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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/92

10:00 a.m., June 6, 1986

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

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
	O. Isleifsson, Temporary
	G. D. Hodgson, Temporary
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	
P. Pérez	G. Ortiz
H. Ploix	
J. J. Polak	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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Also Present

African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; L. M. Goreux, Deputy Director; M. G. Kuhn. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; J. T. Boorman, E. H. Brau, B. de Schaetzen, M. Mentini, B. J. Nivollet. 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, A. O. Liuksila, R. H. Munzberg, J. M. Ogoola. Middle Eastern Department: F. Drees, D. Hammann. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat, 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, M. L. Perry, D. V. Pritchett, G. Wittich. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, J. Ferrán, C. G. Muniz B. Bureau of Statistics: S. Almuina. Office of the Managing Director: R. Noë, Internal Auditor; C. P. McCoy. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, M. B. Chatah, L. K. Doe, L. P. Ebrill, S. Ganjarerndee, S. M. Hassan, J. Hospedales, K. Murakami, G. Nguyen, A. Ouanes, P. Péterfalvy, R. Valladares, A. Vasudevan. Assistants to Executive Directors: A. Bertuch-Samuels, O. S.-M. Bethel, B. Bogdanovic, J. de la Herrán, V. Govindarajan, G. K. Hodges, L. Hubloue, S. King, T. Morita, J. K. Orleans-Lindsay, W. K. Parmena, M. Rasyid, J. Reddy, J. E. Rodríguez, C. A. Salinas, B. Tamami, E. L. Walker, B. D. White, Yang W.

1. ZAIRE - RECENT DEVELOPMENTS

The Director of the African Department recalled that on April 26, 1986 the Executive Board had approved in principle a 20-month stand-by arrangement for Zaïre, pending satisfactory arrangements with respect to the financing of the estimated balance of payments deficit in 1986. On the basis of additional debt relief obtained from creditors in the Paris and London Clubs, and in the light of the possibility of a first disbursement under the structural adjustment facility in 1986, the Executive Board had made the stand-by arrangement for Zaïre effective on May 28, 1986. Zaïre had made the first purchase of SDR 23.8 million under that arrangement on May 30, 1986. On the same date, the authorities had announced a 65 percent increase in government wages effective June 1, 1986.

The wage increase had been announced without prior communication with the Fund's resident representative in Kinshasa and without consultation with the staff and management at the headquarters in Washington, D.C., the Director of the African Department continued. That measure would have a significant adverse effect on the budget deficit and on the program as a whole. The 1986 fiscal program was based on an increase in wages of 10 percent in the second quarter followed by a 15 percent increase in the final quarter, as had been specified in the letter of intent for the present stand-by arrangement. The impact on expenditure for the remainder of 1986 of the announced wage increase was estimated to be in the range of Z 2-3 billion, depending on the size of the increase that was given to employees outside the central government, namely, teachers and military personnel. That increase compared with total expenditure before rescheduling of Z 72 billion that had been programmed for 1986 and accounted for less than 1 percent of GDP.

The Chairman considered that the 65 percent increase in government wages and the failure to inform or consult the Fund constituted a serious breach of the spirit of the stand-by arrangement. The sudden increase in the wage bill was not in line with the increases that were mentioned in the relevant letter of intent and was not accompanied by compensatory measures. As a result, the authorities were likely to breach the ceiling on net bank credit to the Government. He intended to send a letter to the President of Zaïre, who had signed the letter of intent, drawing the President's attention to the seriousness of the matter and asking the authorities either to reverse the increase or, if that was not possible, to introduce additional fiscal adjustment measures in order to keep the program intact. In addition, he would ask the authorities to receive a staff mission that would visit Kinshasa in about a week's time to transmit his letter, to participate in a special consultation with the authorities to assess the authorities' readiness to implement appropriate measures promptly, and to seek assurance that another failure to consult the Fund would not occur. The mission would submit a report soon after its return, and Executive Directors would have an opportunity to consider it before the first scheduled review under the stand-by arrangement.

Mr. Nimatallah noted that the Chairman had suggested that the authorities could either reverse the decision to increase wages substantially or introduce offsetting adjustment measures. A third option seemed possible, namely, to stretch the wage increase over a longer period and to strengthen the adjustment effort.

The Chairman said that the staff would discuss all the various options with the authorities. Wages in Zaïre's public sector were very low, and a case could be made for some increase in them, but the recently announced increase had been made without prior consultation with the Fund even though there had been a clear understanding between the Fund and the authorities on wage increases as reflected in the letter of intent. While the authorities might have a good reason for exceeding the precise increase in wages that had been agreed in the letter of intent, they should have discussed the matter with the Fund before making their announcement. If the wage increase had been announced before the scheduled date of the first drawing under the stand-by arrangement, the Fund would not have permitted Zaïre to make that drawing.

Mr. Nimatallah remarked that some members felt that the Fund interfered excessively in their domestic affairs. However, the authorities in Zaïre should appreciate that they had failed to respect the agreement that they had reached with the Fund.

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

The Executive Directors considered 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 a staff paper on legal aspects of ineligibility to use the general resources of the Fund and subsequent actions by the Fund (SM/86/102, 5/14/86).

The Treasurer noted that the total amount of overdue financial obligations in May 1986 reported in EBS/86/98, Supplement 1 was SDR 654 million, while the comparable figure in EBS/86/98, Supplement 2 was SDR 718 million. The increase was partly explained by the fact that some additional repurchases had become overdue. In addition, while special charges had been levied on 19 countries, and SDR 0.1 million in special charges had been paid, 14 members had not paid SDR 2.7 million in special charges that had fallen due. Virtually all the overdue special charges would increase the amount of deferred income, and the special charges would therefore in effect become a burden on the other members of the Fund, because the income shortfall owing to the deferred income would have to be financed in one way or another. In addition, the staff had provided for the first time information on outstanding balances in the accounts receivable by the Fund resulting from currency valuation adjustments over the previous several years. At present, outstanding valuation claims--all of which dated from April 30, 1985--amounted to SDR 583 million.

Mr. Foot said that he doubted whether the special charges constituted an additional burden on borrowers and on deferred income.

The Treasurer remarked that the special charges were levied in order to recover income that the Fund had forgone. When the Fund received those charges, its income position recovered correspondingly. If a member from which those charges were receivable had any obligation that was overdue for more than six months, the Fund could not accrue those charges as income. In effect, the issue that Mr. Foot had raised had to do with the difference between the Fund's cash position and its accrued income position. The Executive Board had decided that, in the case of members overdue for more than six months, unpaid charges due were not to be added to accrued income. If the members that were obliged to pay special charges did not pay them, other members would have to make up for the consequent deterioration in the Fund's income position.

Mr. Sengupta commented that all regular charges were a part of normal accrued income, and unpaid charges were a part of deferred income. However, Mr. Foot had understandably asked why special charges--which were levied if accrued income became deferred income--should be deemed as potentially accruable income.

Ms. Bush remarked that it would be useful to consider whether or not special charges should be included among deferred income.

The Treasurer, responding to a question, said that, as was suggested by the data in Table 10 in EBS/86/98, Supplement 2, there seemed to have been a growing reluctance in recent years by members to pay promptly their valuation adjustments. There was not a complete correlation between members with outstanding currency valuation payments and members that were overdue in their obligations to make repurchases and to pay charges. Some members that were current in their repurchases and charges had failed to make payments to the Fund in their own currency for the valuation adjustments. Most members that failed to make valuation adjustment payments in local currency had experienced serious administrative problems; some others faced significant budgetary problems. The members with outstanding valuation adjustments included Bolivia, The Gambia, Guinea-Bissau, Somalia, Sudan, Western Samoa, and the Yemen Arab Republic.

The Director of the Legal Department, responding to a question by Mr. Tornetta, said that unpaid currency valuation adjustments were properly classified as overdue obligations once they became due and payable. The sanction for overdue currency valuation adjustment payments was the same as the sanction for overdue repurchases and charges, namely, a declaration of ineligibility to use the Fund's general resources. A complaint under Rule K-1 could be made against members failing to make such payments.

