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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/93

3:00 p.m., June 6, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	M. K. Bush
J. de Groote	
M. Finaish	T. Alhaimus
H. Fujino	
	B. Goos
Huang F.	
J. E. Ismael	Jaafar A.
A. Kafka	H. A. Arias
	M. Foot
	H. Fugmann
	G. D. Hodgson, Temporary
	W. K. Parmena, Temporary
F. L. Nebbia	
Y. A. Nimatallah	
P. Pérez	
	G. Nguyen, Temporary
	J. de Beaufort Wijnholds
	A. V. Romuáldez
	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	L. Tornetta, Temporary

L. Van Houtven, Secretary
K. S. Friedman, Assistant

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2. Senegal - Technical Assistance . . . . . Page 28

Also Present

Exchange and Trade Relations Department: J. Berengaut, J. T. Boorman. External Relations Department: C. S. Gardner, Deputy Director. Legal Department: F. P. Gianviti, Director; J. G. Evans, Jr., Deputy General Counsel; P. L. Francotte, W. E. Holder, R. Munzberg. Middle Eastern Department: D. Hammann. Secretary's Department: P. D. Péroz. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; D. Berthet, J. E. Blalock, J. Caskey, D. Gupta, D. V. Pritchett. Western Hemisphere Department: E. Wiesner, Director; M. Caiola, C. G. Muniz B. Office of the Managing Director: R. Noë, Internal Auditor. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, M. B. Chatah, L. P. Ebrill, S. M. Hassan, J. Hospedales, K. Murakami, A. Ouanes, R. Valladares, A. Vasudevan. Assistants to Executive Directors: A. Bertuch-Samuels, O. S.-M. Bethel, B. Bogdanovic, V. Govindarajan, G. K. Hodges, L. Hubloue, O. Isleifsson, S. King, T. Morita, J. K. Orleans-Lindsay, J. Reddy, J. E. Rodríguez, B. Tamami, E. L. Walker, Yang W.

1. OVERDUE FINANCIAL OBLIGATIONS - SIX-MONTHLY REPORT; AND DECLARATION OF INELIGIBILITY - LEGAL ASPECTS OF SUBSEQUENT ACTION

The Executive Directors continued from the previous meeting (EBM/86/92, 6/6/86) their consideration of the six-monthly report on overdue financial obligations to the Fund (EBS/86/98, 4/28/86; Sup. 1, 5/16/86; and Sup. 2, 6/5/86) and the staff paper on legal aspects of ineligibility to use the Fund's general resources and subsequent actions by the Fund (SM/86/102, 5/14/86).

The Director of the Legal Department recalled that it had been suggested that a setoff could be made at the time of a quota increase, so that the amount paid for subscription purposes by a member with arrears would be used to discharge those arrears. In order to have a setoff, it was necessary to have reciprocal claims; in other words, the Fund and the member concerned should be creditors of each other. However, at the time of a quota increase, there would not be reciprocal claims and a setoff could not be made. At the time of the quota increase, when a member was in arrears, the Fund would be the creditor for the arrears; moreover, the Fund would become the payee for the subscription for the quota increase. In those circumstances, the real problem would not be one of making a setoff, but rather of attributing a payment to the Fund; the Fund would have to decide whether the member would be allowed to pay its quota subscription before discharging its arrears. The Fund had always taken the view, consistent with the general principles of law, that a debtor was free to determine the debts that it wished to discharge first. Therefore, under the Fund's policies, if a member wished to discharge its arrears before paying a quota increase, or vice versa, it was free to do so.

The question had been asked whether the Fund could make an exception and decide to establish a condition that a member must pay its arrears before it was entitled to an increase in quota, the Director continued. A related question was whether the Fund could refuse a quota increase to a member with arrears to the Fund. Those two questions were two aspects of the same problem, the core of which was whether the Fund could make the elimination of arrears a condition for a quota increase. There was no precedent in the Fund's history for considering such a condition, and the Articles did not provide a specific answer in that regard.

Since the Fund's inception, the Director went on, there had been a problem of interpretation with respect to what was the current Article III, Section 2, which dealt with adjustment of quotas. Article III, Section 2(a) stated that "the Board of Governors shall at intervals of not more than five years conduct a general review, and if it deems it appropriate propose an adjustment, of the quotas of the members." The words "if it deems it appropriate" required interpretation on the scope of the power of the Board of Governors in proposing quota increases, and the question had been raised in the early history of the Fund of what the Governors' duties were in that respect. For example, could the Board of Governors decide that there would be a completely disproportionate quota increase for some

members, or that certain members, for whatever reasons, would be deferred a quota increase while others would have one? Under the World Bank's Articles, there was a clear entitlement of each member to subscribe to a proportionate increase in its share of the capital stock of the World Bank subject to conditions that might be imposed by the World Bank concerning payment. There was no such provision in the Fund's Articles. Hence, there had never been a challenge to the idea that the Fund had the power either to propose proportionate quota increases for all members, or to have selective quota increases.

The main question then was the basis on which conditions on quota increases could be introduced, the Director said. Some decisions adopted early in the history of the Fund had introduced conditions. For example, because it had been difficult for the World Bank to increase its own capital stock in the early years of the World Bank, there had been a condition in the Fund that a member requesting a selective quota increase would request a similar increase in its share of the World Bank's capital stock. That practice had been discontinued after a few such cases because it had been felt that the condition was extrinsic to a quota increase in the Fund. It had been concluded that, while the Fund had the power to impose conditions or propose quota increases for members on a selective basis, the conditions had to be based on the purposes of quota increases under the Articles; more specifically, it had been agreed that the decisions of the Fund and the conditions imposed had to be based on the intrinsic purposes of that provision. That opinion had not been incorporated in a decision of the Executive Board, but, in the past, the General Counsel had made several statements to that effect that had not been challenged. Except for the few initial cases mentioned above, the practice of the Fund had been not to take into account conditions other than those that were directly related to the intrinsic purposes of quota increases under the Articles. In a number of cases, quota increases had been proposed to members that were in breach of their obligations under the Articles. For example, some members had had multiple currency practices or exchange restrictions that were not approved under the Articles. One member had been offered a quota increase even though it had become ineligible to use the Fund's resources. On the basis of those precedents, it appeared that the Fund had taken the view that its powers were limited with respect to refusing or imposing conditions on quota increases.

Commenting on the intrinsic purposes of quota increases, the Director said that the purpose of quota increases clearly was to augment the resources of the Fund. Three questions should be asked. What would be the disadvantages for the Fund to increase the quota of a member with arrears to the Fund? Could the Fund refuse a quota increase as a form of sanction? Could there be some other ground for refusing the quota increase? On the first question, it was difficult to prove that there were disadvantages for the Fund to increasing the quota of a member with arrears to the Fund, since such a member could not use the Fund's resources. The quota increase augmented the Fund's liquidity but did not increase the member's access to the Fund's resources as long as the member remained in arrears to the Fund. It was true that, by paying additional amounts

to the Fund, the member with arrears might reconstitute its reserve tranche and be allowed to draw on that tranche. However, the additional amounts paid to the Fund would merely be additional liquidity that the member would be taking back. Moreover, if the member had been declared ineligible to use the Fund's resources, it could not use even its reserve tranche. Lastly, it would be possible to take into account the existence of overdue repurchases to reduce the member's reserve tranche, although that was a highly technical matter. Concerning the second question, the Fund could of course consider new sanctions against members with arrears, but the practice of the Fund, as indicated before, had been not to use quota increases as a means of pressuring a member or as a sanction.

