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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/5

10:00 a.m., January 15, 1992

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	L. E. N. Fernando
	Deng H., Temporary
	G. C. Noonan
	D. Powell, Temporary
T. C. Dawson	Q. M. Krosby
	J. Prader
E. A. Evans	
R. Filosa	B. Bossone, Temporary
M. Finaish	A. F. Mohammed
	J. A. Solheim
H. Fukui	S. Shimizu, Temporary
B. Goos	B. Esdar
J. E. Ismael	T. Sirivedhin
A. Kafka	J. C. Jaramillo
J.-P. Landau	H. Dognin, Temporary
	O. Kabbaj
L. B. Monyake	
D. Peretz	
	A. M. Tanase, Temporary
C. V. Santos	Y.-M. T. Koissy
A. Torres	R. Marino
A. Végh	A. G. Zoccali

L. Van Houtven, Secretary and Counsellor
B. R. Burton, Assistant

Also Present

IBRD: P. Hamidian-Rad, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; H. Hino, P. H. Mathieu. Southeast Asia and Pacific Department: A. Adarkar. Exchange and Trade Relations Department: T. Leddy, Deputy Director; P. Allum, R. Moalla-Fetini. Fiscal Affairs Department: J. R. Modi. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; H. Elizalde. Secretary's Department: A. Jbili, A. Leipold. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; J. E. Blalock, K. Boese, J. C. Coor, E. Decarli, Z. Farhadian-Lorie, D. Gupta, D. V. Kar, C. Kelly, P. R. Menon, A. F. Moustapha, Y. Ozeki, T. M. Tran. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: P. Bonzom, L. E. Breuer, M. B. Chatah, B. R. Fuleihan, M. Galán, J. M. Jones, Y.-H. Lee, M. Nakagawa, S. von Stenglin. Assistants to Executive Directors: T. S. Allouba, J. A. Costa, S. B. Creane, M. Da Costa, Duan J., S. K. Fayyad, H. Golriz, S. Gurumurthi, M. E. Hansen, K. M. Heinonen, Kudiwu T.-M., W. Laux, J. Mafararikwa, R. Meron, F. Moss, L. F. Ochoa, E. H. Pedersen, L. Rodriguez, S. Rouai, P. L. Rubianes, D. Sparkes, N. Sulaiman, R. Thorne, J. W. van der Kaaij.

1. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS TO THE FUND - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on a further review of Sierra Leone's overdue financial obligations to the Fund following the declaration of its ineligibility to use the Fund's resources effective April 25, 1988 (EBS/92/4, 1/9/92).

Mr. Monyake made the following statement:

Since the previous review on September 30, 1991 (EBM/91/136), the authorities have continued their efforts to put in place a comprehensive economic adjustment program with the help of the Fund. Indeed, significant progress has been made toward this objective. However, the armed incursions that intensified in the second half of 1991 remain a major obstacle to prudent financial management and have adversely affected production in key areas of the economy. For instance, efforts to improve public sector finances have experienced setbacks because of emergency military expenditures that have had to be increased sharply, while rice and mineral production have declined because of the security problems. The fall in diamond exports resulting from the incursions has put pressure on the exchange rate and led to increased parallel market activity.

The Sierra Leonean authorities have not given up on the adjustment process. In fact, they have introduced a number of corrective measures. In addition to liberalizing the foreign exchange market, measures recently undertaken to raise revenue and curb expenditure have set the stage for a rights accumulation program, the negotiations for which are now at an advanced stage. On the revenue side, the general sales tax and the tax on petroleum will be increased, the tax base broadened, and tax administration improved.

According to a recent communication from the authorities, the export levy on diamonds has been increased from 2 1/2 percent to 3 percent. They have also given permission to licensed diamond exporters to utilize 100 percent of their foreign exchange inflows to purchase diamonds. The proposal to lift the ban on imported cigarettes is being considered by the Cabinet today, and it is expected to be endorsed.

As to budgetary performance, the revenue intake for December is the highest for any month of this financial year. Correspondingly, the authorities have also instituted tight controls on expenditure, and bank financing for the end-December quarter was, therefore, better than had been anticipated. On the reduction of the civil service, the retrenchment exercise affecting daily rated workers is progressing smoothly.

The stance of monetary policy will be tight to ensure the restoration of confidence in the banking system and orderly operation of the foreign exchange market. In line with this policy, a steady depreciation of the official exchange rate is being observed.