Mr. Foot commented that he wondered whether it was appropriate to permit a member with outstanding currency valuation adjustment payments to use the Fund's resources.

The Treasurer recalled that when the Executive Directors had decided that a member that incurred arrears should not be allowed to use the Fund's resources, overdue currency valuation payments had not been taken into account.

Responding to a further question, the Treasurer said that in the past the Fund had entered into a stand-by arrangement with a member that had an unpaid currency value adjustment payment. Under the original Articles, a member had been able to use the Fund's resources even if it had not fully paid its subscription in its national currency. That fact underscored the relatively soft treatment that had been given to unpaid obligations in national currency. The requirement under the amended Articles to make full payment of subscriptions and the introduction of the valuation adjustment were meant to constitute a substantial strengthening of the Fund's financial position.

Although members should of course meet all their obligations to the Fund, a failure by a member to make a payment to the Fund in the member's own currency did no immediate damage to the Fund's liquidity position if the member's currency was not usable in the currency budget, the Treasurer explained. That fact might help to explain why the Fund had treated overdue payments in local currency somewhat differently from obligations to make payments in the currencies of other members in repurchases and in payment of charges.

Mr. Nimatallah considered that overdue currency valuation claims should be brought to the Executive Board's attention under Rule K-1 through the same process of notifications and complaints that was used for overdue repurchases and overdue charges. Overdue currency valuation claims should be brought to the Executive Board's attention on a regular basis.

Mr. Fujino said that he wondered whether there were financial reasons for a member's failure to provide its own currency to meet its currency valuation adjustment obligation.

The Treasurer replied that it was often difficult to know precisely why a member did not make a payment in its own currency. Administrative problems occasionally kept members from making such payments. Sometimes the minister of finance or the government concerned lacked the authority to create the amount of money needed to pay the Fund or to receive an advance from the central bank. Some members' financial year differed from that of the Fund, and the amounts that eventually became payable to the Fund were not easily foreseeable; hence, there could be delays in payment even if the country concerned was willing to appropriate the necessary amount in its budget.

Mr. Sengupta noted that 30 members had had unpaid currency valuation adjustment payments at the end of July 1985. Further discussion of the problem of outstanding currency valuation claims should be held.

Mr. Nebbia considered that the Treasurer's comments had usefully placed in perspective the importance of outstanding currency valuation claims. The Fund and individual members had been treating overdue currency valuation adjustment payments rather softly, for the reasons that the Treasurer had mentioned. He would discuss Bolivia's currency valuation adjustment payments with the Bolivian authorities. However, he doubted whether the Executive Board had to discuss each and every case of overdue currency valuation adjustment payments as such cases arose; as the Treasurer had stressed, the overdue payments could be explained by a number of different factors.

Mr. Nimatallah said that he wondered whether there were any monetary implications for a member that reconstituted the value of the Fund's holdings of its currency. If there were no monetary implications, the Fund should so inform members that had overdue currency valuation payments to be certain that the members were fully aware of the situation and the implications of paying the Fund as a part of a currency valuation adjustment. Presumably a country merely had to print the money that was required to make a currency valuation payment to the Fund.

The Treasurer remarked that when a country signed the Articles it became obliged to fulfill all the obligations under the Articles. Each member should have the authority through its national law to make administrative arrangements to produce the necessary amounts of domestic currency to meet the country's obligations to the Fund. Members' arrangements for financing their subscription payments to the Fund were diverse, and the economic consequences of paying the Fund therefore differed from one country to the next.

Mr. Nimatallah said that he had had in mind the impact on the money supply of payments to the Fund by a member in its own currency. If a member had reached an understanding with the Fund under which the member had agreed not to increase its money supply beyond a specified limit, the member might be reluctant to expand its money supply in order to pay the Fund as part of a currency valuation adjustment. A member's payment to the Fund for that purpose should be isolated from other transactions so that it would not affect the member's money supply agreement under an arrangement with the Fund and the country's inflation performance. Reminding members that they could sterilize the effects of payments to the Fund in local currency in a manner that would not adversely affect the country's money supply and inflation performance might encourage the members concerned to pay the Fund promptly.

Mr. Foot stated that he agreed with Mr. Nebbia that the staff need not report to the Executive Board each case of overdue currency valuation adjustment payments. Instead, the staff could circulate a table like Table 10 in EBS/86/98, Supplement 2 every six months. In addition, staff papers on requests for and reviews under stand-by arrangements could include a brief paragraph on outstanding currency valuation claims for each member concerned. If overdue currency valuation payments were due to administrative problems, the members concerned might wish to focus on them and solve them fairly quickly. He hoped that the list of members with overdue currency valuation payments could be significantly reduced in the coming several months.

The Chairman remarked that the problem of overdue currency valuation payments seemed to be essentially an accounting problem. Central banks typically made regular corrections in their accounts for exchange rate evaluation changes. The staff would look into the valuation procedures that members followed.

Ms. Bush said that she, like Mr. Sengupta, had noted that as many as 30 members had failed to make currency valuation payments by the end of July 1986. In addition, by the end of June in 1982, 1983, and 1984 all members had made the required currency valuation payments to the Fund. However, by the end of May 1986, 7 members still had not made payments equivalent to SDR 582.6 million.

Mr. Goos considered that the staff should prepare a comprehensive paper on the question of currency valuation claims. The paper should include the policy implications that should be drawn from the information that would be provided in the paper. For example, the staff should address the question of the appropriateness of permitting members with overdue currency valuation payments to negotiate stand-by arrangements and make purchases.

The Chairman said that he agreed with Mr. Goos. The staff should inform the Executive Board on, say, a six-monthly basis of the evolution of outstanding currency valuation claims. Executive Directors from the seven countries with overdue currency valuation payments should encourage their authorities to review their procedures for making the required payments to the Fund. He hoped that the problem of overdue currency valuation payments would eventually disappear. If necessary, the staff would prepare a more substantive paper on the matter indicating why the overdue payments occurred and how the problem could be corrected. Staff papers on stand-by arrangements should include a description of developments concerning currency valuation payments in individual cases.

Mr. Nimatallah commented that it was clear from the staff's latest six-monthly report that the situation with respect to overdue obligations had continued to deteriorate. The total amount was larger, and the average length of the obligations had been increasing. The magnitude of the arrears had increased so rapidly that it was equivalent to more than half of the Fund's reserves, despite the adoption by the Fund of a range of policies and procedures that were aimed at containing and solving the arrears problem.

The main question at hand was how to contain and reduce the growing problem of arrears, Mr. Nimatallah continued. A comprehensive approach, involving a number of elements, was required. It was important for the Fund to introduce preventive measures in Fund-supported programs to ensure that members using its resources would be able to repay the Fund. Moreover, there were countries that were not receiving new money from the Fund but still had some years to complete repayment to the Fund; the staff should closely monitor the ability of those countries to repay on a regular basis and should keep the Executive Board informed of unfavorable developments. The staff had recommended such monitoring in its present report. The Executive Board should in turn alert the countries concerned and perhaps suggest to the authorities specific measures that they should take in advance, before problems with respect to arrears occurred.

At the same time, it was equally important to take steps to ensure that countries in arrears had an incentive to settle their overdue obligations to the Fund, Mr. Nimatallah said. Some steps in that direction had already been taken. However, he favored creating a system that would progressively increase the pressure on members to settle their overdue obligations. He was worried that in the absence of such an approach some countries in good standing might be encouraged not to settle their obligations on time.

Should the Executive Board find it necessary to extend the period for repayment after the first substantive discussion of a member's arrears, and should the country in question remain in arrears, the Executive Board should, following the second substantive discussion of the arrears, notify all development institutions of the situation, Mr. Nimatallah considered. That notification would take place six months after the arrears problem had emerged. By sharing the information the Fund, in keeping with its catalytic role, would alert the development institutions to the fact that the countries in question were not in good standing with the Fund.

