent to the countries' repurchase obligations, a trend that could be interpreted as the result of a kind of rescheduling. If the Fund permitted that kind of rescheduling in dealing with members that had Fund-supported programs over long periods, there was no reason why the Fund should not grant the same relief to members in arrears, provided that those members agreed to adopt Fund-supported programs.

His proposal to provide such relief had four main features, Mr. Ismael continued. First, it would be applied only to countries that faced genuine hardship and were not in a position to repay the Fund. Those countries could be easily identified by the staff on the basis of certain criteria. Second, the relief would be provided only if the member in arrears were to undertake an adjustment program supported by the Fund. Accordingly, the relief would be conditional; it would not necessarily be available to any member with arrears to the Fund. Third, there would be no expectation that the Fund would in every case provide additional resources over and above the rescheduled amounts, although it might assist a member in attracting concessional finance from other sources. Fourth, the present procedures for dealing with arrears would continue to be applied to members that had arrears but did not wish to adopt a Fund-supported program.

There were four advantages to his proposed relief scheme, Mr. Ismael continued. First, the Fund would recognize the difficult circumstances of the developing countries in general. It would in particular recognize the fact that the mechanism governing the international flow of trade and capital was not working smoothly. The problems concerning the flow of trade and capital to developing countries had been emphasized by nearly all the Governors who had spoken at the 1985 Annual Meeting. Granting relief under adjustment programs would be a reasonable, although partial, response by the Fund to the problems related to the flow of trade and capital to developing countries. Second, his scheme would give an incentive to members with arrears to start the process of adjustment which they might not otherwise begin. Adjustment in those countries offered the best hope to the Fund of recovering its debt to members with arrears. Third, adjustment in members with arrears, together with the willingness

of the Fund to provide the necessary assistance, could encourage other creditors and donors to provide financing. Fourth, by allowing a form of relief the Fund would grant members with arrears and Fund-supported programs the same treatment that was being given to prolonged users of the Fund's resources.

It was important for Executive Directors to recognize that the authors of the Articles had envisaged a situation in which some members might not be in a position to make timely repayments to the Fund, Mr. Ismael remarked. Accordingly, the Articles provided for relief to be given to those members. It would be unfortunate if the Executive Board did not recognize those facts.

The present timetable for reporting to the Executive Board about overdue obligations and for reviewing the arrears of individual member countries was appropriate, Mr. Ismael considered. More frequent reviews were unlikely to be productive, especially in view of the Executive Board's already heavy agenda for the coming months.

The staff had suggested that in some cases the Managing Director should issue his report on and complaint about a member's overdue obligations in less than the usual three months following the notification of the existence of the arrears to the Executive Board, Mr. Ismael remarked. It would be best to have a uniform period for all cases.

It had been suggested that the arrears of members that had been declared ineligible to use the Fund's resources should be reviewed on a quarterly basis, Mr. Ismael noted. He doubted whether such reviews would be beneficial. With the exception of expulsion from the Fund, a declaration of ineligibility was the strongest sanction that could be applied by the Fund; accordingly, quarterly reviews of members that had been declared ineligible probably would achieve little. A review each 12 months, at the time of an Article IV consultation, might well be adequate.

Mr. Rye remarked that the staff report clearly showed that overdue obligations were becoming an increasingly serious problem for the Fund. He had been particularly struck by Table 1, which showed a sharp deterioration in the situation with respect to short-term and long-term arrears since the end of September 1985. The table clearly gave the impression that the problem of arrears was continuing not merely to grow but to accelerate.

The report suggested certain lessons that should be learned from recent experience, Mr. Rye went on. On page 5 the staff had concluded that payments problems had persisted in some cases despite repeated adjustment programs and the prolonged use of Fund resources and that obligations to the Fund had risen to levels that were large in absolute terms and in relation to quota. The staff had also noted that in some cases members had become overdue to the Fund immediately following a purchase from the institution. Those observations suggested that in considering requests for arrangements with the Fund and the level of



access under them the Executive Board must pay even closer attention than hitherto to the members' ability to repay the Fund. In that connection, the use of medium-term balance of payments scenarios and the steps mentioned on page 8 concerning the design and implementation of Fund-supported programs to facilitate timely repayment to the Fund were welcome. In addition, he agreed with Mr. Dallara that each staff paper on a member's request to use the Fund's resources should include a section analyzing the member's ability to repay the Fund.

The staff had suggested possible corrective actions for dealing with cases of arrears, Mr. Rye noted. He preferred to shorten the Executive Board's present general timetable for handling such cases by reducing the period before the initial substantive consideration of the Managing Director's complaint about arrears from the present five months to three months. That approach was preferable to the alternative of maintaining the present general timetable but advancing the date of the issuance and consideration of a complaint concerning a member that was taking inadequate steps to deal with the problem of its arrears to the Fund. The present five-month period did not reflect the urgency of dealing with a member's arrears or the severity of the problems that growing arrears could quickly cause for the member concerned. In any event, in principle it was better to have a fairly strict general rule that could be departed from in the direction of leniency in appropriate cases, rather than have a more relaxed general rule from which departures in exceptional cases would need to be in the direction of greater strictness.

Those conclusions concerning the general timetable were supported by the following two points, Mr. Rye went on. First, tightening the general timetable would send a desirable signal to the membership that the Executive Board was increasingly concerned about the arrears problem and increasingly determined to tackle it vigorously. Second, departures from a stricter general timetable in the direction of leniency would be unlikely to attract criticism, while departures from a more relaxed approach in the direction of strictness might be difficult to justify.

The Executive Board needed to retain flexibility in handling cases of arrears and should exercise common sense in so doing, Mr. Rye considered. He was sufficiently confident in the ability of the staff and the Executive Board to believe that a stricter general rule governing the Executive Board's handling of cases of arrears need not reduce the Board's flexibility or cause the Board to act prematurely, thereby complicating a member's efforts to make arrangements to become current in the Fund.

He was pleased that the staff had given some thought to appropriate steps that the Executive Board could take after its declaration of a member's ineligibility to use the Fund's resources, Mr. Rye said. For some time he had felt uneasy because such a declaration had seemed to mark the end of the Executive Board's involvement in a case of arrears. He strongly supported the proposal that the Executive Board should regularly review the arrears of a member that had been declared ineligible. Regular reviews as often as every three months might be somewhat excessive;

six-monthly reviews might be sufficient. He would be glad to hear the staff elaborate on the further steps--short of requiring a member to withdraw from the Fund--which might be available to the Executive Board in handling members that had been declared ineligible to use the Fund's resources.

Arrears were related both to the possibility of imposing special charges on overdue obligations, and to the Fund's income position, and the latter two subjects were to be discussed in detail in the coming several weeks, Mr. Rye remarked. The Fund's income position was already alarming and might well be much worse in the future than the staff had recently projected. The case for imposing special charges in one form or another had become compelling.

Mr. Salehkhoul commented that in the period since the previous review the problem of overdue financial obligations to the Fund had continued to be a cause for considerable concern. Only a small number of members accounted for the bulk of outstanding overdue obligations, and some SDR 145 million had been paid by the ten members with arrears that were currently the subject of action by the Executive Board, and two members had fully settled their overdue obligations. However, there had clearly been a further deterioration in the overall arrears situation. The worsening of the situation was reflected in the total amount of overdue obligations, the amounts of arrears that had been outstanding for a long period, and the ratio of arrears to the Fund's total credit. That deterioration was however unsurprising, as it was consistent with the overall conditions in the low-income debtor developing countries whose economic and financial situation continued to be under considerable strain. Those countries had continued to face adverse exogenous factors, as real international interest rates had remained high, primary commodity prices had further declined, protectionist pressures had intensified, and debt problems had persisted. In many countries those difficulties had been compounded by adverse climatic conditions.

In dealing with the issue of overdue obligations Executive Directors should have three objectives in mind, namely, the need to keep open the channels of communication with members in arrears, the need to maintain flexibility in order to be able to respond to the specific conditions in individual countries, and the need to avoid punitive action in handling a member that was not recalcitrant and which was making every effort to cooperate with the Fund and to settle its arrears, Mr. Salehkhoul said. Those objectives were especially important as most members, including those that were the subject of complaints by the Managing Director or actions by the Executive Board, continued to give priority to settling their overdue obligations to the Fund, and as the main causes of the arrears continued to be the weakness of the external positions of the countries concerned and, in many cases, the virtual depletion of reserves. He wondered whether the staff was aware of any member that had failed to give highest priority to settling its overdue obligations to the Fund. Had a member ever met its financial obligations to other creditors while remaining in arrears to the Fund?

Preventive actions by the Fund might occasionally be appropriate in dealing with cases of arrears, although he had felt uncomfortable with some of the measures that had been implemented thus far, Mr. Salehkhoul remarked. Such measures should not hamper a member's actual access to the Fund's resources; access should continue to be based on a member's balance of payments need and the strength of its adjustment program. Preventive measures dealing with a member's reserves, or establishing special accounts for resources that were to be used to reduce the member's arrears, should not undermine the member's efforts to achieve its overall adjustment objectives or become the central aim of the economic and financial policies of the member concerned, as seemed to be implied by the staff's statement on page 7 that "accordingly, the staff is giving increasing attention to the need for members' balance of payments, reserve, and debt management policies to provide clearly for the fulfillment of obligations to the Fund, in terms of broad program objective and design, the availability of other sources of finance in the medium-term perspective, and also more specific arrangements by the countries concerned to help assure the servicing of financial obligations to the Fund."