The authorities have continued to give priority to settling arrears with the Fund. Since the preceding review, a total of SDR 2.9 million has been paid, which is SDR 0.1 million higher than the obligations falling due in this period. The authorities have reiterated their intention to make payments to the Fund at the rate of $1 million a month in the coming months.

The authorities are doing their maximum to settle arrears with the Fund and implement corrective measures to deal with the problems in the economy. In this endeavor, they would appreciate if the Fund could assist in catalyzing financial support from member countries, as this support would help them make further progress toward the implementation of a rights accumulation program. They are aware that such a program holds the key to a solution to Sierra Leone's problem of overdue obligations and lays the basis for financial stability and economic growth.

Finally, on the security situation, there have been encouraging signals in the past few days. Some areas hitherto in rebel hands, particularly in the southern province, have recently been retaken by Sierra Leonean forces. A new provisional administration is in place, and further reforms on the political front are geared to take the country toward a multiparty democracy.

Mr. Fernando made the following statement:

Although it continues to fall short of expectations, Sierra Leone's payments performance has steadily improved. The level of arrears has been scaled down, even if only slightly; it is now lower than at our previous review in September 1991. Sierra Leone's intention to continue to honor this intermediate objective for the clearance of arrears is encouraging and provides more assurance that the level will be rolled back further--at least to the June 1991 level--before Board consideration of a rights accumulation program. It would be a useful track record to build upon during the period of the rights accumulation program.

However, policy performance, the other aspect of cooperation that was beginning to show encouraging results, has received a setback. The staff attributes this setback to "difficult security and social conditions." Although the full extent of the setback cannot be related to the reversal on the security front, there seems little doubt that this factor initially undercut the authorities' expanding efforts at stabilization. One would note that the border conflict is not a self-inflicted wound, but one caused by the defence of its territorial borders. Therefore, we should continue the effort to rehabilitate the economy as the best prospect for regularizing the arrears situation. Some questions remain, however.

First, at the previous review, the staff reported that, as there were reasonable prospects for a successful implementation of an adjustment program, a rights accumulation program had been negotiated covering the two-year period from mid-1991 to mid-1993. But the paper for today's review says that the rights accumulation program could be finalized only during the next mission later this month. The process has been delayed by the increase in hostilities. The risks arising from the security situation would seem much higher at this point in time, particularly because the conflict, though confined to the border area, has a disproportionately disruptive effect on commercial and production activity. This disruption is, in fact, reflected in the much sharper contraction of GDP for the current year. I heard Mr. Monyake's comments on recent favorable signs. I would be interested to hear the staff comment on the revised prospects for the implementation of an agreed adjustment program, particularly on the safety margins to be built into the program to absorb any further shocks.

A second question concerns the timing for the endorsement of the rights accumulation program. The expenditure overrun for the current fiscal year would effectively push fiscal adjustment and curtailment of reserve money growth to the next fiscal year and beyond. In this context, is it still feasible to consider a rights accumulation program for the current fiscal year and 1992/93 as was perceived at the September 1991 review?

Third, in light of the expenditure overrun for the current year, what mix of expenditure cutting and revenue raising measures will prevent the deficit from worsening? The staff paper mentions new revenue measures to be taken this month. Is there an expectation that these measures will make a significant contribution this year, or is reliance to be placed primarily on expenditure cuts such as accelerated retrenchment? At a time when social conditions had already caused the authorities to advance budgeted salary increases, can this vehicle provide for early budgetary savings? The important question at this point is how can the authorities demonstrate in a credible manner that they can contain the deficit for the current year at a level that does not exceed the previous year's?

The fourth question relates the political processes to economic policy formulation and implementation. A referendum in August 1991 paved the way for multiparty representation and for elections to the legislative assembly that are to be held shortly. The staff has been negotiating the adjustment policies with the present administration. Is there a risk that implementation could suffer on account of the election outcome? In other words, what are the chances for continuity of economic policy, and is the economic team that participated in the substantive negotiations likely to remain?

Finally, some clarification to the language of the draft decision on the matter of Sierra Leone's payments to the Fund would be helpful. This clarification can be taken up later.

Mr. Peretz made the following statement:

I can accept the proposed decision as it is drafted. Sierra Leone's improvement in its payments to the Fund is welcome. Payments in recent months have at last been sufficient to cover--or slightly more than cover--obligations falling due in that period. This performance is concrete evidence that Sierra Leone is serious about cooperating with the Fund and doing what is necessary to secure a rights accumulation program. I am sure that the authorities are aware that, if they can reduce their arrears by a further SDR 3 million to the level owed at end-June 1991, they could benefit from a waiver of special charges.