As to the issue of the steps to be taken to reinforce the effectiveness of a declaration of ineligibility, one possible step would be to strengthen the close cooperation that already existed between the Fund and the World Bank, Mr. Nimatallah went on. One way in which to do so was to ask the World Bank to initiate procedures for suspending access to new World Bank resources by countries that had been declared ineligible by the Fund. That procedure should cover countries that were newly declared ineligible from the date of declaration as well as those that had already been declared ineligible. The aim of that suggestion was not to deprive the countries in question of the opportunity to receive World Bank resources. On the contrary, the suggestion was meant to encourage the countries that had been declared ineligible to introduce a comprehensive medium-term program of structural adjustment that could be financially supported by the Fund, the World Bank, and possibly other development institutions as well as governments, and private creditors. Piecemeal support from different development institutions without the involvement of the Fund could result in a long delay in the settlement of overdue obligations to the Fund by the countries concerned. Some might argue that countries that were in serious economic disarray might choose to reform their economies in a gradual way rather than on the basis of a comprehensive program. However, he doubted whether the gradual approach was appropriate for such countries. Some might also argue that his approach could constitute a form of cross-conditionality. He had consistently stated his opposition in principle to cross-conditionality. His suggestion was aimed merely at closer coordination between the Fund and the World Bank as an accommodation to the new reality of growing overdue obligations.

Should the measures that he had suggested prove to be insufficient, and should the countries concerned make no substantive efforts to normalize their relations with the Fund, the Executive Board might have to resort to the imposition of an ad hoc financial penalty, Mr. Nimatallah said. The possibility of introducing such a penalty should be considered on the occasion of the first review after a declaration of ineligibility.

With respect to the alternative of compulsory withdrawal, the staff paper on ineligibility and the legal aspects of subsequent Fund action was of limited usefulness, Mr. Nimatallah remarked. The discussion in that paper was confined to a presentation of what was feasible within the framework of the current Articles. It was important to remember that the Articles had been formulated at a time when the role of the Fund had been relatively limited. The Fund's role had subsequently been expanded, and the Fund had committed large resources--owned and borrowed--when new payments problems had emerged; hence, it seemed only natural to look beyond the current Articles for solutions to the arrears problem. In particular, the Articles were limited in the sense that they provided only one further step subsequent to a declaration of ineligibility, namely, the drastic option of calling for compulsory withdrawal.

The World Bank's Articles, reflecting that institution's lending role since its inception, were more flexible in the sense that they provided for a two-step procedure in response to arrears, Mr. Nimatallah continued. Under Article VI, Section 2 of the World Bank's Articles, a member could be suspended prior to being asked to leave the World Bank. In addition, the World Bank procedures included automatic cessation of membership one year after suspension should the member fail to fulfill its obligations. The Fund should adopt such a flexible approach. It would be less difficult for the Board of Governors to vote for the suspension of a member than for the country's compulsory withdrawal.

His proposal would obviously require a limited amendment of the Articles, Mr. Nimatallah went on. The Executive Board should actively consider that procedure and should recommend to the Board of Governors the implementation of such a change. The amendment was unlikely to be resisted by any member, as its aim was to enhance the Fund's ability to safeguard its resources. The proposed amendment would make the Fund's procedures parallel with the World Bank's and would be consistent with the present effort to enhance Fund/Bank coordination. If the amendment were enacted, the steps to suspend a member should be initiated on the occasion of the second review after the declaration of ineligibility. Otherwise, steps toward compulsory withdrawal should be initiated instead.

As a part of the exploration of options available to the Executive Board after a declaration of ineligibility, the staff should explore the possibility of depriving a member that had been in arrears for a long period of its right to any increases in its quota as a result of a general review of quotas, Mr. Nimatallah remarked. In the near future Viet Nam and Guyana would be the subjects of the second six-monthly review after the declaration of ineligibility. In the absence of immediate and substantial progress in those cases, the Executive Board should place those cases on its agenda on the basis of the present procedures for treating those cases.

Since compulsory withdrawal might soon be contemplated for some countries, particularly if no intermediate steps were permitted, the legal and financial implications of such an action must be faced, Mr. Nimatallah said. In particular, the staff should further explore the legal recourse for the Fund concerning any unpaid amounts at the time of compulsory withdrawal.

The ideas that he had mentioned were not meant to be exhaustive, Mr. Nimatallah commented. They were meant to indicate the kinds of measures that were needed to encourage prompt settlement of overdue obligations. In the circumstances, some countries might feel that they had been treated by the Fund more favorably after a declaration of ineligibility than before the declaration. Those who argued that the Fund was a cooperative institution that should give its members more time to repay should at least also agree that the Fund should receive the highest priority by members that were eliminating their various arrears.

As he had mentioned on previous occasions, the members in arrears to the Fund had the main role to play in solving the problem of those arrears, Mr. Nimatallah said. The only viable option for those countries was to adopt a comprehensive adjustment program that would place their economies on a path of sustainable growth. In that connection, the recent introduction of the structural adjustment facility and the strengthened involvement of the World Bank as a catalyst could help to provide the needed resources in support of comprehensive adjustment programs in countries with arrears. Those countries should adopt such programs, as the existence of the programs would encourage other donors to support the countries' adjustment efforts. Meanwhile, it was important for the Fund to continue to stress preventive measures in designing future programs.

Mrs. Ploix stated that her authorities were deeply concerned about the seriousness of the overdue obligations problem. The latest data confirmed that the situation with respect to arrears to the Fund had deteriorated in every respect--the amount, the length of time, the number of members with arrears, and the ratio of arrears to outstanding credit. However, there had been some recent positive developments. For example, the Peruvian authorities were committed to repaying the Fund. Those developments should not be a cause for excessive optimism; however, they did show that the efforts to deal with the arrears problem were beginning to show measurable results. The problem was shared by management, the staff, the Executive Board, and the member countries concerned, and much remained to be done to solve the problem.

She agreed with the staff that no changes in the Fund's general policies and procedures with respect to overdue obligations were required at present, Mrs. Ploix continued. Substantive changes and a tightening of the procedures had been adopted during the previous six-monthly review. A pause in the evolution of the procedures was clearly called for, especially as some of the previous decisions--such as the introduction of special charges--had been implemented only recently. Moreover, the Executive Board must give the staff and members sufficient time to become accustomed to the new procedures.

She continued to believe that it was essential to have a consistent system of information on overdue financial obligations, Mrs. Ploix said. The problem of determining when arrears should be considered as deferred income still had to be solved.

The staff should examine possible ways in which to deal with members that were frequently overdue in their obligations but were not in arrears for long periods, Mrs. Ploix commented. The rising trend in the number of members that had overdue obligations frequently and for relatively short periods was worrying.

The staff's suggestions made on page 16 concerning complaints under Rule S-1 and the disposition of earnings on the investment of supplementary financing facility subsidies were acceptable, Mrs. Ploix said.

The issue of overdue obligations raised two categories of questions, Mrs. Ploix remarked. The first was the basic approach to the problem of overdue obligations, namely, prevention or cures. Among the preventive measures, the assessment of the country's capacity to repay the Fund by maintaining appropriate policies was of crucial importance. There was a need to adapt the procedures for dealing with members that had arrears. The Fund must pay as much--if not more--attention to how it could help members with arrears to solve the problems facing their economy and to eliminate their overdue obligations as to how the Fund could reinforce its punitive measures. In that connection, the Fund and the World Bank should closely coordinate their intervention through well-designed technical and financial assistance programs, and each institution should pay due attention to the other's relations with individual members.

A declaration of ineligibility should not be considered as an end to the Fund's relations with a member but rather as an important step in the Fund's continuing relations with countries, Mrs. Ploix considered. A declaration was a serious warning to the country, but it was important to leave open the channels of communications, provided that the country concerned demonstrated a sufficient degree of cooperation with the Fund. The Fund must stand ready to be creative in devising solutions to the problem of overdue obligations. It would be up to the Executive Board to give the staff further guidance with respect to legal options available to the Fund after a declaration of ineligibility. It was important to remember that the problem of arrears would have to be handled by the entire international community, and she looked forward to the scheduled discussion on burden sharing.