As to the proposed use of Trust Fund reflows to support adjustment programs of members that faced protracted balance of payments problems and had large indebtedness to the Fund, he wished to reserve his position until the proposal was formally examined in detail by the Executive Board, Mr. Salehkhoul said. Trust Fund resources were meant to help all eligible low-income countries regardless of their indebtedness to the Fund.

Fund assistance to members with overdue obligations--particularly in adopting viable recovery programs and in catalyzing donors' and creditors' support--should remain the cornerstone of the Fund's response to such cases, Mr. Salehkhoul considered. A program would be viable only if the staff's recommendations were realistic and took into account not only the member's need to settle its obligations to the Fund but also the member's capacity--given its economic, political, and social constraints--to implement the policies proposed by the staff. The Fund should avoid giving the impression that it had been able to require a member to adopt stringent short-term adjustment measures mainly because the member was in a weak bargaining position because it had overdue obligations to the Fund.

The financial measures that the Fund had introduced to offset the adverse impact of overdue obligations on its income and liquidity position had unfortunately been implemented at the cost of members that had remained current in their obligations to the Fund, Mr. Salehkhoul noted. That situation should be kept in mind during the coming discussions on special charges and the Fund's income position.

The staff had noted that there were two basic problems with the legal actions that the Executive Board had typically taken in response to overdue obligations, Mr. Salehkhoul remarked. First, substantive consideration by the Executive Board of the Managing Director's complaint about a country's arrears had taken place about five months after a member's longest obligation had been overdue. Second, some members had tended to consider the

period before the Executive Board's consideration of the Managing Director's complaint and the period between reviews of a member's arrears as grace periods as members had often failed to take effective steps during those periods to settle their overdue obligations. As a result, there had been a continued accumulation of arrears by members. Those trends clearly were not consistent with the Executive Board's intentions and objectives in its handling of cases of arrears.

However, in considering ways of improving the Executive Board's procedures for handling arrears, Executive Directors should continue to bear in mind the need for the Executive Board to be able to act in a flexible manner, Mr. Salehkhoul continued. In that connection, the staff had usefully suggested that the Executive Board should emphasize to members the intentions of Board actions in response to members' arrears. The proposed shortening of the period before the substantive consideration by the Executive Board of the Managing Director's complaint concerning a member's arrears and of the period between reviews of a member's arrears would certainly introduce considerable rigidity into the Executive Board's application of the procedures for handling cases of arrears. As the staff had noted, the various stages before the substantive consideration of a case of arrears by the Executive Board had often enabled the Fund and the member concerned to settle the issue of the arrears in a satisfactory manner. Given the priority that members gave to settling their arrears to the Fund and the impact of the Fund's actions on other sources of financing, it was desirable to keep the present procedures for handling arrears so that the members concerned could negotiate adequate adjustment programs aimed at placing the members in a position to settle their arrears to the Fund. Observance of the principle of uniform treatment of members was seldom as important in the handling of overdue obligations as in other areas.

He agreed with the staff that once a member had been declared ineligible to use the Fund's resources the Executive Board should review the country's arrears at intervals of no more than three months, Mr. Salehkhoul said. Those reviews, together with regular Article IV consultations, would keep open the channel of communications with the members concerned and would enable the Fund to continue monitoring their situation and to encourage the members to eliminate their arrears to the Fund. Finally, he wished to associate himself with the comments in the latter part of Mr. Massé's intervention, which were consistent with his own position on overdue obligations.

Mr. Zecchini remarked that the arrears problem had worsened since the previous discussion on it despite the measures that had been adopted by the Executive Board. The staff report clearly showed that the rate of increase in overdue payments had recently accelerated considerably, and that both the period in which obligations had been outstanding and the number of members with arrears had been increasing. Furthermore, there was a danger that the arrears could continue to grow: the ten members that were currently the subject of complaints or action by the Executive Board had total obligations to the Fund through the final maturity of

their outstanding purchases or Trust Fund loans estimated at SDR 3 billion--an amount nearly three times greater than the Fund's reserves. Those factors clearly underscored the need to strengthen and refine the Executive Board's procedures for dealing with overdue obligations as well as the need for new forms of cooperation between the Fund, debtors, and major creditor countries.

Only two of the countries that had been the subject of formal complaints had settled their overdue financial obligations, Mr. Zecchini noted. When a country's arrears were not due to problems of a transitory or administrative nature, they tended to accumulate rapidly, making it all the more difficult to eliminate them. Even in cases in which payments problems were related partly to unfavorable external factors, the problem of the arrears was usually compounded by the inadequate economic policies of the country concerned. Those policies tended to cause arrears to balloon and discouraged the international financial community from providing the countries concerned with adequate financial support. Corrective action must be taken by members at an early stage in their arrears problem, and to that end the Fund should be more effective in taking the initiative to alert the countries concerned to potential problems. The main responsibility for solving arrears problems clearly rested with the individual countries concerned; other parties could merely support the efforts of the country with arrears to take corrective actions.

He supported the staff's approach to so-called preventive actions, Mr. Zecchini said. In addition, a member's past record of payments should be taken into account in the design of a Fund-supported program for the member as well as in the surveillance of the member's policies under Article IV. The strength of the adjustment effort by a country with arrears as reflected in the country's Fund-supported program should be greater than the Fund normally required of members. In addition, purchases should be timed to take place only after the due dates for repayments. In addition, there should be a greater number of prior measures and closer monitoring of their implementation. In cases in which the Fund's exposure in a member was thought to be excessive in comparison with the country's creditworthiness, access under an arrangement should normally be set in a way that would permit net repayments to be made to the Fund. At the same time, members should clearly understand that the Fund would stand ready to give them financial support once the overdue payments problem had been solved.

He agreed with the staff that some flexibility in the establishment of review periods should be maintained, Mr. Zecchini stated. The three-month review period should be seen as a limit and not as a rule to which exceptions could be made. Such flexibility should help to dispel the impression that review periods were the equivalent of grace periods. Review periods could be shortened for members that had a poor record in meeting their obligations to the Fund and did not seem responsive to the Fund's policy recommendations. Since prompt action by a member was required to keep its arrears situation from deteriorating, he could accept some shortening of the current, five-month period between the

emergence of an overdue payment and the Executive Board's substantive consideration of the Managing Director's complaint; for example, in cases in which the arrears were recurrent and relatively significant, a reduction in the period from five months to four months would be appropriate. A period shorter than four months might not be helpful; members must be given sufficient time to eliminate their arrears.

He agreed with the staff that the arrears of individual members that had been declared ineligible to use the Fund's resources should be held on a quarterly basis, Mr. Zecchini said. It was important for the Executive Board to keep the pressure on those countries by closely monitoring them and by making them realize that the declaration of ineligibility was not the final step that the Board could take. In that connection, the attitude of both of the countries that had been declared ineligible thus far seemed unsatisfactory. After the declaration of ineligibility Guyana had made insignificant payments to the Fund, while it had shown greater willingness to deal with its economic situation and to make payments to the Fund before the declaration. Viet Nam had not changed its negative attitude after the declaration of its ineligibility to use the Fund's resources.

Additional means should be devised to keep the pressure on members that had been declared ineligible; compulsory withdrawal from the Fund should be seen as a feasible solution only in extreme cases, Mr. Zecchini said. Executive Directors should bear in mind the possibility of raising special charges with a view to doing more than merely recovering the financial costs to the Fund of overdue obligations. Such charges could be applied on a case-by-case basis after the Executive Board had taken into account a member's record of repayment and the role of external factors in the emergence of the country's arrears. Special charges were to be discussed further on another occasion in the near future.

The staff's conclusion that members had not always given priority to settling their overdue obligations to the Fund was a cause for concern, Mr. Zecchini said. He wondered whether the staff felt that the countries concerned had attached greater importance to maintaining good relations with non-Fund creditors, or whether the countries repayment decisions had been influenced by the fact that interest rates on Fund credit were below market rates. If the latter were true, special charges that rose over time would seem an appropriate way of creating an incentive for the members concerned to give a higher priority to repaying the Fund.

In response to members that had been declared ineligible to use the Fund's resources but that had maintained a negative attitude toward their arrears to the Fund, the Executive Board could limit, on a case-by-case basis, the availability of some of the services that the Fund normally provided, Mr. Zecchini remarked. For example, the Fund could limit its technical assistance missions to members whose financial conditions did not explain their lack of compliance with their obligations to the Fund and which did not attach the highest priority to repaying the Fund.

Mr. Mtei said that the countries in his constituency attached considerable importance to the present discussion and hoped that it would result in a major reconsideration of the Fund's present approach to overdue obligations. Six of his countries were in arrears to the Fund. The present review should give the Executive Board an opportunity to adopt a more realistic approach to the difficulty that some members had in meeting their financial obligations to the Fund.