Turning to the third question, it should be noted that the purpose of quota increases was to increase the usable resources of the Fund, the Director of the Legal Department continued. If a member's subscription paid in its currency was not usable for the purposes of the Fund, there was no real contribution by the member through the payment of its currency to the usable resources of the Fund. The Fund could take into account the nonusability of the currency in deciding that the member either would not be proposed a quota increase or would be proposed a quota increase subject to making its currency usable by the Fund. In that connection, the Fund could use the provisions of Article V, Section 7(h), which authorized the Fund to adopt special policies with respect to members in arrears. By adopting such policies, the Fund could test the usability of the currency of the member with arrears, and could conclude that the currency was not usable and that it would therefore not make a real contribution to the Fund's usable resources when that currency was used in the payment of a quota subscription. The Fund could then conclude that there would be no proposal for a quota increase for the member concerned or that there should be a condition that its currency should become usable prior to the quota increase becoming effective.

The Treasurer recalled that Mr. Ismael had proposed that members that received a subsidy from the Supplementary Financing Facility Subsidy Account should also receive the interest earned in the period during which the subsidy was withheld because the member had not paid charges on its purchases under the supplementary financing facility. Mr. Ismael had asked whether it would be consistent with commercial practice to offset the interest earnings against a member's overdue obligations to the Fund. The Subsidy Account was part of the Trust Fund that was administered by the Fund. The subsidy was payable by the Trust on supplementary financing facility charges. The Executive Board had decided that any surplus that was not paid should revert to the Special Disbursement Account and then for use of the structural adjustment facility to 1991. In effect, the question that Mr. Ismael had raised was whether the Fund could, as Trustee, impose a condition on the distribution of the earnings of the investment of subsidy amounts to a member that had arrears to the Fund. There would be no difficulty in withholding the distribution of those earnings to a member that had arrears to the Trust Fund itself. However, it would be difficult to have the Fund as Trustee use its power to impose conditions in response to a claim by the Fund in the General Resources

Account. The relevant commercial practices would be based on the contrast between the liabilities concerned. Banks sometimes entered into contracts that allowed the banks to offset claims that were not comparable. The Fund, as the Trustee, could impose a condition on the distribution of earnings from the Subsidy Account if a member had arrears to the Trust Fund because the claims would be within the same account and would therefore be comparable.

The question had been raised whether the Fund should monitor the capacity of a member to service its debt to the Fund, the Treasurer commented. The staff had recently started the practice of including in all papers on the use of Fund resources a special assessment of the member's ability to repay the Fund. Once an arrangement with a member had been approved by the Executive Board, the staff could continue to exercise some control over the situation through reviews until the arrangement expired. However, there were no procedures for monitoring a member's ability to pay the Fund after a stand-by or extended arrangement had expired. The staff had suggested that the staff should monitor regularly--at least once a year--not only the general economic conditions of each member and its balance of payments situation and prospects, but also any changes in a member's capacity to pay the Fund in comparison with the previous examination of that capacity. The review of the capacity to pay could be a part of Article IV consultations or it could be part of other consultations that the Managing Director was empowered to conduct. The staff had assumed that monitoring a member's capacity to pay the Fund would be a duty of the staff, and that the staff would alert the member to any possible problems in that area and would suggest specific measures that could be taken to solve the problem. The staff had not intended to make a special report on such situations to the Executive Board. The staff's discussions on the capacity to pay would be part of the general preventive discussions between members and management and the staff.

The World Bank and the Fund had held discussions on arrears at the management and staff levels, the Treasurer remarked. The staff proposed holding further discussions in the near future. There were informal understandings between the institutions. For example, there was an agreement calling for a full exchange of information on individual countries' situation in the World Bank and on general information on policy issues arising from arrears. It was informally understood that Fund missions would urge members with arrears in the World Bank to settle those arrears, and that World Bank missions would urge members to settle their arrears to the Fund. In one instance, a statement by a Fund mission to the authorities of a member with arrears to the World Bank had led to the quick elimination of those arrears. There was also an understanding that arrears to the Fund would be taken into account by the World Bank in its lending decisions; the arrears to the Fund would not be the only factor that the World Bank would take into account in deciding whether new loans should be made. Similarly, the Fund would take into account arrears to the World Bank in considering Fund financial assistance for the members concerned. The Fund would not automatically deny financial assistance to

a member because of its arrears to the World Bank, and the World Bank would not automatically decide to avoid making new loans to a member because it had been declared ineligible to use the Fund's resources.

While the denial of a quota increase to a member with arrears would not adversely affect the member's cash position, because the member would in any event be unable to use the Fund's resources, it could affect the member's longer-term position in the Fund, the Treasurer said. While it was conceivable that the Fund would be satisfied once a member had paid the Fund and would therefore restore all its membership rights to the country, that was not the necessary outcome. Similarly, the fact that a member with arrears eliminated those arrears did not ipso facto mean that that member had access to the Fund's resources; a decision to that effect was required. Presumably such a decision would be forthcoming, but the final outcome with respect to that decision would depend on the member's general credit standing. In sum, a member would lose a potential benefit if it did not receive the quota increase proposed for it. The overall increase in quotas, as well as the distribution of the increases, might well become issues during the Ninth General Review of Quotas. If the overall increase was relatively limited, the distribution of the increase among the membership would be important; if members with arrears were included in the distribution, they would receive a benefit that would be at the expense of the shares of other members. Making a quota increase conditional upon the discharge of overdue obligations should provide a significant incentive for a member to eliminate its arrears, and he hoped that the Executive Board would consider that option.

The Chairman noted that the Director of the Legal Department had mentioned that there could be legal ways in which either to deny a member with arrears an increase in quota or to make the increase in quota conditional upon the settlement of overdue obligations. The latter option seemed preferable, since it would provide an important incentive to repay the Fund. Denying a quota increase to a member with arrears would eliminate the incentive to pay that could be provided by the quota adjustment.

Mr. Hodgson said that he wondered whether it would be appropriate to treat any income received by the Fund as a result of a payment by a member that had arrears that were more than six months past due as nonaccrued income until all the member's arrears were eliminated.

Ms. Bush remarked that she was interested in the possibility mentioned by Mr. Hodgson. The existing decision on nonaccrued income did not clearly require a member to settle its oldest overdue obligations--those that were past due by more than six months--before the remainder of the Fund's income resulting from payments by that member could be treated as accrued income. In many other financial institutions, a borrower that was on nonaccrued status remained so until all its overdue obligations had been eliminated. The Executive Board might wish to reconsider its policy on nonaccrued income.

The Treasurer said that when the Executive Board had discussed the issue of deferring income, the question of what would happen when a member discharged some of its obligations to the Fund, thereby moving into a position in which the longest overdue obligation was less than six months past due, had not been fully and explicitly discussed. The staff took the position that the decision on deferred income fully reflected the intentions of the Executive Board with respect to the treatment of such income. The general commercial practice, especially in the United States, was not to treat any income on an accrued basis until all overdue obligations had been discharged. The Fund had some flexibility in that connection, and could of course review its treatment of deferred income.

Mr. Fugmann commented that, as he understood it, the Director of the Legal Department considered that a possible argument against making quota increases conditional upon the clearance of all arrears to the Fund was that such a sanction--or incentive--had not been applied in the past. However, the problem of large and worrying overdue obligations to the Fund was relatively new, and past practices might not always be a relevant precedent for the present treatment of arrears.

The Director of the Legal Department recalled that the Fund had had to deal with cases of breaches of obligations in the past. In treating those cases the Fund had not used quota increases as a sanction. That past practice was a relevant source of current law was a widely accepted principle of international law.