Mr. Polak said that there was a clear cause for concern as a result of the increasing size of the arrears to the Fund and the absence of progress toward settlement by countries that had been declared ineligible to use the Fund's resources. That concern warranted the search for any new measures that could provide extra incentives for countries to repay the Fund as soon as possible and to adopt domestic policies that would facilitate repayment. The staff paper on the legal options was therefore welcome. The Chairman had correctly stressed that cases of ineligibility involved difficult judgments about the most likely productive course of action by the Fund. Different approaches might have to be followed in different cases, and rigid rules or procedures would probably have to be avoided. Such a relatively flexible approach could be defended on the ground that the circumstances of individual ineligible members might well differ substantially.

His basic position on the issue of arrears both before and after ineligibility was that the relationship between the Fund and the member must continue to be based on mutual cooperation as long as it was evident that the member was willing to cooperate with the Fund, Mr. Polak said. It was an oversimplification to say that a member had arrears to the Fund only because it could not pay the Fund. There were many members that could make such a claim but by strenuous efforts had managed to remain current in the Fund. Members that were willing to cooperate could be encouraged and helped by the Fund to seek constructive solutions that over time would lead to the elimination of the members' overdue obligations.

In the absence of the willingness to cooperate, new forms of punishment were unlikely to achieve the desired result, Mr. Polak remarked. The strongest option that the staff had mentioned was the initiation of the procedure for compulsory withdrawal. That option was of course the ultimate recourse that should be used only when other actions had failed and the Fund had concluded that its relations with the member were beyond repair. Moreover, it was far from clear whether setting in motion the procedure for compulsory withdrawal would enhance the chances of repayment to the Fund. In addition, the 85 percent majority that was required for compulsory withdrawal implied that explusion would be possible only if there was substantial agreement among members on the need to take such a far-reaching step. Hence, he doubted whether the threat of compulsory withdrawal would be particularly effective except in the most extreme cases. For the time being at least, compulsory withdrawal was not a realistic option.

The staff paper clearly showed that the other options were unimpressive, Mr. Polak continued. As the staff had concluded, a declaration of ineligibility did not alter a member's rights and obligations under the Articles. Therefore, voting rights could not be suspended and Article IV consultations could not be discontinued after ineligibility. In any event, voting rights ought not to be suspended and Article IV consultations should be continued as long as they were seen to be potentially useful vehicles for encouraging the member concerned to implement more effective policies. For other countries, the Fund could decide to place them on a long, or perhaps indefinite, consultation cycle. There would be no point in using the Fund's manpower and operational funds to conduct consultations with a member that was not cooperating with the Fund.

In cases in which technical assistance was a precondition for the design and perhaps the operation of a successful adjustment effort the Fund should be forthcoming with such assistance, Mr. Polak said. However, if technical assistance would do little more than enable a member to make minor policy corrections while the main policy issues remain unaddressed, the Fund should be less accommodating. Technical assistance should not be used to create an aura of collaboration where none actually existed.

In discussing the option of concerted action the staff had recalled the Executive Board's wish to have the Fund keep open its channels of communication with members in arrears, Mr. Polak remarked. The staff had added that efforts by the Fund to assist a member to obtain aid could be accentuated after a declaration of ineligibility. There might be cases in which that approach might be correct at least in the narrow sense that the Fund should do everything to ensure that it would be repaid; however, that approach should be used with great caution. It seemed odd to provide extra assistance to a member that was in arrears to the Fund, just as it would be odd if donors were to direct much of their aid effort toward countries with the largest problems and the least effective policies.

He was opposed to punitive charges on arrears, Mr. Polak stated. The recent decision introducing essentially compensating charges on arrears had taken the Fund as far as it could and should go in the direction of charges on arrears.

The staff had mentioned the principle of offsetting claims between the Fund and the member with arrears to encourage repayment by the member, Mr. Polak remarked. He wondered whether that principle could be applied in connection with quota increases, which traditionally involved payments by a member in SDRs. If the Fund had a prior and overdue claim on that member, any payments by the country should perhaps first be applied to arrears before the discharging of an obligation under Article III, Section 3(a). Linking quota increases to the elimination of arrears might be an effective way in which to reduce arrears and should help creditor countries to mobilize political support for quota increases.

He agreed with the staff's conclusion that there was no need for changes in the Fund's general policies and procedures with respect to overdue obligations at the present stage, Mr. Polak said. The procedures and policies were sufficiently flexible and should continue to be actively applied for the time being.

Mr. Ismael stated that he agreed with the staff's conclusion that no changes in the Fund's general policies and procedures with respect to overdue obligations were needed at present. The amounts of overdue obligations had generally been small, and the period of the arrears had generally been short. The incidence of members with protracted arrears had stabilized.

He did not agree with the staff that a member's right to use SDRs should be suspended automatically and without qualification when a complaint was issued under Rule S-1 after the member had been declared ineligible to use the Fund's general resources, Mr. Ismael said. An automatic suspension would compound the member's problems. In any event, he doubted whether such an action would be legal. It was not the normal banking practice to freeze a client's assets merely because it had overdue obligations.

Executive Directors had been asked to comment on the issue of the disposition of earnings on the investment of supplementary financing facility subsidies withheld from a member pending settlement of the relevant charges, Mr. Ismael remarked. Such earnings should be paid to the member. As to whether such earnings should be used first as an offset against any other overdue obligations of the member, the normal banking practice in that kind of situation should be followed. The staff should comment on the normal banking practice in commercial banks and other commercial organizations.

In SM/86/102 the staff had described the actions that had been taken thus far in dealing with overdue obligations and other actions that were legally possible but had not yet been used, Mr. Ismael noted. The Fund should avoid taking actions that were unlikely to help to promote the normalization of relations between the Fund and a member. The Fund should take a more positive approach to the solution of the problem of arrears. For example, technical assistance would help members with arrears to adopt needed adjustment measures. In addition, the Fund should help a member with arrears to obtain external assistance to normalize its financial situation. The concerted approaches by members in the form of persuasion and offers of assistance could be useful, and procedures to that end should be developed.

Commenting further on the legal issues raised in SM/86/102, Mr. Ismael said that he agreed that it was appropriate for the staff not to take any position in advance on the advisability of applying actions that were legally possible, as it was difficult if not impossible to predict which course of action would be the most productive one. He would go a step further in concluding that it was equally difficult for the Executive Board to determine which course of action would be the most productive one. Hence, the application of legal actions should be approached with great caution. He also agreed that the Fund should keep its channels of communication open with members in arrears in order to help them to formulate adjustment policies to catalyze external assistance so that the arrears could be eliminated.

It would be counterproductive to increase the special charges, Mr. Ismael considered. The penalty charges that had already been imposed on overdue repurchases and overdue charges were sufficient to compensate for the Fund's loss of income and for the administrative costs involved. Penal charges could produce positive results only when the member with arrears had the resources to repay the Fund but was unwilling to repay. All cases of overdue obligations had occurred because the members concerned lacked the needed financial resources; therefore, any additional penalty charge would only compound the problems facing those countries.

It had been suggested that the Fund could amend its policies on the selection of currencies and decide to sell balances of the currency of a member in arrears after consultation with the member, Mr. Ismael commented. He doubted whether that approach would produce any positive results. If a member was in a position to repurchase its own currency, it would do so to avoid falling into arrears to the Fund.

The position of the Executive Board and the Board of Governors on compulsory withdrawal would depend crucially on the answers to two questions, Mr. Ismael commented. Since the Fund's main objective was to secure repayment, the question could be raised whether compulsory withdrawal would lead to the achievement of that objective. The second question was whether compulsory withdrawal of a few members would deter other members from becoming overdue in their obligations to the Fund. In his view, compulsory withdrawal would not secure prompt repayment to the Fund and would not act as a deterrent to other members, because members in arrears faced extreme hardships and were unable to repay the Fund. He was opposed to the use of legal provisions requiring compulsory withdrawal by a member that was unable to repay the Fund owing to its difficult economic circumstances.