Unfortunately, there is less to welcome in the way of policy performance since September 1991. As the staff paper points out, and as Mr. Monyake has told us, the shortcomings in policy performance reflect a worsening of the security situation and, perhaps, partly reflect the uncertainties created by the forthcoming elections. Although I have every sympathy for the authorities in these difficult circumstances, these factors are unlikely to disappear overnight. Ways must be found to contain their impact on the economy. Mr. Monyake described some of the measures that are being taken or considered. All of these measures--and probably more--will certainly be needed if Sierra Leone is to meet the demanding requirements we should expect in a rights accumulation program. Mr. Fernando's questions illustrate that meeting these requirements is not going to be an easy task for Sierra Leone.

The staff has set the authorities clear targets and a firm timetable of substantive prior actions, required before a rights accumulation program can be considered. I hope that all these actions can be taken. Meanwhile, today's draft decision conveys the right sense of urgency to the Sierra Leonean authorities.

It may or may not be possible to have a rights accumulation program in place by the time the Board next considers Sierra Leone's arrears. I hope that it is. If by then it is nearly in place, but not quite, I would not, at this stage, rule out a limited extension of the three-month deadline that the Board is setting today. However, today's decision, as drafted, rightly makes clear that, if no progress is made, then Sierra Leone cannot expect the Board's patience to continue indefinitely. My own view is that Sierra Leone is moving in the right direction. If the authorities can, indeed, meet the targets set by the staff, and meet them convincingly, then they will have earned our support for a rights program.

Mrs. Krosby said that the decision proposed by the staff was appropriate under the current circumstances. Since the previous review, Sierra Leone had made more than the required level of payments to the Fund and had signaled its intention to continue that payments pattern into the future. Sierra Leone had already begun at the time of the preceding review to put in place a set of policies that could have led to a rights accumulation program. Subsequently, renewed invasions by Liberian rebels had created obvious fiscal complications for the authorities that they had since endeavored to redress. The staff hoped to have a rights program before the Board in the "near future," but, given Sierra Leone's track record, the prospects for such a program would be better if more of the planned measures had already been taken.

Still, despite the long duration of Sierra Leone's arrears, firmer signs were in evidence that a resolution was at hand, Mrs. Krosby observed. Even with the spillover from the military chaos in Liberia, Sierra Leone had significantly improved its payments performance to the Fund and had responded to the resulting worsened fiscal situation by planning and taking offsetting measures. Moreover, discussions with the Fund on a rights accumulation program had moved forward. However, the efforts of the Sierra Leone authorities must continue unabated to avoid a negative outcome at the next review.

Mr. Bossone remarked that his authorities had always endeavored to facilitate and encourage any government in protracted arrears to resume cooperation with the Fund, including Sierra Leone, whose authorities were trying to cooperate with the Fund under difficult circumstances and were willing to intensify their efforts. In that connection, he welcomed the intention of the authorities to make, at a minimum, payments to the Fund sufficient to meet obligations falling due in the coming months.

However, the economic and security situation had worsened during the past few months, Mr. Bossone noted. With the economic indicators signalling a dramatic deterioration in economic conditions, local business confidence was sagging sharply. Moreover, the continuation of the unsettled security situation and the intensification of the conflict had complicated policy implementation and imposed a heavy burden on the fiscal budget. Nevertheless, the strong policy action that the Board, during its previous review, had deemed necessary to prevent the countries' financial imbalances from widening further had not yet been implemented, while large salary increases for daily wage workers had gone exactly in the opposite direction. Therefore, the staff's determination to proceed with the preparation of a rights accumulation program was puzzling. Strong concerns had been raised during the earlier review, when the prospects for improvement of the situation had appeared considerably more realistic. Those concerns were even more compelling now. Therefore, although he could support the proposed decision not to consider remedial measures at the current stage, he would not be prepared to accept any proposals for a rights accumulation program before sensible improvements in the economic and security situation could be perceived and there were reasonable prospects for a successful implementation of the program.

Mr. Dognin stated that he welcomed the progress made by Sierra Leone, despite persistent security problems, to improve its cooperation with the Fund. He was in broad agreement with the thrust of the staff paper. Sierra Leone had kept its commitments by meeting obligations falling due since the previous Board meeting. The authorities' determination to pursue the same course of action in the coming months was encouraging. A comprehensive adjustment program was expected to be finalized by end-January 1992, but it could be compromised by the recent deterioration in the economic situation, owing mainly to the intensification of the armed conflict with the Liberian forces, but also to salary concessions to social pressures.