He too was deeply concerned about the level of overdue obligations, the rapid rate of their accumulation, and the serious implications of the arrears for the Fund's monetary character, its integrity as a cooperative institution, and the revolving nature of the Fund's resources, Mr. Mtei continued. Indeed, it was the deep concern of the countries in his constituency about the Fund's integrity that had prompted them to call upon the Executive Board to consider adopting a more pragmatic approach to the problem of arrears to the Fund and the difficulties that some members were encountering in discharging those obligations in a timely manner. At the same time, it was important to note that the Fund was not facing a financial or liquidity crisis because of the arrears. As Mr. Massé and Mr. Sengupta had stressed, the bulk of the arrears were accounted for by a very small number of members. Moreover, his authorities were fairly optimistic about the prospects for settling the arrears as a result of the policies that were likely to be adopted by the countries concerned in the near future, especially Sudan and Zambia, which had adopted comprehensive economic reform measures recommended by the Fund.

The present policies and procedures for handling overdue financial obligations to the Fund and the reactions and views of some Executive Directors at the present discussion seemed to be based on the implicit assumption that members with arrears had the resources to make the overdue payments and merely needed to be urged to do so through the exertion of as much pressure by the Fund as possible, Mr. Mtei said. That assumption was unrealistic. Members with arrears were not deliberately defying the Fund; in fact, they faced genuine difficulty in meeting their financial obligations to the Fund despite the priority they gave to meeting those obligations. Because it was not based on a realistic assessment of the situation in members with arrears, the Executive Board's present approach to handling those cases had failed to solve the problem of arrears. By any measure that problem had worsened in recent months.

The first step that should be taken to solve the arrears problem was to recognize the genuine difficulties that had led to the emergence of arrears in individual countries, Mr. Mtei commented. On page 5 the staff had gone part of the way toward admitting that the members concerned faced genuine difficulties in stating that "in several of these cases (of overdue obligations) payment problems have persisted despite repeated adjustment programs and the prolonged use of Fund resources, and obligations due to the Fund have risen to levels that not only are large in absolute terms and relative to quota but also represent a significant factor in members' overall balance of payments and debt servicing problems."

The Fund was a major creditor of the six members of his constituency with arrears to the institution, Mr. Mtei said. The total obligations of those countries to the Fund in the period up to December 1986 represented on average about 38 percent of their annual export proceeds; the ratio exceeded 70 percent for some of those countries. Total repurchases in the same period by 15 African countries in his constituency would amount to \$1.3 billion, an amount equivalent to all the resources available under the World Bank's Special Facility for Sub-Saharan Africa.

In 1982, when major debtor countries had had serious difficulty in servicing their debt on time, the Fund had stepped in with an innovative approach, asking creditors to provide debt relief and supporting the adjustment programs of debtor countries to enable those countries to maintain their costly adjustment efforts, Mr. Mtei recalled. The Fund should be expected to adopt a pragmatic approach to solving the problem of overdue obligations, taking into account the genuine difficulties in some of the debtor countries. The monetary character of the Fund and the revolving nature of its resources were important, but the Fund should learn from recent experience how to handle the present problem of overdue obligations. On the Fund's advice, the commercial banks were rescheduling debts and providing new resources to debtor countries; they, too, were monetary institutions and made their resources available generally on a short-term basis.

On several previous occasions some Executive Directors had underscored the need for the Executive Board to consider the applicability of Article V, Sections 7(g) and 8(e) to some of the cases of overdue obligations as part of a pragmatic approach to solving the problem of arrears to the Fund, Mr. Mtei said. Several Executive Directors had made the same point at the present meeting. Under those provisions, the Fund could postpone the discharge of repurchase obligations and permit payment of charges in national currency by a member that was facing exceptionally serious problems. On three occasions in the past the Fund had agreed that under Article V, Section 7(g), members could postpone the discharge of repurchase obligations. Given the provisions in the relevant Articles and certain precedents, the Fund should consider postponing repurchases by countries facing exceptional hardships. A postponement would still enable a member to make repurchases within the maximum five-year period stipulated by the Articles, but it would give low-income, debtor developing countries an additional one or two years to make needed adjustments and to feel the benefits of the adjustments.

The Fund should not apply the Articles selectively, Mr. Mtei went on. The Articles obliged members to meet their financial obligations to the Fund but also gave the Fund some flexibility in handling countries facing exceptional hardships. Just as Secretary Baker's plan dealt with the problems facing debtor countries that had borrowed in capital markets, the Fund should take the initiative to propose ways of dealing with problems related to low-income countries' debt, including debt to the Fund. Executive Directors should take a more positive approach than they had hitherto to solving the problem of overdue financial obligations to the Fund.



The level and growth of arrears to the Fund were alarming for both the Fund and the members concerned, Mr. Mtei remarked. However, the figures must be seen in proper perspective: nearly all the countries that were having difficulty in making payments on time were low-income African countries that faced exceptionally difficult economic and financial problems and serious resource constraints even though they had implemented adjustment measures at substantial social and political costs.

In Mr. Dallara's background note the projected impact of the arrears on the Fund's net income and the rate of charge was based on the assumption that countries with arrears would never repay the Fund--something that was most unlikely, Mr. Mtei said. All the overdue obligations would eventually be eliminated. Meanwhile, the Fund must give the members concerned time to implement and feel the beneficial effects of corrective measures and should strengthen the members' adjustment efforts by providing financial assistance. The Fund should adopt a more flexible approach to overdue obligations so that the countries concerned could deal with the problems facing their economies.

The Fund naturally must take steps to ensure the timely discharge of repurchases, Mr. Mtei continued. However, the possible implications of the preventive actions described on pages 7 and 8 of the staff paper for the quality of Fund-supported adjustment programs was a cause for concern. He doubted whether Fund-supported programs could help a member to deal with the imbalances in its economy if the overriding preoccupation of the staff in designing an adjustment program was the maintenance of reserve targets, the need to accumulate sufficient budgetary resources, and the establishment by a member with arrears of a special foreign exchange account that would guarantee future repayments to the Fund. The only real security for timely repayment to the Fund was the restoration of financial stability and the resumption of economic growth in debtor countries. The Fund's intensive efforts to help members to formulate corrective measures should be continued. However, in the absence of adequate financial support, corrective efforts could not succeed. During the recent discussion on developments in capital markets (EBM/85/165 and EBM/85/166, 11/13/85), Executive Directors had stressed that a further reduction in the exposure of commercial banks to debtor developing countries would weaken the quality of the banks' existing assets in those countries. The same conclusion was applicable to the Fund's assets in low-income debtor developing countries with arrears to the Fund.

He agreed with the staff that the present policies to reduce or prevent arrears had not been effective, Mr. Mtei remarked. However, that problem had little to do with either the timing of the Executive Board's involvement in cases of arrears or the intervals between reviews of such cases. He disagreed with the staff that members had seen those intervals as a kind of grace period and that speeding up the timetable for reporting and action by the Executive Board as recommended by the staff would help to solve the problem of overdue obligations. The present policies concerning arrears could not be effective because they overlooked many of the main factors that contributed to the arrears problem. In some cases the

Executive Board had gone as far as declaring that a member was ineligible to use the general resources of the Fund, but the only clear result of that action was that it had aggravated an already difficult situation in the country concerned by weakening the country's ability to obtain further resources, which in turn reduced the chances of eliminating the country's overdue obligations at an early date.

The staff recommendations concerning steps that the Fund could take following a declaration of ineligibility would be counterproductive, Mr. Mtei considered. Punitive actions would merely alienate the members concerned and would lead to a further deterioration in the relations between the Fund and those countries at precisely the time when the channels of communication should be kept open. It was difficult for him to see how imposing additional financial penalties, severing nonfinancial relations with a member, or initiating compulsory withdrawal proceedings would make a positive contribution to an early settlement of a member's overdue obligations to the Fund. He was encouraged by Mr. Dallara's statement that Mr. Dallara's views on ineligibility and expulsion were not yet fully developed. Steps such as compulsory withdrawal from the Fund would not be in the Fund's best interest in dealing with countries that had been cooperating with the Fund, were implementing adjustment policies approved by the Fund, and were facing difficulties caused by factors beyond their control.

Mr. Sugita said that he was deeply concerned about the deteriorating situation with respect to overdue obligations to the Fund. The serious nature of the problem was reflected in the Fund's income position in the first half of the present financial year. The arrears had an unfavorable impact on the Fund's financial integrity, and the cost of offsetting the arrears would have to be borne by members that had remained current in the Fund. The preventive and corrective measures that had been introduced thus far might have helped somewhat to prevent additional arrears, but they had not gone far enough to reverse the deteriorating trend in arrears. Accordingly, the policies for dealing with cases of overdue arrears should be kept under continual review. Any feasible means of further strengthening the preventive measures would be welcome.