Mr. Foot said that the issue of deferred versus accrued income that had been discussed at the present meeting should be further considered on another occasion.

Ms. Bush remarked that the staff report showed that arrears had increased by more than SDR 47 million between November 1985 and May 31, 1986. Moreover, while the number of members in arrears had fluctuated since November 1985, it had remained at about 19 on average, and even though most of the arrears related to obligations of a relatively small group of members with obligations outstanding for more than six months, total obligations coming due from that group in 1986 and 1987 equaled about SDR 1 billion. Furthermore, overdue payments had increased in relation to various measures of the Fund's financial activities. Most notably, overdue payments as a percentage of obligations due to the Fund had risen on average from 4.4 percent in 1985 to 5.7 percent in the year ended on March 31, 1986.

The staff report clarified some of the procedures that had been adopted to address the problem of overdue payments, Ms. Bush continued. The staff had summarized the factors bearing on the timing of Fund action and on the substantive approach that had been used in handling individual cases. She fully agreed with the staff that uniformity of treatment--in the sense of fair treatment--did not mean identical treatment. Identical treatment could imply that all countries were treated alike regardless of the quality of the effort that they had made to eliminate their arrears.

Two major factors that the Executive Board had taken into account with respect to a member's arrears situation at any particular time were the record of payments by the member and the evidence of the member's willingness and intention to settle fully its obligations to the Fund. If a member had clearly stated its intention to pay the Fund in full and had actually made payments, the Executive Board had generally considered that case in a more favorable light. However, if a member had not demonstrated a clear intent to meet its financial obligations to the Fund, the Executive Board had taken that fact into account in its deliberations, and it should continue to do so in the future. The Executive Board's assessment of intent was necessarily based on judgment, and the Executive Board would need to weigh all the evidence concerning a member's intentions in making such a judgment. She agreed with the other factors that the staff had mentioned with respect to assessing the quality of a member's intention to pay the Fund that were mentioned on page 9, including the length of time arrears had remained outstanding, whether a member was according priority to paying the Fund, whether a member was cooperating with the Fund in adopting economic policies that were needed to strengthen its external position, and whether those policies would strengthen the member's ability to attract and earn foreign exchange.

To some extent the Fund already examined certain indicators--for example, reserves and a country's efforts to obtain financing to permit it to pay its arrears to the Fund--of countries' ability to eliminate immediately their overdue obligations, Ms. Bush said. While members had a clear obligation to explore all avenues for arranging payment to the Fund and to pay the Fund, there was some difference between a member that had adequate means to remain current in the Fund but had chosen not to do so and a member that all the evidence suggested might not have the means to pay the Fund. Therefore, the Executive Board must carefully look at any evidence that might suggest that a member had the capability to repay the Fund; that evidence should be taken into account by the Executive Board when it adopted a decision concerning a member's arrears.

The staff had mentioned the possibility of shortening the six-month period for issuing a complaint in the case of a member with continuous arrears, Ms. Bush remarked. It would be helpful to know the number of cases in which a member had been in continuous arrears for a long period but the oldest arrears had been outstanding for less time than was required to trigger the complaint process. The Executive Board should not evaluate cases of continuous arrears differently from cases in which it used as a trigger point the oldest overdue obligation. Cases of continuous arrears were as serious as other cases, and the period that was used to trigger the complaint process should be shortened for cases of continuous arrears. It would also be helpful to know the number of cases in which members had been in arrears, had settled their obligations, and had subsequently fallen back into arrears. While some of the cases of repeated arrears might be caused by administrative problems that members had in making timely payments, she wondered whether the staff believed that some of the cases were serious and warranted the Executive Board's attention.

Under present practice, Ms. Bush noted, a member that had an obligation that was six months overdue was placed on a nonaccrual status. However, as she understood it, if the obligation that was six months overdue was paid, the member was returned to accrual status and obligations that were overdue for less than six months were treated on an accrued basis. That treatment implied that overdue charges could be moved in and out of nonaccrual status depending upon whether or not a member's overdue obligation was more or less than six months old. Mrs. Ploix and Mr. Hodgson had raised that issue and had asked the staff to provide information on practices of other financial institutions. As she understood it, the standard practice in other financial institutions differed somewhat from the Fund's income from loans that were in nonaccrual status and were not restored to accrual status until all delinquent obligations, including principal and interest, had been eliminated. The most appropriate practice for the Fund would be to keep overdue charges on nonaccrual status until the member was completely current in all its financial obligations to the Fund.

She attached importance to having the staff include in staff documents its assessment of a member's ability to pay the Fund, Ms. Bush said. Such assessments should appear consistently in staff papers and reports. In that connection, the staff's ongoing preparation of guidelines was welcome, and she was pleased that the staff intended to include assessments of ability to pay in staff papers on the use of Fund resources and in staff reports for Article IV consultations for any member that had outstanding credit to the Fund. She hoped that it would be possible to develop a standard set of tools to use in assessing each member's ability to pay, although she recognized that such a set of tools must be adaptable to individual cases. The elements that the staff intended to consider in making such assessments appeared to be broadly appropriate, but the analysis of the prospects for medium-term viability should be a key. The analysis of a member's ability to pay the Fund should be an important element in the consideration of the appropriateness of new lending by the Fund and of particular levels of new lending, particularly to members that had large amounts of outstanding Fund credit.

The staff had asked the Executive Board for guidance on whether a member should be able to benefit from investment income from amounts of Supplementary Financing Facility Account subsidies that had been withheld while a member was in arrears on charges on purchases under the supplementary financing facility, Ms. Bush remarked. She agreed with the staff that the members concerned should not be able to benefit from the investment income. The only reason that investment earnings would accrue would be a delay in disbursement because a member was in arrears. Members clearly should not be rewarded for making late payments. Members would not have an incentive to pay on time if they received larger subsidy payments when they were late in their payments than when they paid on time.

Using the provisions of Article V, Section 7 or defining exceptional hardship cases would not be consistent with the character of the Fund and would weaken the incentive to pay the Fund, Ms. Bush considered. Therefore, she agreed with Mr. Goos that those issues should not be further examined.

The staff had carefully examined the steps that the Executive Board had taken thus far in dealing with the problem of overdue obligations, Ms. Bush remarked. Except for compulsory withdrawal, the various options seemed to be somewhat limited. The staff should give further thought to other possible legal options for the period after a declaration of ineligibility. It was important for the Executive Directors to understand fully all the options--including compulsory withdrawal--that were available at present. Having such an understanding was particularly important, as it was clearly not consistent with the cooperative spirit of the Fund for members to fail to honor fully their financial obligations and other requirements of membership. The staff paper on the legal issues helpfully clarified the option of compulsory withdrawal. The Executive Board should not ignore the remedies and potential steps that were provided for in the Articles.

The Fund must continue its efforts to provide technical assistance to members in formulating economic programs and in finding donor support for their adjustment programs, particularly since bilateral donor support was often crucial to solving a member's arrears problem, Ms. Bush said. The Fund must consider further developing methods of catalyzing donor support. For example, the Fund and the World Bank could convene informal sessions of major donors to elaborate on the actions that were needed by a member to eliminate its arrears and to regain its good standing with the Fund. Those meetings could help to better inform aid and other interested organizations about the problems facing members, could give the aid donors an opportunity to press for policy actions by the countries concerned, and could facilitate a preliminary assessment of potential financing needs of members with adjustment programs.