The corrective measures taken by the authorities, namely, the retrenchment of government workers and new revenue measures, were steps in the right direction, Mr. Dognin commented. Nevertheless, they were insufficient to turn around the economic situation, which was characterized in 1991 by a 5 percent decline in growth, rising triple digit inflation, and a steep devaluation of the leone. Under those circumstances, and given the fragile security and political conditions, the authorities urgently needed to take early and decisive policy actions to pave the way for a credible adjustment program. The difficulties facing the authorities should not be underestimated, but appropriate and convincing economic policies would be needed in the near future, so that the Fund could soon conclude a rights accumulation program and enable Sierra Leone to normalize its relations with the international financial community. He supported the proposed decision.

Mr. Esdar made the following statement:

Like previous speakers, I would like to commend Sierra Leone for meeting its current financial obligations to the Fund over the past three months. These payments are slightly higher than the amounts that have fallen due during this period. However, the arrears to the Fund remain above the June 1991 level that was originally envisaged as a starting point for the rights accumulation program. Therefore, I urge the authorities to strengthen their efforts in this respect.

Policy performance--partly reflecting a worsening of the security situation--is far less encouraging. Large salary increases, emergency military expenditures, and increased subsidies have worsened the budgetary situation. The rate of inflation accelerated to 120 percent. A depreciation of the exchange rate and increased capital flight have destabilized the situation even more. Although some corrective measures have been taken, there remain severe doubts that they are sufficient to bring the downward process to a halt. A fundamental reorientation of policies with the objective to consolidate the fiscal situation, to bring the monetary aggregates under control, and to reestablish confidence by a comprehensive policy package is of utmost importance to deal with the problems effectively. Therefore, I welcome the authorities' reiteration of their commitment to pursue a comprehensive adjustment program. Moreover, the additional information received today from Mr. Monyake is encouraging.

With respect to the proposed decision, I can go along with the staff proposal. It is certainly adequate to consider sending communications to the governors if the policy performance has not been sufficiently strong. However, I wonder whether it might be appropriate to be a little more concrete with respect to the conditions that must be met to proceed with a rights accumulation program. Mr. Fernando in this connection has asked some interesting questions, including the election issue. Given the disappointing policy performance in the past, in my view a rights accumulation program could only be justified if Sierra Leone demonstrates an impeccable track record in both policy implementation and payments to the Fund in the next two months. In this respect, it would be highly desirable if the major adjustment measures were already taken prior to the Board's consideration. In addition, the chance to implement an adjustment program successfully depends on the domestic security situation. Therefore, it might be appropriate to refer to this issue as well. Perhaps the staff could inform us about their expectations in this regard.

The staff representative from the African Department remarked that the presidential election would be held in November 1992; the Cabinet, whose members were not elected to Parliament, was likely to remain in place until that time. Under the constitution adopted in September 1991, either parliamentary elections could be called, or, if the security situation made holding elections impossible, the term of the current Parliament could be extended. The President intended to call parliamentary elections at the earliest possible date, but he could not schedule a vote until the people displaced by the security problem were able to return to the districts where they were supposed to vote. While the potential negative impact of elections on adjustment policies must be recognized, the prospects of an election might act as an incentive to the authorities to adopt the appropriate policies early enough to produce good results before the presidential election.

The authorities were confident that the fiscal objectives to which they had agreed could be implemented before the program commenced, the staff representative explained. If the security situation deteriorated significantly, necessitating much larger emergency expenditures, meeting those targets would become difficult; therefore, a safety valve had been built in, which would prevent Sierra Leone from moving toward a rights accumulation program if the security situation worsened substantially. The authorities needed to demonstrate their ability to persevere with the program.

The authorities aimed at reducing somewhat the fiscal deficit in the current year in relation to GDP from the previous year's level, the staff representative from the African Department commented. Because they saw limited scope for reducing expenditures, they had taken measures in late November 1991 to raise revenues about 0.2 percent to 0.3 percent of GDP. The end to the import ban on tobacco expected shortly would also raise some revenue. A few other revenue measures were scheduled to go into effect by mid-February 1992. Preliminary indications suggested that, through December 1991, expenditures had been held in line with the targets and the overall deficit had been in line with the objective for the year as a whole.

Mr. Shimizu said that he agreed with the staff paper. It was regrettable that the deterioration in security owing to Liberian rebels had resulted in the worsening of the fiscal position and the overall economic situation. Policy actions, such as the increase in the excise tax on petroleum products, were welcome, but additional corrective measures were needed. He urged the authorities to implement fully the revenue measures equivalent to 0.5 percent of GDP that the staff paper had indicated would be implemented by January 1992. He asked the staff to elaborate on the revenue measures that were being taken.