Arrears to the Fund were almost always associated with deep-rooted economic imbalances and economic management problems in the countries with the arrears, Mr. Sugita noted. He was therefore pleased that the staff had stood ready to assist the members concerned in formulating needed adjustment policies, and the staff should continue to do so in coming months. At the same time, the Fund must urge members with arrears to give the highest priority to eliminating their overdue financial obligations. Mr. Dallara had made an interesting suggestion to include a section on a member's ability to repay the Fund in each staff paper on a member's request to use the Fund's resources. He looked forward to receiving at the earliest possible date a staff paper on the introduction of provisions to cover losses due to overdue repurchase obligations.

The intervals between Executive Board discussions of a member's arrears must be used to formulate and implement the policies needed to settle the arrears, Mr. Sugita said. To that end, more active participation by the Executive Board at an earlier stage might be warranted in some cases, as experience showed that an Executive Board discussion of a member's arrears frequently prompted the member to make some payment or even full settlement. Advancing the timetable for the Executive Board's discussions on a member's arrears would be appropriate if the member concerned seemed likely to make little progress in settling its arrears to the Fund. The staff's suggestion to establish a timetable that would provide for a more rapid overall consideration of a member's arrears was worth examining.

It might be useful for the Executive Board to consider the arrears of a member that had been declared ineligible to use the Fund's resources on a regular basis in order to underscore the Board's strong interest in such cases, Mr. Sugita remarked. Alternatively, in the context of the effort to strengthen surveillance the Fund could conduct a consultation with the countries concerned six months after the Article IV consultation. The main objective of the additional consultation would be to expedite a settlement of a member's overdue obligations to the Fund; the size of the mission for such consultations could be kept to the minimum, and the staff paper resulting from the mission need not be comprehensive.

His authorities were strongly opposed to postponing a member's payment obligations to the Fund, Mr. Sugita said. That option had been discussed and rejected in April 1984, and he saw no reason to revive it. A postponement of payment obligations in the present circumstances would be a fundamental departure from the Fund's established lending policy and would critically damage the Fund's monetary character.

Mr. Fugmann stated that he supported Mr. Foot's request for separate indications of total overdue repurchases and overdue charges. The accumulation of overdue obligations to the Fund was a growing and serious problem. The buildup was particularly worrying because it had taken place during a period of accelerated growth in the world economy.

The staff report mentioned two especially disquieting aspects of recent developments in arrears to the Fund, Mr. Fugmann remarked. First, for a number of members, their arrears to the Fund comprised a substantial part of their total external arrears. Second, in several cases, the possibility of eliminating the arrears did not depend upon a satisfactory adjustment program alone; it also depended upon the resumption of adequate financing from other sources in support of strengthened policies. The need for additional financing seemed to complicate the effort to find a solution to the arrears, as the negotiations on such financing often involved a relatively large number of parties.

He endorsed the measures that management and staff had already taken in working intensively with individual members to prevent and correct problems that had caused overdue obligations to the Fund, Mr. Fugmann

commented. The initiative that the Fund had taken in alerting members to potential problems, in emphasizing the importance of early action to deal with problems, and in providing assistance in devising preventive measures was of great significance, although it had not proven adequate in many cases. Given the growing arrears problem, clarifications of and certain changes in present procedures were called for. He agreed with the staff that the Managing Director's complaints should be issued at an earlier stage in certain cases and that the review periods should be shortened if the member was not making adequate progress in eliminating its arrears to the Fund.

The present five-month period from the time a member's obligations became overdue for more than a month until substantive consideration of the arrears by the Executive Board was too long; substantial additional arrears could accumulate in that period, Mr. Fugmann said. As a general rule, that period should be shortened so that the Executive Board would become actively involved in a member's overdue obligations at an earlier stage than hitherto. Earlier involvement by the Executive Board would be beneficial for the country with arrears, as the Fund could help the member to formulate corrective measures, thereby avoiding the accumulation of an unmanageable amount of arrears. Subsequent review periods of no more than three months each should provide the desired and necessary flexibility to tailor each period more closely than hitherto to a member's actual performance and to the expectations regarding the member's ability to settle fully its arrears in the near future. He was willing to consider the proposal of Mr. de Forges concerning the review periods, even though it would not necessarily treat all members in the same fashion. He was not fully convinced that it would be wise for the Fund to establish different procedures for members with large and small arrears. In any event, the staff should continue to help members with arrears to re-establish normal relations with the Fund. In that connection, the proposed use of Trust Fund reflows in support of adjustment programs should be helpful. Finally, he accepted the staff's suggestions regarding the steps that the Fund should take after a member had been declared ineligible by the Executive Board to use the Fund's general resources; reviews of such members at six-monthly intervals would be sufficient.

Mr. Polak commented that the problem of arrears had obviously become increasingly serious in recent months, and there was every reason to consider strengthening the Fund's policies for dealing with arrears.

The staff had suggested either leaving the existing corrective policies in place and applying them more firmly in individual cases, where-ever necessary, or adopting a tighter schedule for applying the relevant procedures while maintaining some flexibility in specific cases, Mr. Polak remarked. He agreed with Mr. Massé's comments concerning the preferability of the second approach. Extra charges on overdue payments would be an appropriate part of the effort to strengthen the Fund's policies for handling members with arrears. In addition, there was scope for preventive actions by the Executive Board, although he shared some of the reservations that Mr. Massé and Mr. Mtei had expressed about that alternative. He

agreed with Mr. Dallara that each staff paper on a member's request to use Fund resources should include a section on the member's likely ability to repay the Fund on schedule.

However, it was important to recognize that the various proposed preventive and corrective measures would have a limited impact on the arrears problem, Mr. Polak continued. The ultimate sanction available to the Executive Board for the time being was the declaration of a member's ineligibility to use the Fund's resources. In fact, however, as soon as any country fell into arrears it was automatically unable to use the Fund's resources. Moreover, those members had very limited access to World Bank credit and probably no access to commercial bank credit. Even though the economic cost for those countries of their arrears was high, they persisted in maintaining policies that perpetuated the arrears.

The Fund's policies on arrears worked essentially when they were applied to members that attached substantial value to their international financial reputation, Mr. Polak noted. The policies had been of great success in dealing with members such as Nicaragua, Chad, and some others that had taken steps to eliminate the arrears before they seriously harmed their international financial reputation. The policies apparently had also encouraged some members--including some African countries--to avoid accumulating any arrears despite the very difficult conditions in those countries.

The declaration of ineligibility to use the Fund's resources was an indispensable part of the Fund's procedures for handling arrears, Mr. Polak considered. At the same time, the need to make such a declaration was in effect evidence of the Fund's failure to handle a member's arrears successfully. Once a declaration had been made, a member's arrears could be dealt with only by informal procedures involving management, the Executive Director for the country concerned, the staff, and friendly countries. Once a declaration had been made it was important for the Fund to show clearly that it had not given up on the country. Accordingly, the Article IV discussion subsequent to the declaration of ineligibility was important. Quarterly reviews after a declaration of ineligibility would not be useful; they would soon be seen to be merely empty gestures. Forced withdrawal from the Fund did not seem to be the next logical step after a declaration of ineligibility. Forced withdrawal should be reserved for a member whose actions clearly showed that it had lost all interest in maintaining any relations with the Fund. In any event, forced withdrawal was a particularly difficult step to take as it required approval of a decision by an 85 percent majority of the Board of Governors. At present, only one country--Democratic Kampuchea--seemed to qualify for such treatment. It was not helpful to pursue further the possibility of compulsory withdrawal for members that had been declared ineligible to use the Fund's resources because of their arrears to the institution. Finally, the staff should study the possibility of introducing loan-loss provisions; a staff paper on the subject at an early date would be welcome.

Mr. Finaish said that the data provided by the staff on recent developments in overdue obligations to the Fund indicated that the seriousness of the problem had increased. As difficult as the problem appeared to be, it was crucial for the Fund to avoid giving the impression that the problem was intractable. A concerted effort to deal with the problem at the present juncture stood a good chance of reversing the current trend in arrears before it reached the stage at which drastic solutions would be required. An essential requirement for the success of that effort was the willingness of all the parties concerned to strengthen and improve the coordination of their roles in dealing with the problem of arrears. Each of the parties--the countries with arrears, the Fund, creditors, and donors--would have an essential role to play in solving the problem of arrears.

The primary responsibility for becoming current in the Fund and for maintaining that status rested with the members with the overdue obligations, Mr. Finaish stated. The adoption of credible corrective policies was crucial not only to send a signal to the other parties that a member with overdue obligations was doing its share to solve the problem but also to avoid the recurrence of the problem in the future. It was of course true that some countries might choose for one reason or another to avoid or postpone taking painful but necessary policy actions. However, it was difficult to imagine that a large number of members would accept the costs of a member's long-standing or permanent overdue status. In most cases, a concerted effort by the Fund and other sources of financing to develop a workable formula for dealing with a particular case of overdue obligations was unlikely to be rejected by the country concerned in favor of the status quo. An important criterion for judging whether a particular formula was workable was whether the formula was perceived by the country concerned as being a better alternative to the country's remaining overdue in its obligations to the Fund. That task was admittedly often a difficult one. However, intensive and coordinated efforts by the Fund and other creditors and donors could play an important role in the shaping of the perceptions of the costs and benefits of the countries with arrears and would thereby affect the policy decisions of the countries with arrears.