If a proposal for the compulsory withdrawal of a member was made to the Executive Board and the Board of Governors, two questions would have to be asked, Mr. Ismael said. First, what were the economic circumstances of the member that was being subjected to the compulsory withdrawal procedure? In other words, was that country able to repay the Fund, or was it unable to do so? Second, what remedies, if any, did the Articles give a member that had arrears to the Fund and had difficult circumstances? The staff should prepare a paper outlining the legal remedies that might be available to a member with overdue obligations under the Articles and under the Rules and Regulations. The Executive Board must not continue to postpone agreeing on the definition of "exceptional hardship" and "exceptional circumstances." The staff should also prepare a paper on possible objective indicators that might be used in applying the provisions of Article V, Sections 7(g) and 8 (e).

Mr. Kafka remarked that the arrears problem was clearly still important, even though it was encouraging to learn that the incidence of members with protracted arrears appeared to have stabilized for the time being. There was every reason to pursue corrective and preventive actions. As to the latter, he was puzzled by the staff's purportedly new suggestion to assess members' ability to service their debts to the Fund. After all, the formulation of a program with a member must have always implicitly involved a conclusion by the staff that the member would be able to service its debt to the Fund.

In the period after an arrangement with a member had expired, he doubted whether formal Executive Board assessment of the member's continued ability to repay the Fund would be the best way in which to ensure that an arrears problem would not suddenly emerge, Mr. Kafka commented. Without any change in their present formal practices, management and staff should continue discreetly to counsel members that appeared to be in danger of encountering difficulty in repaying the Fund or other creditors. He agreed with other aspects of the six-monthly report, with the qualifications that had been made by Mr. Ismael.

In SM/86/102, the staff had discussed possible actions by the Fund after a declaration of ineligibility, Mr. Kafka remarked. At present, the Fund already undertook periodic reviews after a declaration of ineligibility. In addition, the Fund engaged in a degree of publicity after such a declaration. Whether or not the Fund should engage in further publicity when a member remained in arrears after a declaration of ineligibility was a delicate question. In theory, additional publicity could exert some pressure on the member concerned, but it might also undermine the member's ability to obtain the financial assistance that it needed to introduce appropriate adjustments. It seemed best to deal with the issue of additional publicity on a case-by-case basis. The publicity should always be as helpful as possible to enable a member to obtain all possible assistance from other sources that it might need in order to normalize its relations with the Fund. Communications by the Fund to other institutions asking them to refrain from assisting a member that was in arrears to the Fund would be improper for the Fund and probably would be resented by the other institutions. Such communications could only be seen as a kind of vendetta, and they would damage the Fund's ability to recover overdue debt.

A request for technical assistance by a member with arrears to the Fund should be welcomed; the Fund should not create difficulties for members making such requests and should not require members to bear the costs of technical assistance, Mr. Kafka considered. Indeed, the Fund should persuade members to request technical assistance, which would help members to adopt needed adjustment measures, thereby placing those countries in a better position to repay the Fund.

In the financial area, the Fund should certainly do no more than it did already, namely, to impose compensatory special charges, Mr. Kafka said. In his opinion, it had been a mistake to impose compensatory charges. It probably would not be helpful to offset claims that a country had against the Fund by attempting to sell the currency of a member that had arrears to the Fund or through other offsetting mechanisms. It was important to remember that, as Mr. Ismael had stressed, one reason why members had protracted arrears was that they were genuinely unable to pay the Fund. The export capacity of those members would be damaged if they repaid the Fund; accordingly, the arrears of those members would increase rather than decline, despite adjustment measures introduced by the members. In addition, payments to the Fund could threaten social stability, something that would of course probably contribute to an increase--rather than a decrease--in the member's arrears. Hence, he strongly supported Mr. Ismael's conclusion that the Executive Board should avoid any further delay in defining the meaning of "exceptional hardship" and "exceptional circumstances" in Article V, Section 7(g) and Section 8(e), especially Section 7(g). In addition, Mr. Polak's suggestion to link quota increases with the payment of arrears to the Fund was interesting.

The ultimate sanction for nonpayment of arrears was compulsory withdrawal from the Fund, Mr. Kafka noted. He agreed with previous speakers that compulsory withdrawal was the least likely way in which to produce the desired normalization of relations between the Fund and a member with overdue obligations. Expulsion was therefore inadvisable and should not be threatened or attempted unless it was clear that the Executive Board and the Board of Governors would accept a recommendation to expel a member. The rejection by the Board of Governors of an expulsion recommendation by the Executive Board would do irreparable damage to a member that wished to normalize its financial position and needed financial assistance to do so. Similarly, even if the 85 percent majority required for an amendment existed, any proposal to introduce a provision permitting the suspension of a member should be rejected.

Instead, the Fund should develop a procedure based on its willingness to assist members with arrears to normalize their financial relations even if the Fund were not prepared formally to negotiate with the country, Mr. Kafka went on. The staff had usefully suggested that the Fund should encourage other interested members to undertake a concerted approach to helping members with arrears. That approach could combine persuasion with offers of assistance by some of the members concerned. In addition, in principle the approach need not involve publicity, which could be externally and internally highly embarrassing to the member with arrears and therefore counterproductive to the Fund's objective of receiving repayment by the member with arrears. Moreover, the procedure that he favored could be used through diplomatic intervention in the capital of the member with arrears and could focus on the problem of the country's failure to fulfill its obligations in the same spirit that was reflected in the Baker initiative, namely, to promote adjustment in the context of an early resumption of growth and an improvement in economic conditions. Finally, the two members that had been declared ineligible to use the Fund's resources should not be expelled from the Fund. Their cases moreover were unlike each other.

Mr. Hodgson commented that overdue financial obligations to the Fund had had a profound impact on Fund policy and practice during the previous year and were still a cause for serious concern. Overdue obligations had worsened during the previous six months in a number of respects, and it was imperative for all members to impress upon the countries with arrears the seriousness of the situation.

There had been some positive developments, Mr. Hodgson continued. Zambia and Somalia had been able to clear their arrears to the Fund and had introduced stronger adjustment policies supported by stand-by arrangements. In addition, Peru had made a commitment to the Executive Board to eliminate its overdue obligations by August 15, 1986. The elimination of those arrears would go a long way toward improving the Fund's income position. Nevertheless, the Fund must not relax its vigilance. The list of countries that were ineligible to use the Fund's resources had grown during the previous six months, and in the absence of a substantial change in direction by other countries that were in arrears, the list might grow longer in coming months.

The staff had proposed no further changes at present in the Fund's general policies concerning arrears, but a few ideas might be worth exploring, Mr. Hodgson said. For example, as Mrs. Ploix had suggested, once a member's obligations were overdue by more than six months and were therefore treated as nonaccrued income, any income from that member should not be treated as accrued income until the member had eliminated all its overdue obligations to the Fund. The staff should comment on that proposal. A possible benefit of that approach would be to reduce the instability in the rate of charge and in the income projections over time. In addition, the approach would make the real impact of overdue obligations on the Fund's income more transparent than under present rules, under which many factors could change if a member were to move back and forth between accrued and nonaccrued status.

The staff paper touched on the suggestion that the Fund could examine the capacity to service debt of a member that was using the Fund's resources, Mr. Hodgson continued. He agreed with the staff that there were good reasons not to overly standardize that analysis, since the fundamental purpose of Fund programs was to permit a country to rebuild and restore its balance of payments stability and, by implication, its debt service capacity. It was even more important to consider the Fund's approach in the period after which a member was no longer operating under a Fund arrangement. In those cases, subsequent Article IV consultations should ensure that the member was adhering to the spirit of the adjustment measures and would therefore be able to meet its obligations to the Fund.