Peer pressure--namely, pressure by one debtor on another and pressure by a creditor on a debtor--on members with arrears and the active involvement of the Executive Director for the member concerned were important aspects of the efforts to solve arrears problems, Ms. Bush continued. In addition, the proposals that Mr. Nimatallah had made to deal with arrears problems should be explored. The possibility of withholding a quota increase or making a quota increase in some way conditional upon the elimination of arrears should be examined by the staff.

As long as the problem of arrears remained serious, the Fund must step up its efforts to address the problem, Ms. Bush said. Those efforts must include methods to encourage members to pay their obligations to the Fund, to prevent future arrears from arising, and to protect and strengthen the Fund's financial position. The staff should prepare a further paper, for discussion no later than at the next six-monthly review, on the options that would be available to the Executive Board in dealing with the arrears problem.

Mr. Tornetta remarked that the staff report was mainly descriptive and statistical in nature; it did not contain any proposals for substantive changes in the Fund's general policies and procedures with respect to overdue financial obligations. That outcome was probably due to the

fact that there was already a fairly well developed set of procedures based on more than two years of experience and the adoption of a variety of measures. The present discussion provided a good opportunity to evaluate the success of the established procedures and to identify areas in which further refinements were needed.

There had been limited success in applying the present procedures, Mr. Tornetta noted. Four members that had been subject to complaints under Rule K-1 had become current with the Fund. The recent cases of Zambia and Somalia were particularly encouraging as they showed that, through cooperative efforts, it was possible for members with serious and protracted financial difficulties to return to a viable growth path if they were willing to adopt sound economic policies.

In other cases, however, the results had not been encouraging, Mr. Tornetta continued. Some countries had not shown a strong willingness to adjust their economy and had permitted their financial situation to deteriorate. Four countries had already been declared ineligible to use the Fund's resources, and there was little likelihood that they would quickly eliminate their arrears to the Fund. The procedures for handling those cases of protracted arrears should be strengthened, and the staff's discussion on actions that could be taken after a declaration of ineligibility was welcome.

He agreed with the staff's recommendation in its six-monthly report that, in cases of continuous arrears, a complaint should be issued after three months even if no individual obligation had been outstanding for more than three months, Mr. Tornetta said. Moreover, cases of repeated or systematic delays in meeting financial obligations should be brought to the Executive Board's attention even if the arrears had not existed sufficiently long for a complaint to have been issued.

He agreed with the staff's recommendation concerning complaints under Rule S-1 following a declaration of ineligibility, Mr. Tornetta remarked. Accordingly, the suspension of a member's right to use SDRs would not be automatically lifted upon the settlement of overdue charges; an Executive Board decision would be needed to end the suspension.

Special charges on overdue charges on supplementary financing facility drawings should continue to be applied, Mr. Tornetta considered. A different approach would be inconsistent with the principle of uniform treatment of members. Special charges were levied on all overdue charges, and there was no reason to make an exception for charges on drawings under the supplementary financing facility.

More effective procedures seemed to be needed to deal with members that had been declared ineligible to use the Fund's general resources, Mr. Tornetta remarked. The growth of arrears was due mainly to the increase in the amount of arrears of a limited number of countries with prolonged arrears rather than to an increase in the number of all countries with overdue obligations. Moreover, apparently members were less

committed to paying the Fund after a declaration of ineligibility: experience showed that almost no payments had been made by members that had been declared ineligible to use the Fund's resources. The Fund should therefore find ways in which to increase pressure on those countries after a declaration of ineligibility. The responsibility for improving a country's economic and financial situation rested mainly with the country itself; cooperative action to assist a country was not possible in the absence of strong adjustment measures.

Some of the proposals that the staff had made in SM/86/102 could be useful, Mr. Tornetta went on. Further efforts were needed to cope successfully with the arrears problem. To that end, previous speakers had made a number of interesting suggestions. As to the proposals in SM/86/102, it could be useful to publish a brief report on the economic situation of a member with arrears containing the Fund's views on the policy actions that the authorities needed to take. Those reports could be published at the end of Article IV consultations and should reflect the views expressed by the Executive Board during the consultations. Through similar actions the Fund would increase the pressure on the authorities concerned to adopt the necessary corrective measures. As for technical assistance the Fund should continue to cooperate with a country with arrears in the country's efforts to pay the Fund. An argument could be made for limiting technical assistance missions in cases in which the assistance was not directly instrumental in the rapid payment of arrears. However, the Fund's approach to technical assistance should be flexible, and decisions on such assistance should be made on a case-by-case basis. In certain circumstances, it might be appropriate to consider imposing penalty charges.

The staff should comment on its discussion on page 8 of SM/86/102 regarding the legal problems that an international institution like the Fund could encounter if it decided to bring a case before a national court to try to recoup the amounts that were owed to it by a member, Mr. Tornetta remarked. In posing that question he was not implying that such a course of action was necessarily advisable.

Two of the proposals that Mr. Nimatallah had made were particularly interesting, Mr. Tornetta said. At some stage before a declaration of ineligibility the Fund should inform development institutions of the fact that a particular country was not current in its financial obligations to the Fund. In addition, closer cooperation with the World Bank would be appropriate in handling cases of arrears. After a member had been declared ineligible to use the Fund's general resources, it would be appropriate for the World Bank to reassess its financial relations with that country. Any form of cross-conditionality should be avoided and he had noted the comments by the Treasurer in that respect. The World Bank's approach to such cases could greatly enhance the Fund's leverage in dealing with those cases. In turn, the Fund should be willing to take into account the status of a member's financial relations with the World Bank in the Fund's decisions.

He would be reluctant to consider at the present stage any request for compulsory withdrawal by a member, Mr. Tornetta commented. That procedure was in sharp contrast with the cooperative nature of the Fund and should therefore be used only in extreme cases. Moreover, fruitful results would eventually be obtained by cooperating with members that faced dire financial problems.

Mr. Finaish stated that he too was concerned by the arrears situation that was described in the six-monthly report. Nevertheless, the experience of recent months, although still insufficient to conclude that the situation had improved fundamentally, provided some hope that perhaps the Fund was on the road toward reversing the trend of the previous three years. He had in mind specifically the recent settlement of arrears by Zambia and Somalia and the positive developments in the particularly difficult case of Peru. However, it was important to place those positive developments, tentative as they were, in the proper perspective and to try to build on them to achieve even more positive movement in the future. The recent developments in those three cases had certainly not been random and had not occurred in a vacuum. They had been made possible by the persistent and coordinated efforts of the countries themselves, their creditors and donors, and the Fund to bring together all the elements necessary for the settlement of the arrears. In particular, the positive attitude of the Fund in taking into account the particular nature of each case and in being forthcoming in adapting its policies to the circumstances of each member had been instrumental in the positive developments of recent months. The Fund should continue and strengthen that flexible approach in the future.

Commenting on the issues that were addressed in the six-monthly report, Mr. Finaish said that generally he had no difficulty with the staff's approach to the assessment of members' capacity to service their debt to the Fund. Caution was required with respect to the manner in which the assessment was taken into account in determining access to the Fund's resources. A country's ability to pay the Fund on schedule should certainly be taken into account in determining the access for the country, but it should not always be assumed that reducing the access would limit the risk of the member falling into arrears; sometimes the opposite would be true, especially when a lower access level might aggravate an already tight short-term liquidity situation, thereby increasing the risk of arrears on obligations falling due during the program period. It was important to keep that aspect in mind when evaluating the risk of arrears associated with alternative access levels.