Another important responsibility of members with arrears was to show that they were giving priority to settling their overdue obligations to the Fund, Mr. Finaish continued. He wondered whether the staff's blanket judgment expressed on page 10 that members with arrears had not given priority to the settlement of those arrears was justified. That conclusion might be true in some cases, but it was probably not true in all cases. In any event, it was important to bear in mind that the degree of priority given by a member to the settlement of its arrears to the Fund could not realistically be divorced from the question as to whether or not the settlement of arrears was included as part of a comprehensive package to improve the member's financial situation. In that connection, the coordination of efforts by all the parties concerned played an important role.

It was legitimate and necessary for the Fund to seek the assistance of all the parties concerned in dealing with a problem of arrears, but given the Fund's unique position, it was the Fund's responsibility to lead the required concerted effort, Mr. Finaish said. To a significant extent that requirement was already being met, at least in some of the cases of overdue obligations. That active role should be further strengthened. In adopting policy guidelines and procedures for handling members with arrears the Fund should not put itself in a position of not being able to play its role in the most effective manner. In that connection, there had been a positive change in the Fund's attitude in the recent past, especially with respect to the scope of discussions between the staff and members with arrears. In that connection, Mr. Massé's final comments were particularly useful.

If the preventive measures outlined by the staff were implemented carefully, selectively, and in a balanced manner, they could help to reduce the risk of the occurrence of arrears in the future, Mr. Finaish considered. However, those measures should not result in any unwarranted generally restrictive procedures by the Fund. The contagion effect associated with commercial bank response to the debt problem was all too familiar. In addition, as a preventive measure the Fund could also play a useful role by helping members to manage their cash flow; cash flow problems had clearly been a significant factor in the emergence of the arrears in at least some cases.

As to the Executive Board's procedures for noting complaints by the Managing Director and for dealing with cases of arrears after the complaints had been given substantive consideration by the Executive Board, he preferred to maintain the current timetable as a general guideline and to maintain sufficient flexibility to deal with special circumstances, Mr. Finaish remarked. Such flexibility inevitably involved an element of judgment and the Executive Board should therefore be cautious. Holding reviews every six months after a member had been declared ineligible to use the Fund's resources would be more realistic than the quarterly reviews suggested by the staff. However, all those procedures should be seen in proper perspective: unless they were part of a wider effort to deal with arrears cases, the procedures--no matter how refined--could only have a limited effect. As for the further prudential measures mentioned in the staff paper, he looked forward to discussing them in greater detail at a later stage.

Cooperation by donors and creditors would be an essential element of a durable solution to the arrears problem, Mr. Finaish commented. One aspect of the role of donors and creditors was the flexibility in the type and timing of the assistance they provided. The recent case of Somalia underscored the importance of that aspect of the role of donors and creditors. There were, of course, occasional logistical problems in the disbursement of aid, but an extra effort was needed to minimize such problems that, in certain instances, could have a direct bearing on a member's ability to become and remain current in the Fund. Most donors understandably preferred to provide project and other development aid

instead of cash or a cash equivalent. However, in some cases a member's development effort could be jeopardized by the emergence of overdue obligations as a result of inadequate balance of payments assistance. In some cases in the past the provision of adequate development assistance had been linked to the existence of a Fund-supported adjustment program. The absence of any cash assistance made it extremely unlikely that a member could implement the required adjustment program without accumulating new arrears to the Fund. It would be unfortunate for such problems to threaten the process of genuine economic reform that at least some countries with arrears to the Fund had undertaken.

Mr. A. R. Ismael said that the continued deterioration in 1985 in the overall situation with respect to overdue financial obligations to the Fund was a cause for serious concern. The policies and procedures that had been adopted to deal with the growing problem had been effective in a few cases, but the total amount of arrears had increased. The arrears problem had not yet become unmanageable, but a review of the existing policies and procedures might well be called for, although it should be approached cautiously and pragmatically. The Fund should not be seen to be in a hurry to change those policies and procedures, which had been applied in a flexible manner over the previous six months. Furthermore, those policies and procedures were still evolving, and more time was needed before a thorough assessment of them could be made. The arrears problem seemed to be intractable because the economic and financial circumstances of a few countries were particularly difficult.

The general external debt problem was the root cause of the failure by members to discharge promptly their financial obligations to the Fund, Mr. Ismael observed. In its brief discussion of the economic and financial developments behind the emergence of arrears to the Fund the staff had indicated that following the economic recovery in industrial countries, debtor countries as a group had recorded an improvement in their external current account position. It was important to note that the members with substantial arrears to the Fund also had not fully benefited from the recovery in industrial countries and continued to have weak external payments positions. Those countries, and especially the ones with particularly difficult economic and financial conditions, were in a very vulnerable position. It was in recognition of that fact that the Fund had been flexible and pragmatic applying its policies and procedures for handling arrears.

The staff report clearly showed that delays or difficulties in making repurchases were due largely to the underlying domestic and balance of payments problems of the members concerned and to the members' slow progress in achieving the necessary degree of adjustment, Mr. Ismael continued. While the Fund's catalytic role had helped some countries to increase their ability to meet their external debt service obligations, including arrears to the Fund, preventive and corrective actions for dealing with arrears could be effective only if the members in arrears were prepared to implement strong adjustment measures quickly and flexibly and if the adjustment effort were sustained in the medium run. The degree



of flexibility in designing and monitoring Fund-supported adjustment programs was also an important aspect of preventive and corrective actions.

The prudential measures that the Fund had introduced thus far to strengthen its financial position were appropriate, and he looked forward to discussing various aspects of those measures in the near future, Mr. Ismael said. The present timetable for Executive Board consideration of reports and complaints on members' arrears should remain unchanged for the time being. The flexibility and pragmatism that had helped the Executive Board to deal with cases of arrears thus far should be maintained in the coming period. The Executive Board was already actively involved in all the stages of a member's arrears, and Executive Directors for countries that had fallen into arrears had already impressed upon their authorities the fact that the Executive Board's review periods were not meant to serve as grace periods for the members concerned. The Executive Board's present timetable for considering individual arrears cases gave debtor countries sufficient time to formulate appropriate adjustment policies that would help the countries to eliminate their arrears. A distinction should be made between members that were unwilling to repay the Fund and members that were simply unable to make payments; that distinction was admittedly difficult to make.

The Executive Board should set reasonable review periods on a case-by-case basis, Mr. Ismael considered. Any shortening of the present three-month period would constrain some of the already difficult communication channels between the Fund and some of the members of his constituency. Tightening the present policies and procedures for dealing with arrears cases would not help to solve the overall arrears problem.

Mr. Hospedales said that the staff report was useful and that he agreed with many of the staff's recommendations. However, he was worried that the present method of dealing with overdue obligations had not prevented a steady increase in the number of countries with arrears. The arrears problem had serious implications for the entire international monetary system, and more effective ways of dealing with the problem should be found. In that connection, he wished to associate himself with Mr. Massé's personal comments.

At present, when a member incurred arrears to the Fund it was immediately prevented from using the Fund's resources, and the Fund was prohibited from formally negotiating a program with the member, Mr. Hospedales noted. Those prohibitions increased the difficulty the member had in obtaining bridging financing that would enable it to repay the Fund, particularly if the country concerned could not obtain the bridging financing from official creditors and was forced to resort to commercial sources. Accordingly, in carefully selected cases, where exceptional hardship or other exceptional circumstances were evident, and the members concerned were prepared to introduce a comprehensive adjustment program, the Fund should take advantage of the provisions of Article V, Sections 7(g) and 8(e), provided that the adjustment program and the financial assistance that the Fund would be able to provide under those provisions would accelerate

the liquidation of the members' arrears and the restoration of a viable balance of payments. The provisions of Article V, Sections 7(g) and 8(e) should be used only in those cases in which payments to the Fund would create exceptional hardship for the members and the Fund's financial assistance was likely to accelerate the elimination of the members' arrears to the Fund. Otherwise, no changes were needed at the present in the policies and procedures for dealing with cases of overdue obligations to the Fund. The procedures for taking advantage of Article V, Sections 7(g) and 8(e) would have to be the subject of careful study.

Mr. Dallara's background note clearly showed the potential adverse impact on the Fund's income position of the growing arrears to the Fund, Mr. Hospedales remarked. The Executive Board would have an opportunity to discuss that matter during its scheduled review of the Fund's income position in the near future. He hoped that the Executive Board would take the steps that he had suggested to ensure that the unfavorable scenarios in Mr. Dallara's background note would not materialize.

Mr. Salinas said that he too believed that the growing problem of arrears was a cause for grave concern and that steps should be taken to solve it promptly. The amount of outstanding overdue obligations had continued to increase in the first nine months of 1985 at a pace that by end-1985 would more than double the amount at the end of 1984. At the same time, the amount of time that arrears had been outstanding and the number of members with arrears had also increased.