As to the timing of action by the Fund in cases of arrears, it was important to stress the need for even-handed treatment of members, Mr. Hodgson said. It would clearly be wrong to adopt an excessively rigid approach toward the process of reviewing members with arrears, since the particular circumstances of each member must be taken into account. At the same time, if the Fund were to move too far toward a judgmental approach in the interest of being fair toward a particular member, the Fund might in fact be acting unfairly toward other members that had already passed through the review process. As to members with continuous arrears, complaints under Rule S-1, and investment of supplementary financing facility subsidy resources, he generally agreed with the staff's views. There was no reason why members in arrears on supplementary financing facility charges should be excluded or exempted from special charges. Nor was there any reason why members that were in arrears to the supplementary financing facility should receive added benefits in terms of investment income from that facility.

The staff paper on legal aspects of ineligibility included some ideas on further steps that could be taken in dealing with members that had already been declared ineligible to use the Fund's resources, Mr. Hodgson commented. What was needed at the present stage was to develop a systematic series of graduated measures that would impress upon members the Fund's concern about overdue obligations. The ultimate measure, compulsory withdrawal, was not a productive option, as withdrawal was unlikely to increase the Fund's leverage or to improve the prospects for repayment. Mr. Nimatallah's suggestion should be examined in the context of an overall system, although he doubted whether added financial penalties would be helpful. The two-stage suspension process that Mr. Nimatallah had suggested should also be given further thought.

Other intermediate options might be considered as well, Mr. Hodgson continued. As the staff had noted, the Fund could limit technical assistance that was provided to an ineligible member only to areas that would expedite repayment to the Fund or to the design of comprehensive policy measures. That option might be applied automatically shortly after a declaration of ineligibility. In addition, publicity might be used more often than at present. For example, the Fund could issue a press release at regular intervals listing all ineligible members and the length of time that they had been ineligible; a brief description of the members' economic policies and prospects also could be included. When a member was declared ineligible the Fund could formally notify official creditors and donors, including the World Bank and regional banks of the ineligibility. The communication to those institutions could include an assessment of economic prospects of the country concerned. That notification should not condition actions by others, but it would help official creditors and donors to place their lending and aid programs in perspective. Finally, further thought should be given to the suggestion by Mr. Polak and Mr. Nimatallah to withhold quota increases until arrears were eliminated.

Mr. Abdallah remarked that most of the countries with overdue obligations to the Fund faced structural balance of payments problems that could be solved only over an extended period. Therefore, the Fund should be willing and ready to do everything possible to encourage long-term flows to those countries rather than consider proposals that would curtail flows to those countries.

Some progress had been made in dealing with the arrears problem in recent months, Mr. Abdallah noted. Zambia and Somalia had made payments to the Fund, and another member was likely to reduce its arrears in the near future. The Managing Director should discuss arrears with members of the African, Latin American, and Asian groups during his meetings with them at the 1986 Annual Meetings. Members without arrears could exert peer pressure on countries with arrears to make a greater effort to repay the Fund.

The number of potential cases of overdue obligations should be kept to the minimum possible, Mr. Abdallah remarked. Accordingly, the Fund's effort to solve the arrears problem should not keep the Fund from responding to the needs of members that faced genuine financing problems. All members with arrears to the Fund clearly should adopt strong adjustment policies, and peer pressure and diplomatic pressure would encourage the authorities concerned to do so. Staff missions and individual Executive Directors alone might not be able to exert sufficient pressure; an intermediator, like the Paris Club, might be able to contribute to the effort to encourage members with arrears to adopt appropriate measures. The recent Special Session of the UN General Assembly that had dealt with problems facing Africa had generated considerable goodwill and cooperation that was a reflection of the fact that a collective effort was needed to solve the problems facing sub-Saharan Africa not only by increasing financial flows, but also by improving administrative, economic, and financial mechanisms in those countries. Most of the countries in his constituency had considerable experience with the devastating effects of exogenous factors on their ability to service their external debts. Most of those countries were fully aware of the need to eliminate their overdue financial obligations to the Fund. The Fund should collaborate closely with the World Bank to ensure that adequate financing was made available to those countries. The authorities in most of those countries felt that they needed more financial support than even the Fund and the World Bank together could provide.

A declaration of ineligibility generated ill will in members with arrears and made it difficult for Fund missions to conduct fruitful discussions with the authorities concerned, Mr. Abdallah commented. The Executive Board should delay such declarations as long as possible. Some members were reluctant to repay the Fund part of their total overdue obligations when they were aware that the payment would not result in the restoration of their access to the Fund's resources; those countries might well prefer to use available funds to pay for available imports. The Fund understandably needed to encourage members to eliminate their arrears to the Fund. However, he agreed with Mr. Nimatallah that the Articles did not give the Fund sufficient leeway between a declaration of ineligibility and compulsory withdrawal. He wondered whether any intermediate steps could be taken. Countries were facing unparalleled difficulties in the post-war era. Arrears on debts within and beyond the Fund had been widespread, and the size of the overdue payments to the Fund was not particularly large and should be seen in the proper perspective. The prospects for full repayment to the Fund should improve as the global economic situation improved. Accordingly, he agreed with the staff that no change in the present procedures for handling arrears was required. He also agreed with Mr. Nimatallah that members with arrears should give the highest priority to repaying the Fund before other creditors.

Mr. Sengupta remarked that the staff report clearly showed that many countries continued to face serious external difficulties, and that in the absence of corrective policies the prospects for a reduction in the overdue obligations of those members were uncertain and the arrears might well rise. However, the staff had not analyzed the steps that would facilitate the adoption of corrective policies, especially in the light of the substantial fall in many commodity prices that had adversely affected the export prospects of developing countries and of the growing limitations that had been imposed on the access of those countries to industrial country markets. Nor had the staff analyzed the reasons for the persistent failure of some members to remain current in the Fund and the systemic and other difficulties that those members might be facing in servicing their debt. That analysis played an important part in the Executive Board's consideration of the arrears problem.

In order to keep the problem of overdue obligations to the Fund in perspective, Executive Directors should remember that of the 12 members that were subject to complaints in the two years since end-March 1984, only one had not made any payment to the Fund since the noting of the complaints and the rest had made some or all of the required payments since the complaints had been noted, Mr. Sengupta noted. Members with arrears had clearly shown their desire to eliminate the overdue payments; in fact, 4 of the 12 members concerned had fully repaid the Fund. However, 4 members had been declared ineligible to use the Fund's general resources. Of the other 4 members, 1 was likely to become current in the Fund by mid-July 1986, and another had assured the Executive Board that it would settle all its overdue obligations by mid-August 1986. The adjustment efforts by the remaining 2 members had elicited the Executive Board's appreciation and encouragement. The overdue obligations of 2 members were admittedly substantial, and the Fund's efforts in the area of arrears would therefore have to be concentrated on those countries, so that the arrears of those members could be reduced considerably.

Thus far, the Fund had taken four steps to deal with the problem of arrears, Mr. Sengupta remarked. First, the Executive Board had decided to reduce the period between the emergence of arrears and the substantial consideration of the arrears by the Board. Second, to protect the Fund's financial position, the Executive Board had decided to place charges that had been unpaid for six months or more on a nonaccrual basis, to raise the net income target to 5 percent of reserves, and to introduce special charges. Third, the Executive Board had agreed not to permit any purchases under an arrangement with a member that had arrears to the Fund. Fourth, the Executive Board had decided to include aggregate data on overdue payments in some of the Fund's publications.

It was important to recognize that, while most of those actions were helpful from the Fund's point of view, they did not have a direct bearing on a member's ability to discharge its financial obligations to the Fund, Mr. Sengupta went on. The serviceability of those obligations should be ensured not only by the member's commitment to adjustment, but also by the provision to the members of technical and financial assistance from the Fund, other creditors, and interested members. The Fund could give the members concerned technical assistance in preparing adjustment programs that could help to catalyze resources that would enable the members to pay the Fund and to be in a position to undertake a new arrangement with the Fund immediately after all arrears to the Fund had been eliminated. The Executive Board had already agreed that such an approach would be appropriate, as was reflected in the Chairman's statement at EBM/85/176 (12/6/85). Creditors and interested members could make concerted representations, as described by the staff in SM/86/102, if they could play an active role in providing financial assistance, including bridging finance as necessary in the period prior to the clearance of the member's arrears to the Fund.