He agreed with the staff that uniformity of treatment did not imply identical application of procedures, Mr. Finaish commented. However, the text of the decisions that were taken by the Executive Board on the reviews of individual overdue cases had become more or less standard. At a certain stage in its graduated approach the Executive Board usually adopted a decision that stated an expectation that in the subsequent review the country would be declared ineligible unless the arrears were fully settled. In a number of such cases, the Executive Board had decided

during the subsequent review not to act upon that expectation, usually because of some positive movement toward settlement of the arrears by the country concerned. Although there was nothing essentially inappropriate about that trend, it was legitimate to ask whether it was proper and useful for the Executive Board to adopt a decision when it knew in advance that short of full settlement the expectation would not be fulfilled even if progress were achieved. Perhaps in those cases the wording of the decision should allow for that possibility without necessarily diminishing the strength of the decision. That strength was as much a function of the decision's credibility as of the wording of the text of the decision. He was worried that, with an increase in the number of cases in which the expectation was not acted upon despite the absence of full settlement, the credibility of the Executive Board's decisions might be jeopardized.

The staff paper on ineligibility and subsequent actions by the Fund provided a useful analysis of the ineligibility provisions in the Articles and of the circumstances and procedures leading to compulsory withdrawal, Mr. Finaish remarked. In addressing the question what the Fund could or should do following the declaration of a member's ineligibility Executive Directors should keep in mind that, as the staff had mentioned on page 5, such a declaration did not add to the spectrum of other actions that could be taken except compulsory withdrawal. In addition, Executive Directors should bear in mind that a declaration of ineligibility was a serious step from the standpoint of both the Fund and the member concerned. He doubted whether any member, including those that were already ineligible to use the Fund's resources, could afford to take a declaration lightly. As experience showed, the threat of ineligibility did not in itself ensure the settlement of arrears. However, in most cases, that outcome was more a reflection of the degree of financial difficulty facing members with arrears than it was of any misperception on the part of those members of the seriousness of ineligibility. It was partly because of that fact that his chair had always taken the view that a great deal of caution was needed in deciding on the ineligibility of individual members with arrears. Experience thus far with members that had already been declared ineligible had reinforced his belief that declarations of ineligibility should be made very sparingly and only after taking into account the particular circumstances of each case. That approach would be consistent with the principle of uniform treatment, which should not be interpreted to mean identical treatment, irrespective of individual circumstances. In applying Fund policy both before and after ineligibility the Fund had to make a clear distinction between normal cases of overdue obligations and cases in which the member was clearly able but unwilling to pay the Fund. In general, he fully agreed with the Managing Director that in applying its policy on arrears to individual cases the Fund had to make a judgment as to what was likely to be the most productive approach not only in securing a settlement of arrears and restoring normal relations with the country concerned, but also in serving the Fund's interest in dealing with the overall problem of overdue obligations.

Compulsory withdrawal was the only step provided for under the Articles in the period following a declaration of ineligibility, Mr. Finaish considered. The extreme nature of such a step was widely recognized, and it was therefore crucial to avoid adopting any policy that would start in motion the procedures associated with compulsory withdrawal as a normal course of events in the period following ineligibility. That conclusion did not of course mean that compulsory withdrawal should be ruled out in all cases. It was clear that the drafters of the Articles had made every effort to make the drastic step of compulsory withdrawal an exceptionally difficult one to take; accordingly, such a step required a voting majority of 85 percent under the Second Amendment. It could be argued that compulsory withdrawal was even more drastic than the application of the provisions of Article V, Sections 7(g) and 8(e) in those cases in which exceptional hardship could be clearly ascertained. Nevertheless, the Fund had thus far refrained from applying those provisions as a matter of policy.

In the light of those considerations, the steps that the Fund should take after a declaration of ineligibility were not fundamentally different from the steps that the Fund should take prior to such a declaration, Mr. Finaish continued. The Fund's efforts in helping a member to normalize its relations with the Fund--including policy discussions, technical assistance, and assistance in obtaining external financial support for the member--certainly should be continued after a declaration of ineligibility, provided that the member was willing to cooperate with the Fund in good faith. Any other approach would merely reinforce any misperception that might exist that in declaring a member ineligible the Fund severed its relations with that member; any other option also would be counterproductive in terms of achieving the main objective of a full settlement of a member's arrears.

Selling the Fund's holdings of the currencies of members with arrears probably would not be practical in most if not all cases, Mr. Finaish remarked. The problem of arrears clearly had to do less with the mechanism of payment to the Fund than with the ability or willingness of the members concerned to settle their arrears. Nevertheless, in the light of the comments that had been made during the discussion, a more thorough examination of that issue might be useful.

Mr. Foot said that he agreed with previous speakers who regarded the current situation with respect to overdue financial obligations as being far from encouraging. Perhaps the most discouraging aspect was the reappearance of the names of several large borrowers on the list of members soon after those members had been taken off the list. He agreed with the staff that at present there was no need for major changes in the Fund's practices with respect to arrears. The Executive Board had made some changes the effects of which had yet to be felt, and the time was not ripe to make further changes. However, he agreed with Mr. Goos and Ms. Bush that the Fund must develop and standardize its assessment of a member's ability to pay its debt to the Fund as a part of the consideration of requests for Fund resources.

The Fund must do everything possible to encourage members to meet their obligations, Mr. Foot considered. He was increasingly concerned that the Fund's approach to dealing with individual cases of arrears was becoming fragmented. It had been suggested that greater automaticity, while retaining the Executive Board's involvement in dealing with individual cases, was a possible option. That option would probably become more attractive if the number of cases of arrears continued to increase and the approach to those arrears continued to be fragmented.

Commenting on the legal issues that the staff had raised, Mr. Foot said that his chair had consistently favored exploration of the active use of incentives through constraints on quota increases of members with arrears and the use of setoffs, which would increase the Fund's leverage in dealing with the arrears situation. He would wish to give further thought to the staff's comments on those options, although he continued to believe that the options were essentially desirable. Any attempt at the compulsory withdrawal of a member with arrears at the present stage would be a drastic one. The time was not yet ripe for the Fund to take such a step.

His chair advised U.K. representatives in other international institutions of the arrears situation of individual members of the Fund, Mr. Foot commented. His authorities believed that countries should not assume that they would be able to maintain normal relations with other institutions while failing to fulfill their obligations to the Fund. His authorities would generally expect to examine closely requests for new loans--especially those linked to macroeconomic policies--in all the other international financial institutions in which the United Kingdom was represented.

He agreed with previous speakers who felt that it would not be appropriate to charge members for technical assistance over and above the payment of any charges that might normally be agreed between the Fund and members, Mr. Foot said. The income to be gained by the Fund would be minor, and the effort to charge members for technical assistance would give the impression that the Fund had exhausted all the options for dealing with the problem of overdue financial obligations.

He did not favor paying investment income on the Supplementary Financing Facility Subsidy Account to members with arrears, Mr. Foot stated. The staff's proposed procedural changes with respect to Rule S-1 were acceptable. Finally, he doubted whether it would be of any value to have the staff undertake additional work on the definition of objective indicators with respect to the provisions of Article V, Sections 7(g) and 8(e).

Mr. Mawakani said that the six-monthly report indicated that almost all the outstanding overdue obligations were owed by a relatively limited number of members that faced severe economic and financial problems that had arisen partly because of the unfavorable international environment. Developments since the previous review were a cause for concern and

warranted a continuation by the Fund of its unremitting efforts to deal with the problem of arrears. In dealing with that problem the Fund should maintain the cautious and flexible manner that had characterized the application of the relevant policies that had been strengthened during the previous two reviews of the arrears situation. That flexible approach had yielded some positive and encouraging results: some members had fully settled their outstanding obligations, and others had made partial payments or had shown a renewed national commitment to fulfill their overdue financial obligations to the Fund.