However, outstanding overdue obligations were still not particularly significant in comparison with other aspects of the Fund's financial position, Mr. Salinas went on. Overdue obligations were the equivalent to 1.1 percent of outstanding Fund credit, a low figure, particularly in view of the slow rate at which Fund credit had grown over the previous two years. Moreover, although the number of members with arrears had increased to 17, a smaller group--just 6--accounted for almost 85 percent of total arrears. The arrears problem was still confined to a relatively small number of countries whose imbalances had been known to be substantial even before they had become users of the Fund's resources.

Commenting on the staff's analysis of possible actions to prevent arrears, Mr. Salinas said that there was an increasing tendency to design Fund-supported programs with a view to ensuring that the members concerned would be able to meet their obligations to the Fund, an effort that added little to the effectiveness of the programs. The appropriateness and desired strength of a member's adjustment effort should be judged in the context of not only the likelihood of achieving the program targets, but also the member's ability to regain a manageable domestic and external position. If a member with a Fund-supported program was likely to reach the program objectives, there was no need to worry that the member might not remain current in the Fund. The problem of arrears was usually not the result of the unwillingness of a member to remain current in the Fund. The problem usually arose because of objective conditions that kept a member from discharging its obligations on time regardless of the

magnitude of the adjustment that the member could have undertaken and despite the member's prolonged use of the Fund's resources. Such members needed to implement feasible adjustment programs with appropriate financial support, and they must be given reasonable amounts of time to implement the programs and to make repayments to the Fund.

During the scheduled discussion on special charges, Executive Directors would have an opportunity to examine in detail the prudential steps that the Fund had taken and could adopt in the future, Mr. Salinas commented. As to the application of established policies concerning arrears, he agreed with the staff that the present period between the initial report on a member's arrears and the substantive consideration of the report by the Executive Board should not be viewed by members as a grace period. Furthermore, the period between the substantive consideration of a member's arrears and a declaration of the member's ineligibility to use the Fund's resources should be seen as a last opportunity for the member to become current in the Fund rather than as a period for the initiation of new negotiations on how and when payments to the Fund could be made.

Earlier involvement than hitherto of the Executive Board through its consideration of reports on overdue payments might be useful; at an earlier stage the member's arrears would be smaller than they would be at a later stage and would therefore be easier for the country to handle, and at the earlier stage the country concerned might have a greater capability to implement corrective actions or to negotiate successfully a new program with the Fund if necessary, Mr. Salinas continued. Any shortening of the timetable for the application of the current procedures for dealing with members with arrears should not be accompanied by a reduction in the flexibility with which the procedures were applied. The flexibility should be retained, and members' arrears should continue to be assessed on a case-by-case basis; that approach was still the most adequate way of dealing with the individual circumstances of each country concerned and of differentiating between countries that faced genuine hardships and countries that were recalcitrant. Finally, the existing procedures for handling a member's arrears after the country had been declared ineligible to use the Fund's resources should be retained; accordingly, such cases should be discussed in the context of the next regular Article IV consultation with the member concerned.

Mr. Dallara remarked that the issue of loan-loss provisions was complex and would require detailed examination before definitive judgments could be made. He was not convinced that the establishment of such provisions would necessarily send a signal that the Fund had concluded that the arrears would never be eliminated. Loan-loss provisions could represent a certain percentage of total arrears on repurchases which had been outstanding for more than, say, 30 days. The loan-loss provisions need not be attached to any particular member.

In his address at the 1985 Annual Meetings, U.S. Treasury Secretary Baker had made a proposal designed to mobilize substantial additional funds in conjunction with the Trust Fund reflows for low-income

countries facing serious and protracted balance of payments problems, Mr. Dallara recalled. That approach could catalyze significant sums from other donors and from the multilateral development institutions, and the U.S. Government was prepared to back it by seeking funding of the order of \$450 million as the United States' contribution to supplementing directly the Trust Fund reflows. He hoped that Executive Directors who wished to help the low-income countries would actively support Secretary Baker's Trust Fund initiative, which was designed specifically to benefit that group of members. Indeed, the initiative was consistent with the staff's encouragement of actions to prevent the appearance and accumulation of arrears. There was clearly a widespread feeling among Executive Directors that a combination of adequate adjustment policies and adequate financing was needed to prevent arrears from emerging. Secretary Baker's initiative on behalf of the low-income countries met both those criteria.

The Treasurer said that more frequent information on overdue financial obligations to the Fund could be provided to the Executive Board. For example, the information could be provided on a quarterly basis if Executive Directors so wished. It was the staff's understanding that quarterly reports would be designed to update the relevant information and that the Executive Board did not wish to hold a discussion each quarter on the subject of overdue financial obligations. In future, the reports would provide summary tables showing separately overdue charges and overdue repurchase obligations.

Reports could also show the importance of future obligations to the Fund in relation to quota, the Treasurer continued. Such information had been provided occasionally in past staff papers. Future staff reports on individual members could contain the amount of each country's overdue obligations and forthcoming obligations in proportion to quota. There were other criteria that were relevant in judging whether a member's overdue obligations and forthcoming obligations were significant. In the recent case of Somalia, the staff had noted that that country's overdue obligations of SDR 9.1 million were equivalent to about 7 percent of Somalia's outstanding use of Fund credit and loans from the Trust Fund. It was also helpful to assess the importance of the arrears in the light of a country's projected exports for the current year and in the light of total arrears. All those measures were useful in judging the importance of individual cases of arrears, and the staff would provide the necessary information to the extent possible.

The question had been raised whether the criteria he had mentioned could be used as a trigger to speed up the procedures for handling individual cases of arrears, the Treasurer noted. In that context, a small amount of overdue obligations was as important as a large amount. Indeed, it could be argued that the procedure should be advanced if the amount of the obligations was small but the member concerned had made no effort to deal with the problem and seemed unwilling to act in the coming period. The appropriateness of using some kind of a trigger mechanism probably was not the main issue at hand but rather the appropriateness

of exercising the option to speed up the current procedures for handling individual cases of arrears if management felt that such action would help to produce a positive result.

The external auditors had not requested that the Fund should adopt loan-loss provisions, the Treasurer explained. They had said that the Fund should examine whether it had adequate procedures to judge whether loan-loss provisions would become necessary. The auditors felt that the Fund should consider the probability that it would incur a loss and the circumstances in which the Fund should proceed to establish loan-loss provisions. If the Fund were to decide that the circumstances warranted its proceeding with the introduction of loan-loss provisions, that move would not mean that the Fund had acknowledged through that action that the overdue obligations would never be paid. A decision to proceed with the introduction of loan-loss provisions would merely be a sign that the overdue obligations had been protracted, that the Fund could conceivably incur a loss, and that the Fund should therefore take precautionary steps to protect the quality of its assets. The question whether or not to introduce loan-loss provisions was similar to the debate that the Executive Board had had on the nonaccrual of overdue charges. The taking of the decision on nonaccrual had not implied that the charges concerned would never be collected. Those charges were still shown in the Fund's accounts as deferred income, thereby clearly showing that the Fund expected to collect the charges eventually but that meanwhile the Fund did not wish to continue as if there had been no change in the quality of the Fund's assets as a result of the overdue charges.

One of the criteria for judging the quality of the Fund's assets was the impact of the assets on the Fund's liquidity, the Treasurer continued. Many Executive Directors had noted the staff's conclusion that for the time being the Fund's liquidity position was not a serious issue. That conclusion was correct when seen in the light of the Fund's present high level of liquidity, but overdue obligations totaled more than SDR 500 million and were becoming at least a visible element in the context of the Fund's liquidity. There was also a difference between judging the impact of certain assets on current liquidity and the likely ultimate impact. For example, some Executive Directors had drawn attention, first, to the consequences that the existence of the arrears might have for creditors' willingness to consider lending to the Fund if such lending were to become necessary again in the future, and, second, the impact that the arrears might have on members' willingness to accept quota increases as a part of the next general review of quotas.

He agreed with Executive Directors that the issue of loan-loss provisions was complex and should be examined carefully, the Treasurer went on. The examination should not be hasty, as there were potential negative consequences for the Fund of the adoption of loan-loss provisions. Possible loan-loss provisions also raised presentational and funding issues. Such provisions could create serious deficits for the Fund if the institution moved in that direction to any significant extent. The staff would need some time to produce a paper on loan-loss provisions.

The staff expected to finish its work on that matter before the end of the current financial year, so that the Executive Board could consider the potential effects of such provisions on the Fund's balance sheet and income statement when it took decisions on the reserve target, rate of charge, and rate of remuneration for the coming financial year.

A question had been raised about the steps, short of expulsion, which could be taken after a member had been declared ineligible to use the Fund's resources, the Treasurer recalled. The Fund lost much of its leverage with a member when it declared a country ineligible, and careful consideration should therefore be given to the steps that were taken prior to the declaration of ineligibility.