He fully agreed with Mr. Kafka that the Fund could take steps to help a member with arrears to normalize its relations with the Fund, Mr. Sengupta continued. The Fund should refrain from giving any publicity to a member's economic conditions, the member's payments due to the Fund, and the measures that the member concerned should take to become current in the Fund. In addition, the Fund should not withhold or limit technical assistance to such members; the assistance would be crucial for the member's effort to introduce adjustment policies. Giving publicity and denying or limiting technical assistance would be unnecessarily punitive. In addition, it would not be proper for the Fund to inform any agencies or organizations of a member's economic conditions or overdue obligations to the Fund; such an action would serve only to affect adversely the member's relations with the Fund and would not contribute to the member's ability to repay the Fund. Hitherto, the contents of Executive Board discussions and reports on individual countries had not been provided to anyone outside the Fund without the express consent of the member concerned. That practice had worked well and should be preserved.

In its paper on the legal aspects of arrears, the staff had noted that the Fund could increase the special charges and adopt nonuniform rates of charges on overdue repurchases, Mr. Sengupta said. Neither of those measures would help to place the member in a position to become current in the Fund. Indeed, both measures would add to the member's heavy burden. A member that could not pay normal charges would be unable to pay any additional charges. Raising the special charges would merely increase the book value of the member's arrears.

Members certainly should not be recalcitrant in discharging their obligations to the Fund, Mr. Sengupta stated. Members should take corrective actions on their own or with the Fund's help so that they could become current in the Fund. The Fund should take a close look at the economic problems facing those members and examine the actions they could take that would be socially and politically acceptable and that would ensure growth. It was already agreed that adjustment programs had to be formulated in the context of growth.

In its paper on the legal aspects of the arrears problem the staff had clearly explained the grounds for, procedures concerning, and effects of compulsory withdrawal, Mr. Sengupta commented. The legal provisions for withdrawal were adequate and had served the Fund well. It was undesirable to envisage compulsory withdrawal unless a member had repudiated its obligations to the Fund.

The Articles already provided for sufficient action in response to a default by a member, Mr. Sengupta considered. Limiting the use of the Fund's general resources was the first step and it could have serious consequences for many countries that could not borrow from non-Fund sources. The second step--the declaration of ineligibility to use the Fund's general resources--had even more serious consequences both inside and outside the Fund. A member in arrears paid a high price for defaulting and did not gain any advantage by remaining in default. The Articles provided for withdrawal only as a last resort, after all measures to help a member to become current had been exhausted, including those provided for in the Articles, such as possibilities of rescheduling of repurchases and of paying charges in the member's own currency. The implications of Mr. Polak's suggestion to relate quota increases and the payment of overdue obligations would have to be carefully examined. Such an option might be appropriate, but only at a later stage, when the arrears problem became crucial and could not be solved through the measures that were already available under the Articles.

The staff had asked for Executive Directors' guidance concerning the supplementary financing facility subsidy payments to members with arrears, Mr. Sengupta remarked. Since overdue charges on purchases under the supplementary financing facility were subject to special charges, it would be appropriate to return to the member concerned the earnings on the investment of supplementary financing facility subsidies that were withheld from a member until it cleared its charges under the supplementary financing facility. The Executive Board had already correctly decided that the Fund should not set off subsidy payments against any overdue payments to the Fund, and it was not clear to him why a set-off provision should be introduced in respect of the earnings on investments by the Supplementary Financing Facility Subsidy Account. Such a provision might be appropriate only in a case in which a member had severed its relations with the Fund. In other cases, a set-off provision would be unnecessary. The only acceptable option would be to return to the member concerned earnings on investments in respect of the subsidy that had been withheld from the member until it had eliminated all its arrears to the Fund. In any event, the amounts involved would be small, and members, if approached to do so, would probably be willing to use the amounts to reduce their overdue obligations, if any, to the Fund.

Mr. Goos said that he had been increasingly concerned about the growing arrears to the Fund, and especially the substantial increase in the amounts that had been overdue for extended periods. Hence, he fully agreed with the staff that the Fund must persevere in its efforts to correct the problem of protracted arrears and to prevent future problems from arising, and that the Executive Board should consider what further action might be appropriate to safeguard the Fund's financial position.

Despite the deteriorating arrears situation, he agreed with the staff that, for the time being, there was no need to make basic changes in the existing policies and procedures for handling arrears, Mr. Goos continued. The present approach of maintaining a dialogue with members in arrears and of urging them to take corrective actions while the Fund assisted those members in designing appropriate adjustment programs and in obtaining the needed additional financing appeared to remain the most promising way in which to tackle the arrears problem. The effectiveness of that approach had been demonstrated in the recent cases of Zambia and Somalia. Nevertheless, those two cases offered little reason to feel optimistic that the Fund had achieved a major breakthrough in the solution of the arrears problem; indeed, there were indications that the opposite was true.

If the situation with respect to overdue obligations to the Fund were to deteriorate further, the Executive Board would have to undertake another review of its procedures with a view to strengthening their effectiveness, Mr. Goos considered. In that event, he would be prepared to examine all the options available to improve the payments performance of members vis-à-vis the Fund, including the possible introduction of a greater degree of automaticity in the Executive Board's review procedures, as Mr. Foot had proposed. The Executive Board should also explore the possible exclusion of members with overdue obligations from future quota increases as long as the arrears remained, as well as Mr. Nimatallah's proposals to notify all development institutions of a member's arrears to the Fund and perhaps to ask the World Bank to consider suspending new lending to countries that had been declared ineligible to use the Fund's resources, although he was not certain about the advisability of the latter option. While he could probably go along with some form of enhanced cooperation between the Fund and the World Bank in handling cases of countries with arrears, compulsory withdrawal of such members would not be a useful option at the present stage. Before considering that ultimate sanction, the Fund should vigorously apply all the other instruments at its disposal.

He could go along with the thrust of the staff's recommendations in its six-monthly report, Mr. Goos commented. He attached great importance to the staff's assessment of a member's capacity to service its financial obligations to the Fund in staff papers on the use of Fund resources and as long as a member continued to have outstanding Fund credit. Such assessments, together with appropriate proposals for corrective action in cases of deteriorating debt service capacity, would be an important instrument for containing the emergence of arrears.

Commenting on the factors bearing on the timing of action by the Fund in handling cases of arrears, Mr. Goos said that highest priority should be attached to the principle of equal treatment. In cases in which that principle required the Fund to take into account the individual circumstances of members, the circumstances should be assessed on the basis of objective criteria, such as actual payments performance and the duration of the arrears. By contrast, criteria related to a member's willingness to cooperate with the Fund or statements of specific intention to cooperate should clearly play only a supplementary role. Such largely subjective assessments or criteria opened the door to political and other irrelevant considerations that threatened to impair the effectiveness of the Fund's procedures for handling cases of arrears.

In handling cases of continuous arrears to the Fund, a shortening of the period for the circulation of a complaint from the present six months to three or four months would be appropriate for the same reasons that had led to the acceleration of the general review procedure, Mr. Goos commented. He agreed with the staff that the Fund should not adjust special charges on overdue supplementary financing facility charges for the earnings on the investment of the resources of the Supplementary Financing Facility Subsidy Account. For the reasons that the staff had mentioned, earnings on withheld subsidy payments should not be distributed to the members with arrears after they had cleared their arrears.

The presentation of overdue financial obligations to the Fund in Table 4 on pages 20-23 provided a clear picture of the duration of arrears up to six months, Mr. Goos remarked. However, the final column should be further broken down into subperiods of, say, 6-12 months, 12-18 months, and similar periods. That more detailed and comprehensive presentation would be helpful in the consideration of possible loan-loss provisioning.