The problem of overdue obligations required special attention and imaginative solutions if its root causes were to be attacked, Mr. Mawakani commented. The existing policies and procedures for dealing with overdue obligations were more than adequate and should therefore remain unchanged for the time being. However, the flexible application of those policies and procedures should be a major element of the Fund's strategy in dealing with overdue obligations. A rigid and inflexible application of the relevant policies and procedures was unlikely to yield the desired result, namely, the elimination of the overdue obligations to the Fund. In any event, since the flexible application of policies and procedures for solving the arrears problem had proved to be beneficial to the Fund and to members in general, it should be continued. Furthermore, the clarifications that the staff had provided with respect to certain aspects of those procedures and policies would substantially enhance their effectiveness.

The progress that had recently been made in dealing with some cases of overdue obligations underscored the fact that maintaining channels of communication and contacts with members with arrears could go a long way toward finding positive solutions to protracted and difficult cases, Mr. Mawakani remarked. Nevertheless, there were other major cases that had yet to be corrected. The Fund needed to intensify its efforts to keep open the channels of communications with the members concerned to encourage them to implement the adjustment measures that would attract external financial assistance and enable the countries to settle their arrears to the Fund.

Commenting on preventive actions, Mr. Mawakani said that he welcomed the steps that the staff were taking to assess a member's capacity to service its external financial obligations, including those to the Fund. Given the different circumstances of individual members, he agreed with the staff that no attempt should be made to standardize unduly the analysis of a member's capacity to pay the Fund. The guidelines that were being prepared for the evaluation of a member's capacity to service its debt should be formulated for application to all uses of Fund resources and in Article IV consultation and surveillance reports and should be based on a consistent framework embodying all the policy elements needed to achieve balance of payments viability in the medium term. He agreed with the staff that the Fund could take the initiative to propose corrective measures when it became evident that weaknesses in a member's adjustment policies were likely to create problems with respect to its ability to service its financial obligations to the Fund.

He had no difficulty with the staff's explanation on pages 8-10 of the six-monthly report of the factors that influenced the staff's judgment of a member's intentions to pay its overdue financial obligations, Mr. Mawakani commented. However, in exercising that judgment the Fund should bear in mind the principle of uniformity. In addition, the staff should continue to monitor cases of repeated arrears to the Fund and should make appropriate recommendations to the Executive Board if necessary. He did have some difficulty in accepting the staff's reasoning concerning complaints under Rule S-1 following a declaration of ineligibility. In that connection, a further comment on the case of Sudan and the rationale for using the approach that the staff had described in future cases would be helpful.

He favored a procedure that would allow payment of earnings on Supplementary Financing Facility Subsidy Account investments to members with arrears, Mr. Mawakani said. Such earnings should first be used as an offset to reduce the overdue obligations of the members concerned.

The staff paper on legal issues clearly described the three situations in which a declaration of ineligibility to use the general resources of the Fund could take place, Mr. Mawakani noted. The same actions that could be taken prior to a declaration of ineligibility also could be taken after such a declaration. The actions that were taken should be aimed at encouraging the normalization of relations between the Fund and members with arrears.

The main question at hand was whether the overall problem of overdue obligations to the Fund had reached the stage at which the Fund should urgently seek a solution by resorting to all the legal options that were available to it, Mr. Mawakani said. In his view, the Fund had not yet reached that stage, although the arrears situation appeared to be worrying. He agreed with the Managing Director that while a number of actions were legally possible, some might have the potential for both negative and positive effects on a member's efforts to settle its obligations to the Fund, and it was difficult to predict, especially without reference to a particular case, which action, if any, was likely to be more productive. The Fund should therefore be careful to avoid taking any steps that would be counterproductive, especially by appearing to set up a confrontation with a member that was unable to pay its debts to the Fund. As a cooperative institution the Fund should not be seen to be adopting such an attitude toward any member, even on a case-by-case basis on which all the relevant circumstances of an individual member were taken into account.

Accordingly, he strongly favored the five measures mentioned in Section II, subparagraphs (a)-(e) for use in the periods both before and after a declaration of ineligibility, Mr. Mawakani continued. The periodic reviews of the situation of a member with arrears before and after a declaration of ineligibility should be continued, but he strongly opposed any extension of the publicity that was given after a declaration of ineligibility. Further publicity would not be productive. In fact, it would harm the member's credit standing and the Fund's financial integrity.

The Fund must intensify its efforts to keep open the channels of communication with members that had substantial arrears in order to encourage them to implement adjustment measures that would place them in a position to settle the arrears. The Fund should welcome requests for technical assistance by those members. Moreover, the Fund should not add to the member's payments burden by imposing charges for the provision of technical assistance. A member should be required to cover the costs of technical assistance only in extreme cases, if at all.

Special charges on overdue obligations had no positive effect on a member's ability to repay the Fund, Mr. Mawakani considered. Some members with overdue obligations also had overdue special charges. The special charges had merely compounded the financial problems facing members with arrears. The reasons for members' inability to settle their arrears to the Fund were well known. Offsetting a member's claims against the Fund by selling the country's currency would not be an effective means of inducing or ensuring payment to the Fund.

The concerted actions that the staff had described were closely linked to the Fund's efforts to keep open the channels of communcation with members in arrears, including in the period after a declaration of ineligibility, Mr. Mawakani said. Concerted actions were more beneficial than the other measures that were available to the Fund, and the optimal use of such actions should be actively encouraged. Finally, compulsory withdrawal was an extreme procedure that should be used only in the most extreme and compelling circumstances, if at all; the procedure was likely to undermine the Fund's cooperative spirit.

Mr. Fujino stated that he agreed with the main conclusions in the six-monthly report. There had been some positive developments during the previous six months: two members had fully repaid their protracted arrears, and one member had made a firm commitment to settle its arrears by mid-August 1986. However, there had not been an underlying improvement in the serious problem of overdue obligations to the Fund. Indeed, the overall situation had deteriorated during the previous six months, as the total amount of arrears had risen to SDR 717 million through the end of May 1986. The total amount of forthcoming obligations of members with protracted arrears amounted to almost SDR 1 billion. That figure was alarming, and the Fund should effectively tackle individual cases of arrears under the existing policies and procedures. A convincing case could be made for a further increase in the reserve target.

The major improvement during the previous six months in the general policies for dealing with the arrears problem was the inclusion in staff papers on the use of Fund resources of an assessment of a member's capacity to service its future financial obligations to the Fund, Mr. Fujino said. The staff's efforts in making such assessments were welcome. He agreed with the staff that the analysis involved in making such assessments should not be excessively standardized. A case-by-case approach to the assessments was appropriate.

While no modifications were needed in the procedures for dealing with arrears problems, Mr. Fujino commented, procedures should be applied flexibly, particularly in cases in which the standard procedures were being misused by individual members. A member's right to use SDRs should be suspended without qualification in cases in which a complaint under Rule S-1 had been issued following a declaration of ineligibility to use the Fund's general resources.

He agreed with the staff that it would not be appropriate to exempt members with arrears from the obligation to pay special charges on overdue charges on purchases under the supplementary financing facility even if subsidy payments under that facility had been withheld until the overdue charges had been paid, Mr. Fujino remarked. Such members should not be permitted to benefit from investment earnings on the withheld amounts after the settlement of arrears. Providing such benefits would act as a disincentive to settling arrears to the Fund and would be tantamount to rewarding members that had made late payments on charges in respect of purchases under the supplementary financing facility.