The steps that were available to the Fund following a declaration of ineligibility could best be described in general terms rather than in specific detail, the Treasurer continued, because they would depend to a large extent upon the circumstances of each case. The most important criterion in judging which steps to take was that they should hold the promise of producing positive results; the steps should not be empty gestures and should not be likely to produce negative results. One alternative was for friendly pressure to be applied by countries that were willing to assist the member with arrears under certain conditions, including the condition that the assistance would be used to eliminate the member's arrears to the Fund. That approach required consultation among donors, something that was not always easy to achieve. The Fund could conceivably take smaller steps. For example, it might cease providing technical assistance in areas other than the formulation of an adjustment program. That step did not appear appropriate at present in the two current cases of members that had been declared ineligible to use the Fund's resources, but it could conceivably be used in the future. As a general rule, the steps that the Fund would take in dealing with members that had been declared ineligible would have to be decided on an ad hoc basis.

The staff believed that in general it was true that members in arrears to the Fund had not given first priority to eliminating those obligations when making decisions about how to use their foreign exchange revenues, the Treasurer commented. The members with arrears to the Fund had significant export receipts, but some of them had not devoted even a small portion of those receipts to payments to the Fund. It could be argued that the Fund should be given a high priority even in relation to the members' need to pay for imports. In general, the countries concerned had considerable export receipts but had decided that they would fall into arrears with the Fund in order to maintain a higher level of imports than would otherwise have been possible.

One Executive Director had raised the question whether other creditors had been paid by members with arrears when the Fund had not been paid, the Treasurer went on. In fact, some other creditors--including other multilateral institutions--had been given priority over the Fund. It was not clear to the staff whether other creditors had been given preference

because of the relative levels of charges by the Fund and the other creditors. The fact that the Fund's charges were concessional might have encouraged some members to pay off more costly credit first, and it was apparently for that reason that some Executive Directors had suggested that the Fund should consider imposing special charges that would eliminate the concessionality of the Fund's regular charges. At present, the special charges that were being considered would merely recover costs to the Fund of arrears; they would not necessarily eliminate the concessional element of Fund credit. In any event, there was no guarantee that special charges would produce positive results in all cases.

One of the reasons why certain other creditors were sometimes paid before the Fund was that members usually fell into arrears to the Fund after a stand-by or extended arrangement had ended and the members had no expectation of receiving any new funds unless an adequate adjustment program were adopted, the Treasurer continued. Some other creditors did not impose similar conditions and were prepared to continue to disburse funds to the members as long as the countries remained current with those creditors. The World Bank often financed a project over a long period and without the kind of conditionality associated with Fund financing. A member could help itself by remaining current in such a multilateral lending institution because it could receive additional funds without necessarily having to accept conditions on the use of the funds.

As Mr. Polak had mentioned, arrears had their own costs not only for the Fund but for a member in arrears, the Treasurer remarked. The Fund had twice postponed payments due by Guyana; it had also postponed payments due by Nicaragua on one occasion. The postponements had not prevented the arrears of those countries from arising, and that was one of the considerations that the Executive Directors had had in mind in deciding not to grant further postponements. It had seemed clear to the Executive Directors that in those two cases postponements had not been helpful; indeed, the postponements might have worsened the situation, because the overdue obligations had been bunched at the end of the usual five-year repurchase period and both Nicaragua and Guyana had fallen into arrears at the end of that period. The postponements for those countries had not been based on the "hardship" provision of Article V, Section 7(g). They had been based on the staff's view that as the countries had had no cash in hand at the time the repurchases had fallen due, the postponement might have given the authorities time to meet their obligations soon thereafter.

Many members had what could easily be termed hardship conditions but had managed to remain current in the Fund, the Treasurer went on. Frequent use of Article V, Section 7(g) would run the risk that members that made the effort to remain current in the Fund would feel that their efforts were in effect going unrewarded. Those countries might feel that they were being treated unfairly if other countries in similar circumstances were permitted to postpone their payments to the Fund on the ground that the payments would cause a hardship.

Mr. Dallara said that he hoped the staff could complete its examination of loan-loss provisions before the end of the current financial year. Such provisions could be particularly important if the already large repurchase arrears of certain members were to continue to grow in the coming weeks. In that event, it might well be prudent for the Fund to consider possible loan-loss provisions before the arrears problem became even more serious. The arrears situation could conceivably deteriorate more rapidly than had been anticipated earlier in 1985.

Mr. Sengupta remarked that he assumed that after deducting loan-loss provisions from the Fund's final income position, it would not be necessary to increase charges on all users of the Fund's resources. In addition, he wondered whether if two members incurred arrears to the Fund--one because of, say, inadequate expenditure restraint and the other because of exogenous factors such as a sharp drop in commodity prices--the Fund would be able to treat those members differently.

The Treasurer replied that comparing the two countries described by Mr. Sengupta was tantamount to trying to compare twins. There was a third possible situation--namely, that a member that was in a difficult position because of inadequate domestic policies and exogenous factors continued to meet its obligations to the Fund on time by adopting appropriate measures that created confidence among its creditors and resulted in their providing the member with foreign exchange that could be used to pay the Fund. If a member approached the Fund at an early stage in the development of balance of payments problems due to exogenous factors, such as a fall in commodity prices, the Fund could of course consider the member's request for an arrangement with the member before the country fell into arrears. The precise nature of that arrangement would depend upon the Fund's policies at the time. There might be a limit to what the Fund could do in terms of the amount of purchases it could make available because the member might have already made protracted use of considerable amounts of Fund resources in relation to the member's quota. Mr. Sengupta's comments also brought to mind the question of permitting a country to reschedule its payments to the Fund because the payments would result in exceptional hardship for the member. In that connection, the main issue seemed to be whether rescheduling on the ground of exceptional hardship should be agreed after a country had fallen into arrears or before, and whether such rescheduling should be made without any policy conditions. If it were to grant such a rescheduling, the Fund must make certain that the rescheduling would be conducive to solving the member's balance of payments problem and would not simply postpone the solution to the problem.

In considering the issue of rescheduling by the Fund, Executive Directors should not compare the Fund too closely to commercial banks, the Treasurer considered. Some Executive Directors had noted that the Fund was asking commercial banks to reschedule arrears to the banks and to make fresh money available. The Fund was a financial institution and a creditor, but it was a special kind of creditor: the Fund tackled the most difficult cases and should therefore be given first priority by debtors so that those members could preserve their last lifeline to



credit. A member that fell into arrears to the Fund ran the risk of losing that lifeline. If a member approached the Fund before falling into arrears and the member was willing to adopt the adjustment measures that were needed to safeguard the revolving nature of the Fund's resources, that country would reap greater gains from requesting a stand-by or extended arrangement than from requesting a rescheduling. In that connection, much would depend upon the amounts that were involved and on the time that would be needed to adjust the balance of payments to the point at which the country would be in a position to be able to pay the Fund. In that context, rescheduling might not be as preferable as a stand-by or extended arrangement or a purchase under the compensatory financing facility.

The Chairman made the following summing up:

There was broad agreement on several general considerations. First, the present situation concerning overdue obligations is serious; all Directors expressed great concern about it. The situation has worsened in terms of the size and length of the overdue obligations and, to a certain extent, the number of countries in arrears. This has happened despite the range of policies and practices adopted by the Executive Board over the past year to resolve the problem. The seriousness of the situation compels the Fund to consider taking certain decisions; the relevant financial decisions will be addressed in our coming discussions on special charges and the Fund's income position. If it is not checked, the situation concerning arrears to the Fund could weaken the Fund's monetary character as well as the willingness of its creditor members to support and finance it in the future. If allowed to continue, the arrears could create serious problems for those countries that have remained current with the Fund even though many of them face the same types of problems that are facing members with overdue financial obligations to the Fund.

Second, the responsibility for dealing with the problem rests primarily with the member countries that are in arrears to the Fund. While exogenous factors explain to some extent--and sometimes to a substantial extent--the deterioration of economic conditions in a number of countries with arrears, the adoption by those members of strong adjustment measures to restore balance of payments viability is essential.

Third, member countries in arrears should be induced to give priority to actions that are designed specifically to enable them to repay the Fund. In addition, they should introduce corrective measures at an early stage to improve their economic policies and to avoid the emergence and further accumulation of arrears to the Fund.

Fourth, the Fund should keep open its channels of communication with countries in arrears in order to help them formulate adjustment policies and to catalyze external assistance so that these concerted efforts can ultimately be supported by Fund assistance and lead--prior to the Fund's formal commitment to providing such assistance--to settlement of the arrears. A number of Directors underlined the complexity of the negotiations involved in, and the solutions to, such complex cases. In some cases strong bilateral financial support and multilateral development support will be indispensable components of the packages.

Fifth, intervals between Board reviews should be put to good use; they should never be seen as grace periods or as periods in which a member is excused from making every effort to settle its arrears to the Fund.

Sixth, while equal treatment and evenhandedness are essential in Fund procedures, there must be sufficient flexibility in applying our procedures to take into account specific circumstances, performances, and problems.