Commenting on the staff paper on possible actions in the period after a declaration of ineligibility, Mr. Goos said that the Fund should maintain close contact with members in the period after a declaration of ineligibility. Indeed, those contacts could be intensified with a view to assisting the members concerned to adopt appropriate adjustment policies and to catalyze external support. Accordingly, the Fund should maintain the present six-monthly review of the arrears situation of members that had been declared ineligible to use the Fund's resources. Those reviews, as well as Article IV consultation reports, should focus inter alia on the performance of the countries concerned with respect to their repayment to the Fund and other creditors to determine whether the members were treating the Fund in a discriminatory manner. In addition, the reports should review reserve developments in the members concerned and the countries' policies to contain or reverse capital flight.

His views on the appropriateness of technical assistance for members with arrears were similar to those of Mr. Polak, Mr. Goos remarked. The Fund should provide such assistance to members that had been declared ineligible only to the extent that it was in the Fund's own interest to do so, namely, when the assistance would contribute directly to the repayment of arrears. Moreover, such assistance should be justifiable in terms of the costs of the assistance. In that connection, it would be interesting to consider the extent to which the Fund could use the currency of ineligible members to finance the costs of its technical assistance to those members.

It did not seem possible to bring the issue of overdue obligations to national courts, and the Fund should therefore adopt a decision providing for the possibility to set off claims on overdue members against the claims of such members on the Fund, Mr. Goos said. Mr. Polak's proposal to offset payments on quota increases against overdue obligations was interesting.

Although the sale of the Fund's holdings of a currency of a member with arrears could create serious difficulties for the execution of the currency budget, that possibility should not be ruled out, Mr. Goos considered. In certain circumstances, such currency sales could offer the opportunity to test the willingness of ineligible members to cooperate with the Fund, particularly in cases in which the reserve position of the members concerned had significantly improved.

Coordinated action in the form of concerted representations to members with arrears was an interesting possible way in which to maintain pressure on ineligible members to repay the Fund, Mr. Goos commented. The staff should explore that idea further and present concrete proposals based on that idea. It had been suggested that the Fund should extend the repayment period for members in arrears, in accordance with Article V, Section 7, and should define the meaning of "exceptional hardship." He was worried that the use of Article V, Section 7 would not be consistent with the character of the Fund and could weaken members' incentive to repay the Fund.

The Treasurer, responding to a question, said that there were technical assistance agreements under which the member receiving the assistance covered part of the cost. In some of those cases, the member concerned had failed to cover the cost, although the amounts involved had been small. The Fund had not established procedures for responding to a member's failure to pay the cost of technical assistance under an agreement with the Fund. The question had been raised whether the Fund could use its holdings of a member's currency to pay for the technical assistance that it provided to a member. The Fund was required to hold at all times a minimal balance of a member's currency. The Fund was therefore in a position to draw a check on its account in a member country in the member's currency and use the funds to pay some of the costs of the technical assistance in the country concerned. Under that approach, the Fund could pay some of the costs in local currency rather than in U.S. dollars, as was the current practice. However, some technical assistance costs had to be paid in currency other than the currency of the member concerned. That fact raised the issue whether the Fund's balances of members' individual currencies were convertible in fact.

Each currency was convertible by law, but he doubted whether the Fund should test that currency conversion obligation by providing a member's currency to technical assistance experts as a part of their salary to meet costs incurred in a country that had arrears to the Fund and, in many instances, did not have available foreign exchange.

Mr. Nimatallah considered that Mr. Goos' proposal to sell the currencies of countries with arrears to the Fund should be carefully examined. Such sales should perhaps be attempted on a trial basis, and if the experiment succeeded, the Fund should establish a permanent mechanism for such sales, provided that they would not negatively affect the economies of the members concerned. The local currency involved could be used to pay expenses that did not have to be paid in foreign currencies.

Mr. Nebbia said that he agreed that Mr. Goos' suggestion was interesting. The Fund might well be able to save substantial amounts on the hotel bills of missions that remained in a country for long periods. However, he wondered whether active selling of the Fund's holdings of the member's currency might not reduce the country's quota.

The Treasurer responded that sales of the currency of a member with arrears would not affect the member's quota. The Fund would merely be making use of currency that the member had not yet repurchased. Accordingly, the Fund's sales of the currency would be in place of a repurchase by the member concerned. The Articles permitted the Fund to sell a member's currency only to finance the Fund's operations. The sales of the currency of a member with arrears would have to involve another member or members that needed to use the Fund's resources.

The Director of the Legal Department said that the Fund would not include in a currency budget the currency of any member that had outstanding purchases that were not overdue. Article V, Section 7(h), however, permitted the Fund to sell the currency of a member that had overdue repurchase obligations to the Fund. The member's currency would be included in the currency budget and would be used in a transaction with another member or members. Under the Articles, the Fund could not sell in the market the currency of a member with overdue obligations to the Fund unless the member had withdrawn from the Fund and the sales were made in connection with the liquidation procedures.

Mr. Nebbia remarked that many trade transactions in Latin America were undertaken in local currencies. It was conceivable that a member using the Fund's resources would accept the currency of a member that had overdue obligations to the Fund.

The Treasurer said that he agreed with Mr. Nebbia that it was conceivable that the currency of a member with arrears to the Fund might be acceptable to other members using the Fund's resources. A member drawing on the Fund might not find that the currency of the member with arrears was immediately usable. However, the member using the Fund's resources might have a bilateral trade arrangement with a member with arrears, and might be able to use the currency of the member with arrears in paying for imports from that country. As an experiment, the Fund could ask members making drawings whether they needed a currency that had not been repurchased on schedule. The Fund could sell the currency to a member making a drawing under Article V, Section 7. However, he doubted whether such sales would have a major effect on the arrears situation.

The Director of the Legal Department noted that, under Article V, Section 7, the Fund was required to consult with the member whose currency was to be sold. The Fund did not have to secure the agreement of the member in order to be able to sell the member's currency, but consultation was a prerequisite for making such a sale.

Mr. Sengupta commented that bilateral arrangements might be worked out in order to make possible sales of currencies of members in arrears under Article V, Section 7.

The Chairman said that the possibility of having a routine procedure under which the currencies of members with arrears could be sold to cover the Fund's costs in local currency was interesting and should be explored.

Mr. Foot commented that it would be useful to have a staff paper on the possibility of selling the currency of a member with arrears in order to cover the Fund's payments in local currency for costs resulting from the provision of technical assistance. However, if the Fund were unable to sell the currencies concerned, the Fund's external auditors might feel that there was a considerable risk that those Fund assets were not usable and that a loss with respect to those assets might be incurred.

The Chairman remarked that, if the consultation with members showed that other members would be willing to buy some of the currency of the member in arrears to pay for, say, their diplomatic mission expenditures in the member with arrears, the Fund should perhaps have procedures that would facilitate those transactions. A lack of interest in members in engaging in such transactions need not necessarily be considered proof that the currency of the member with arrears was not usable. The amounts involved would probably be marginal, but the procedure was worth considering. There were probably a number of members that were acquiring some of the currencies of the members with arrears to the Fund.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/91 (6/2/86) and EBM/86/92 (6/6/86).

3. APPROVAL OF MINUTES

(a) The minutes of Executive Board Meetings 85/146 through 85/148 are approved. (EBD/86/157, 5/27/86)

Adopted June 2, 1986

(b) The minutes of Executive Board Meetings 85/149 through 85/151 are approved. (EBD/86/159, 5/29/86)

Adopted June 4, 1986

(c) The minutes of Executive Board Meetings 85/152 through 85/155 are approved. (EBD/86/160, 5/30/86)

Adopted June 5, 1986

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/126 (5/30/86), EBAP/86/128 (6/2/86), and EBAP/86/130 (6/4/86) and by an Assistant to Executive Director as set forth in EBAP/86/127 (5/30/86) is approved.

APPROVED: February 24, 1987

LEO VAN HOUTVEN
Secretary