The fact that of the four members that had already been declared ineligible to use the Fund's general resources only one had made payments to the Fund following the declaration of ineligibility was a cause for great concern, Mr. Fujino said. A declaration of ineligibility was an inevitable outcome in certain circumstances, but it did not solve the problem of arrears. It was important to have satisfactory follow-up procedures after a declaration of ineligibility so that normal relations with the country concerned could be restored as soon as possible.

There should be three basic elements in the effective handling of members in the period after a declaration of ineligibility, Mr. Fujino went on. First and foremost, members with prolonged arrears should introduce corrective measures that would enable them to pay the Fund. The Fund should keep open its channels of communication with those countries to help them to formulate the necessary adjustment policies. In some cases, the channels of communcation would have to be even more effective after a declaration of ineligibility than before. Second, the Executive Board should continue to review every six months the arrears situation of any member that had been declared ineligible. Although the experience with those reviews was limited, the reviews were clearly useful. They brought to the attention of the Executive Board the seriousness of an arrears problem and permitted the Executive Board to consider each case extensively, including possible means of solving individual arrears problems. The staff papers for such reviews could perhaps be somewhat improved; for example, they could contain more specific policy recommendations than in the past. In addition, a regular staff mission could be scheduled every six months in the period after a declaration if it was thought that the mission would be instrumental in promoting the adoption of strong adjustment policies by the member with arrears. Third, since the existence of overdue financial obligations was a serious breach of a member's obligations under the Articles, the possibility that a member might be asked to withdraw from the Fund because of those obligations

could not be ruled out, and he agreed with the legal interpretations of compulsory withdrawal in SM/86/102. However, he also fully agreed with the Managing Director that any discussion on the potential positive and negative effects of compulsory withdrawal had to be considered on a case-by-case basis. All four of the countries that had been declared ineligible had expressed their intention--although to a different degree in each case--to cooperate with the Fund in normalizing their relations with the institution. H- was reluctant to go as far as considering the actual application of the compulsory withdrawal procedure at the present stage. Finally, Mr. Polak's suggestion to link quota increases with the clearance of arrears to the Fund could be examined in the context of the next general quota increase exercise.

Mr. de Groote commented that despite the discharge of large amounts of arrears by a few members in recent months, the problem of overdue obligations to the Fund continued to be a cause for serious concern. Although recent experience showed that the number of members with long-standing arrears tended to level off over time and that intensive and concerted efforts might succeed in unblocking even the most serious arrears situations, those positive signs were overshadowed by the sizable amount of arrears that had been accumulated by a number of members that had not yet given any indication that they were ready to normalize their financial relations with the Fund. Even though Somalia had become current in the Fund, and even assuming that Peru would become current by mid-August 1986, as expected, the total amount of overdue obligations would double by the end of 1987 if the arrears situation of other members against which complaints had been made did not improve.

It was therefore crucial for the Fund to persevere in its efforts to correct the existing problem of protracted arrears and to increase the emphasis on preventing further deterioration of the overall arrears situation, Mr. de Groote continued. In that context, a welcome development was the emerging practice of addressing the issue of a member's ability to service its external debt--including its obligations to the Fund--in staff papers on the requests for the use of Fund resources. An even more important way in which to prevent the emergence of arrears to the Fund was to continue those assessments even after the Fund had ended its financial assistance to the member concerned whether or not the stand-by arrangement with the member had been fully and successfully completed. If an arrangement had been discontinued because of the non-compliance of the member with some of the performance criteria, a member might suddenly attain an important net repayment position vis-à-vis the Fund; in that event, a close assessment of the member's prospective debt servicing capacity and its commitment to remain current in its Fund obligations would be called for.

The present procedures for dealing with members in arrears struck the appropriate balance, first, between the need to act quickly and the need to give members a reasonable period in which to take corrective action and, second, between the need for uniformity of treatment and the need for flexibility, Mr. de Groote considered. He fully agreed with the

staff that the quality of a member's commitment to become current in the Fund was an important element in the justification for a flexible approach to the treatment of that member. Of course, assessing the quality of those intentions was a highly judgmental exercise, and great care must be taken to protect the principle of uniform treatment by avoiding any decision that might be interpreted as being discriminatory.

He agreed with the staff that there appeared to be no need at present to change the existing rules governing the treatment of continuous or repeated arrears to the Fund, Mr. de Groote continued. The staff should carefully monitor the application of the procedures in order to detect at the earliest possible stage any evidence of their abuse. He agreed with the staff that a member's right to use SDRs should be suspended without qualification following a declaration of ineligibility. He did not favor exempting members with arrears from the obligation to pay special charges on overdue charges on supplementary financing facility purchases by giving those members the benefit of investment earnings on withheld subsidy payments. He agreed with the staff that such an exemption would discriminate against other members that had paid the supplementary financing facility charges on time and would run the risk of appearing to reward late payment of those charges.

Commenting on the possible legal actions that the Fund might take in the period after a declaration of ineligibility, Mr. de Groote said that SM/86/102 gave the impression that the decisions that the Executive Board had already taken to conduct periodic reviews of members' situations and to give publicity to a declaration of ineligibility left little room in which to take further useful legal action that was aimed at prodding members to restore normal financial relations with the Fund. Indeed, apparently the declaration of ineligibility must be accepted as the end of a long legal road that had many steps and stages, and that beyond such a declaration the only constructive action that the Fund could take was to continue trying to assist the member in formulating corrective policies that might help the member to obtain aid from external donors and creditors. Actions such as withdrawal of the Fund's technical assistance or compulsory withdrawal from membership seemed to be self-defeating and should not be taken.

Any addition to the existing armory of legal sanctions might give the impression that those sanctions were ineffective and would thereby weaken rather than reinforce the Fund's leverage over the members that had arrears to the Fund, Mr. de Groote went on. The only useful addition to the present possible actions would be in the sphere of the direct and indirect contacts that the Fund might wish to have with the members concerned. It would be wrong to reduce or cut off the Fund's contacts with a member that had arrears--for example, by withdrawing the Fund's technical assistance--in the hope that such an action would lead the member concerned to pay the Fund. Indeed, the Fund should intensify its contacts with the members concerned. Fund missions, headed by the Director of a department or the Deputy Managing Director, an invitation to the Governor of the member with arrears to consult the Managing

Director in Washington, peer pressure exerted in the regional groups and constituencies to which the member with arrears belonged, and diplomatic action by friendly countries were practical measures that should be actively pursued. In that connection, he agreed with the suggestions that had been made by Mr. Kafka and Mr. Abdallah. A member of his constituency had volunteered to send two of its high-ranking financial officials on a goodwill mission to a member with arrears with which the member of his constituency had maintained friendly relations. The various regional groups and constituencies should impress upon their members with arrears the seriousness of the damage that the arrears caused for each group as a whole. Regional groups and friendly countries should make available to members with arrears that faced insuperable difficulties in paying the Fund the resources that would enable the countries concerned to become current in the Fund. Such action would clearly indicate the priority that friendly countries attached to the revolving character of the Fund's resources.

It was necessary to establish categories of members with arrears based on a careful analysis of each case, including the reasons that had led to the arrears of each member, Mr. de Groote considered. The case of a country for which the reimbursement due to the Fund represented only a small fraction of its total export proceeds should be clearly distinguishable from the case of a country that had lost a substantial share of its export proceeds. If the Fund succeeded in classifying members with arrears, it might be appropriate to examine Mr. Sengupta's suggestion to consider the circumstances in which special hardship would justify a postponement of the date of discharge of a repurchase obligation under Article V, Section 7(g) within the time limits established by Article V, Section 7(c).