I come now to the procedural matters that were discussed today. First, seven Directors--who do not carry a majority of the votes--favor changing the Board's general strategy for dealing with overdue financial obligations. Basically they consider that arrears arise mainly because of exogenous factors that are beyond the control of the authorities concerned; in those cases, arrears do not arise because the members are unwilling to pay the Fund. Those Directors consider that such countries should be helped to formulate programs supported by the Fund and should not first have to settle their overdue obligations to the Fund. In the view of these Directors, requiring the members concerned to settle their arrears before negotiating a Fund-supported program would typically be incompatible with the low level of reserves and the general economic situation of those countries. These seven Directors believe that the best way for the Fund to handle such cases would be to negotiate programs with the countries concerned and to invoke Article V, Section 7(g), which permits a member to postpone the date of discharge of a repurchase obligation. This general approach to the problem was not supported by a majority of Directors. Indeed, the majority of Directors expressed strong reservations about such an approach, which in their view could considerably weaken the Fund's credibility and pose a threat to the future of the institution by possibly encouraging members to delay repurchases.

The second major procedural problem that was discussed today was the nature, intensity and timing of the Board's involvement in the handling of cases of arrears to the Fund. A

number of Directors would like to be informed more frequently about developments in the arrears situation, and in future, papers will be circulated on a quarterly basis. This does not mean that each quarter we should review all the relevant procedures and prepare lengthy papers like the one on today's agenda. However, at the least, tables should be updated so that Directors will be able to remain informed of developments. In preparing the tables the staff will take into account the suggestions made by Directors today and any suggestions Directors might wish to make on a bilateral basis.

A majority of Directors favor reducing the period between the emergence of arrears and the first substantive consideration of a complaint. These Directors felt that the present five-month period was too long, as it has tended to coincide with a buildup of arrears that has made it more difficult to tackle the matter; earlier involvement by the Board would have been helpful. Although some Directors favor taking a flexible approach to this period, a majority clearly supports limiting the period to three months. Issuing the complaint two months after arrears have arisen instead of three months would certainly be consistent with today's discussion. The review period following the first substantive consideration would remain three months, but the three months would be considered an outer limit: the decision on the actual timing in each case should take into account the particular circumstances and the performance of the member.

In the area of preventive actions the Fund will continue to work with members to help them avoid the emergence of arrears. A number of Directors stressed the need to improve the design of adjustment programs and to keep in mind the importance of debt and reserve management. I would stress that we are paying increasing attention to those matters; they clearly deserve our close involvement.

Mr. Dallara's suggestion that papers on the use of Fund resources should include the staff's analysis of the member's ability to carry and repay such new debt received strong backing today, and we will try our hand at that.

A majority of Directors felt that once a member has been declared ineligible to use the Fund's resources the Board should not wait as long as the next Article IV consultation to discuss the member's arrears situation. The majority of Directors would like to review the member's situation every six months.

A number of Directors asked the staff, in the wake of the suggestion made by the external auditors, to produce a paper on possible loan-loss provisions. Such a study will be undertaken with a view to holding a discussion in the Board before the end of the current financial year.

To conclude, I would like to stress that the question of arrears has important ramifications for the Fund as a whole. I would emphasize, as I have in previous occasions, that the Fund is a unique institution. I would have great difficulty in agreeing with the small number of Directors who today compared the Fund to commercial banks. The Fund is a cooperative institution and has no commercial objectives. It is on this basis that the rules governing the utilization of Fund resources were established, and these rules must be followed. It is thus improper to consider that, because we are asking banks to increase their exposure after they had become overexposed for purely commercial reasons, the Fund should be asked in effect to take the same course. There is a difference.

In that connection, I have been heartened to hear today from virtually all Directors that the Fund should not cut its relations with members that have arrears and are in difficult situations; Directors stressed that we have to keep the channels open and do all we can to help the members become current in the Fund. This will involve in many cases Fund assistance in formulating appropriate policies for a member that intends to put its affairs in order. Such cases may well also require the Fund to catalyze external assistance. That is the logical route to take once the alternative of resorting to Article V, Section 7(g) has been discarded. One has to look at the full dimensions of the problem of overdue obligations on a country-by-country basis. I would stress the close relationship between the treatment of some of these cases in a cooperative way--particularly with respect to the provision of financial assistance--and the financial consequences for the membership as a whole of not helping to ameliorate such situations. If we are unable to put together reasonable packages of adjustment policies backed by adequate external financing, then the situation will become more difficult for the institution as a whole: the Fund will be confronted with unpleasant consequences for charges and the rate of remuneration.

APPROVED: July 11, 1986

LEO VAN HOUTVEN  
Secretary

Background Note by Mr. Dallara for the Discussion  
of Overdue Financial Obligations to the Fund -  
Six-Monthly Report

The situation relating to overdue financial obligations to the Fund is becoming increasingly serious. Arrears to the Fund have risen rapidly, contributing to the latest projection of a deficit in the net income position of the Fund for Fiscal Year 1986. We will not be focusing today on the specific effects of arrears on the Fund's income position. Nevertheless, I thought it might be useful to give attention to this aspect of the arrears problem, and its potential financial implications. Therefore, I have attached a table providing data that reflect the potential impact on the rate of charge of an increased amount of overdue financial obligations under alternative hypothetical scenarios.

The revised staff estimates for the Fund's income position in FY 1986, as outlined in the paper on the Review of the Fund's Income Position (EBS/85/258, 11/20/85), indicate that in order to generate the additional income needed to reach our income target of SDR 52 million, the rate of charge will need to be increased to 7.87 percent effective November 1, 1985. This is based on a revised projection of a net deficit of SDR 32 million for FY 1986.

In making that projection, the staff has deducted SDR 139 million of overdue charges from operational income, in accordance with the policy of nonaccrual of overdue charges from members in arrears to the Fund over six months. Unfortunately, the amount of income from charges that may actually have to be deferred could be larger, unless members in arrears take immediate action to become current in their obligations and unless their actions receive appropriate support from bilateral donors.

The staff acknowledges this possibility, in Table 4 of EBS/85/258, providing the figure of SDR 255 million as actual overdue charges, plus charges due through April 1986, for members overdue in payments to the Fund at October 31, 1985. I want to make clear that we do not view this as a projection of overdue charges by the end of the financial year; we remain hopeful members will act to eliminate their overdue obligations. But it is important that members be aware of the implications of inaction by members in arrears. The attached table illustrates, in Scenario II, that if deferred charges were SDR 255 million, the rate of charge would need to be raised to 8.94 percent, effective November 1, 1985, in order to generate the additional income needed to reach the agreed income target.

There is a related and complex question concerning the possible need to consider the establishment of loan-loss provisions, a question which the external auditors have raised--see page 10 of EBS/85/245. This issue requires further examination before any decisions can be taken regarding the need to establish loan-loss provisions. The increase in arrears on

repurchases, however, both in amount and length of time, makes it increasingly important. This is particularly the case since the increase in the general reserve target to 5 percent may well be insufficient in the face of the current arrears situation.

For illustrative purposes, therefore, we have developed in Scenario III a hypothetical case where, in addition to the deferral of SDR 255 million in overdue charges, SDR 120 million is deducted from Fund income to establish a loan-loss provision. This is approximately 20 percent of all overdue repurchase obligations through April 1986 by members overdue in payment to the Fund by more than one month at October 31, 1985. In this scenario, the rate of charge needed to meet the income target would be 10.1 percent effective November 1, 1985. It should be noted that if the rate of charge were to exceed the SDR interest rate, this would trigger a review of the remuneration coefficient.

The above scenario is purely illustrative; it is not intended to reflect what would necessarily be the "correct" amount of provisions that should be established, were a decision made to establish such provisions. It is simply designed to illustrate the potential adverse financial implications for the Fund of growing arrears on both charges and repurchases, and to underscore the need for urgent action to eliminate these arrears.

I urge Directors to take these considerations into account in discussing the Six-Monthly Report, as well as in our subsequent discussions on special charges and the midyear review of the Fund's income position. They should also be borne in mind when dealing with particular arrears cases.

Fiscal Year 1986 Net Income (Deficit)  
Under Various Alternative Hypothetical Scenarios

Fiscal Year 1986	Scenario I Staff Revised Estimates <u>1/</u>	Scenario II <u>2/</u>	Scenario III <u>3/</u>
	<u>(Millions of SDRs)</u>		
1. Total operational income assuming deductions of:	3,080	2,964	2,844
(Deferred charges)	(139)	(255)	(255)
(Loan-loss provisions)	(--)	(--)	(120)
2. Operational expense	2,873	2,873	2,873
3. Net operational income (deficit)	207	91	(29)
4. Administrative expense	239	239	239
5. Net income (deficit)	(32)	(148)	(268)
<u>Notes:</u>			
Additional income needed to reach income target (5% of reserves: SDR 52 million)	84	200	320
	<u>(In percent)</u>		
Rate of charge (effective November 1, 1985) to generate additional income	7.87	8.94	10.1

1/ See Table 1, page 3 of EBS/85/258.

2/ Scenario II assumes that deferred income for FY 1986 is SDR 255 million--all actual deferred charges to date, plus charges coming due through April 1986, of members overdue in payments to the Fund at October 31, 1985. See Table 4, Appendix III, p. 24 of EBS/85/258.

3/ Scenario III assumes deferred income of SDR 255 million as explained in footnote 2 and SDR 120 million of loan-loss provisions--20 percent of current overdue repurchases plus repurchases coming due through April 1986, of members overdue in payments to the Fund by more than one month at October 31, 1985.