He agreed with the staff that the prospect of being deprived of a quota increase might be a serious incentive for a member with arrears to become current in the Fund, Mr. de Groote continued. The next quota increases should be large enough so that any member would have serious second thoughts about taking steps that would exclude the member from the quota adjustments.

He agreed with the Managing Director that the merits of each step that was outlined in SM/86/102 should be evaluated with reference to individual cases and circumstances, Mr. de Groote said. The Fund could not exclude the possibility that at some future date it might wish to consider additional steps in exceptional cases in which the entire financial and nonfinancial relationship between the Fund and a member had been fundamentally disrupted. However, he doubted whether sanctions and penalties could achieve what persuasion would fail to obtain as long as the Fund's role was not fundamentally reinforced. After all, the difficulty that the Fund had had in devising sanctions was a reflection of the limitations on the role of the Fund. The members that were most concerned about maintaining the liquidity of the Fund's claims should recognize that to achieve that aim the Fund's role and resources must be reinforced.

Mr. Huang commented that the arrears situation had improved somewhat over the previous six months, as several members had partially paid their overdue obligations and one member had become fully current. However, the number of countries and the size of arrears were still large; therefore, the efforts to eliminate the arrears should not be relaxed. Further progress could and should be made through the joint efforts of the Fund and individual members.

To avoid overdue obligations in the future the staff had suggested several preventive measures, Mr. Huang noted. It was important to bear in mind that arrears occurred for many complicated reasons, such as domestic policies, or unfavorable external developments that were beyond the authorities' control, and that in most cases the latter set of factors was the most important. Hence, the Fund must show flexibility in dealing with members with overdue financial obligations. An announcement of a member's ineligibility to use the Fund's general resources should be made rarely and cautiously, and a decision to make such an announcement should fully take into account its consequences on the image of the member concerned, its ability to borrow, and thereby its ability to pay the Fund. The Fund should give priority to taking positive steps to help a member with arrears--including members that had been declared ineligible--so that the member's normal position in the Fund could be restored.

Commenting on legal actions prior to a declaration of ineligibility, Mr. Huang said that the staff had explained that only under Article XXVI, Section 2(a) were arrears considered to be a breach of obligations that might lead to a declaration of ineligibility and eventually to the compulsory withdrawal of the member, while Rule K-2 offered a more flexible way in which to deal with arrears, namely, by limiting the use of the Fund's general resources. The Fund had shown some flexibility over the previous several years in dealing with members with arrears by following such steps as postponing a declaration of ineligibility and giving a member with arrears a reasonable period in which to reconsider its position, or by refraining from making a declaration of ineligibility in the event that a member had paid part of its overdue obligations. Executive Directors apparently recognized that a declaration of ineligibility might not be effective in preventing overdue obligations from arising in a large number of members. Although members knew that the Fund could eventually make a declaration of ineligibility, the number of countries with arrears and the absolute amount of arrears had increased over the previous six months. Those facts should encourage the Executive Directors to consider modifications in the existing procedures that were designed to lead to the elimination of members' arrears.

Members with arrears faced structural problems that could be corrected only in the medium term, Mr. Huang remarked. However, Fund credit was essentially short term in nature. Hence, there was a gap between members' relatively long-term need for resources and the relatively short period in which Fund resources must be repaid. Much could be done by the Fund to improve the adjustment programs that it encouraged members to adopt.

Most of the members with arrears were developing countries that had economies that were vulnerable to external shocks, Mr. Huang continued. Therefore, members could continue to face payments difficulties and arrears could be accumulated even though the countries concerned had made strong adjustment efforts. The occurrence of arrears owing to unfavorable external developments should not be viewed merely as a failure to meet financial obligations to the Fund, and any rush to declare such members ineligible should be avoided to the extent possible. Indeed, a member with arrears that had been caused by unfavorable external developments might well be an acceptable candidate for an additional arrangement with the Fund. The importance of domestic policy adjustment should be properly emphasized, but the external factors that contributed to arrears should not be underestimated.

A declaration of ineligibility was a legal but harsh action that jeopardized a member's normal relations both with the Fund and with other creditors, Mr. Huang said. A declaration of ineligibility could have counterproductive effects, making it more difficult for a member to pay the Fund. Given the severity of a declaration of ineligibility, the Executive Board should pay due regard to the difference between cases involving members that were unwilling to repay the Fund and members that were unable to repay the Fund.

The most important legal step that the Fund could take after a declaration of ineligibility was to help a member to normalize its relations with the Fund and with the financial markets, Mr. Huang considered. Any legal action that exerted additional pressure on a member after a declaration of ineligibility, thereby harming its reputation and ability to borrow, should not be seen as a positive approach except in extreme and exceptional cases.

The Executive Board had already adopted decisions on the publication in the Annual Report and in press releases of arrears that had been outstanding more than six months and of each declaration of ineligibility, Mr. Huang noted. To help members, future publications of a declaration of ineligibility should be based on a differentiation between cases in which a member was unwilling to pay the Fund and cases in which a member was unable to do so.

He agreed with Mr. Kafka that the Fund should welcome a request by a member for technical assistance rather than impose difficulties in providing such assistance or requiring members to pay the cost of the assistance, Mr. Huang continued. Prior to a declaration of ineligibility the Fund repeatedly stressed the need to keep all channels open to a member with arrears, and after a declaration of ineligibility it should not refuse technical assistance or require the member to cover the costs of such assistance. He wondered whether the Fund had ever charged a member for the cost of technical assistance. If it had not, charging members in the period after a declaration of ineligibility might well be discriminatory. The Fund was entitled under Article V, Section 2(b) to decide whether or not it should meet a member's request for technical

assistance. However, it was not clear whether that provision entitled the Fund to charge members for the cost of technical assistance. Article V, Section 8 made no mention of requiring a member to cover the costs of technical assistance after a declaration of ineligibility.

The special charges on overdue obligations were likely to increase the debt burden of members with arrears and to undermine severely their ability to pay the Fund, Mr. Huang remarked. Assessing special charges might well be counterproductive unless charges were assessed on a case-by-case basis and on the basis of differentiation among individual cases.

Compulsory withdrawal was the final and least efficient way in which to deal with cases of arrears, Mr. Huang considered. The consequences of compulsory withdrawal were tragic for the member, the Fund, and the international community. Compulsory withdrawal ruined the member's reputation and was likely to tarnish the image of the Fund by giving the impression that the institution was incapable of helping members that faced economic problems.

The Fund had limited experience in helping members that had been declared ineligible to regain their right to use the Fund's general resources, Mr. Huang said. In the period after a declaration of ineligibility, the Fund should concentrate on helping members with arrears to eliminate the arrears, thereby hastening the restoration of the right of those countries to use the general resources. Prior to a declaration of ineligibility, the Fund gave each member with arrears a reasonable period in which to reconsider its position vis-à-vis the Fund. He wondered whether the staff could formulate an alternative approach that would speed up the restoration of the right to use the Fund's general resources for a member that had partially or fully paid its obligations that had been overdue for more than six months.

The Executive Directors agreed to continue their discussion on June 9, 1986.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/92 (6/6/86) and EBM/86/93 (6/6/86).

2. SENEGAL - TECHNICAL ASSISTANCE

In response to a request from the Senegalese authorities for technical assistance in connection with a revision of the income tax legislation, the Executive Board approves the proposal set forth in EBD/86/162 (6/4/86).

Adopted June 6, 1986

APPROVED: February 25, 1987

LEO VAN HOUTVEN
Secretary