He welcomed the improvement since the previous review in Sierra Leone's payments to the Fund, which had exceeded its obligations falling due, despite the difficult security situation, Mr. Shimizu stated. However, at that earlier review, the Board had noted the authorities' intention to reduce the arrears to the level of end-June 1991. The authorities' plan to make payments of $1 million a month--noted by Mr. Monyake and the staff paper--would not be sufficient to reduce the arrears to the end-June level. He wondered whether the authorities had changed their repayment objectives. He supported the proposed decision.

Mr. Santos said that he welcomed Sierra Leone's attempts in the past few months to make regular payments to the Fund, in order to clear its overdue financial obligations. The unexpected security situation had slowed the development of a comprehensive adjustment program and the presentation of a rights accumulation program to the Board. Nevertheless, the authorities were striving to take firm measures, especially in the fiscal area, to improve the overall macroeconomic environment. Mr. Monyake had provided information that gave further assurances of the authorities' commitment to an approach that should lead to the restoration of normal relations with the Fund and the international financial community. Furthermore, the Government's commitment to a free foreign exchange market had led to a revival of trading activities and to more active operations in the diamond mining sector.

In the context of their record of payments to the Fund and economic policy implementation, the Sierra Leonean authorities had, under difficult circumstances, cooperated with the Fund in their efforts to find a lasting solution to the protracted problem of overdue obligations to the Fund, Mr. Santos commented. He welcomed their commitment to make regular payments to meet obligations falling due in the coming months and noted that, notwithstanding the prevailing uncertain security and political environment, the authorities were prepared to undertake urgent economic reforms. He strongly encouraged them to persevere in their efforts to formulate and implement appropriate adjustment policies that could merit the support of the donor community. He supported the proposed decision as it stood.

Mrs. Sirivedhin noted the security problems and the fragile social and political situation had adversely affected the Sierra Leonean economy. Despite severe difficulties, the authorities had shown a determination to cooperate with the Fund by recently increasing payments to the Fund, so that their arrears were currently slightly below the level at the time of the previous review. Their intention to make payments sufficient to meet obligations falling due in the coming months of 1992 plus their commitment to pursue economic reforms despite the complications brought about by the unsettled security situation were grounds for cautious optimism that a rights accumulation program could be concluded in a few months as envisaged, although, as noted by previous speakers, an even stronger indication of their commitment would be necessary. She supported the proposed decision.

The staff representative from the Treasurer's Department recalled that a number of speakers had referred to the current level of arrears as being lower than the level at the preceding review. The obligation of almost SDR 500,000 that the staff paper had noted was to have fallen due on

January 13, 1992, two days before the current review, had not yet been settled. As a result, the level of arrears was slightly above that at the previous review. However, the staff had every expectation that the authorities would make a payment in the next few days that would be more than sufficient to cover that obligation and would, in fact, further reduce the arrears toward the authorities' target of the end-June 1991 level.

Mr. Monyakẹ noted that Directors had recognized the Sierra Leonean authorities' efforts to cooperate with the Fund and turn the economy around. The efficacy of economic reform was widespread, not confined to a few countries experiencing certain economic difficulties. In Zambia, the newly elected Government had shown that it was equally, if not more committed to the pursuit of economic change than the previous one. Likewise, whoever succeeded the current Sierra Leonean Government would continue the economic reform.

Mr. Fernando remarked that the proposed decision did not include a provision, like the one in the September 1991 decision, to reduce the arrears to the end-June 1991 level.

The staff representative from the African Department said that the authorities certainly wished to reduce the arrears and were making every possible effort toward that end. The September 1991 review had been conducted in the context of a program and financing plan beginning July 1991. The program was now scheduled to begin in March 1992, and large obligations would be falling due in February 1992. An assessment of how much progress could be made toward the interim objective of a reduction in the arrears to the end-June 1991, level together with a timetable for achieving it, would be made once the preparation of the financial plan was sufficiently advanced.

Mr. Fernando replied that, in that event, he could support the draft decision.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Sierra Leone's overdue financial obligations to the Fund in light of the facts and developments described in EBS/92/4 (1/92/92).

2. The Fund welcomes the Sierra Leonean authorities' intention to pursue a comprehensive economic adjustment program that could be endorsed by the Fund as a rights accumulation program. The Fund intends to continue to collaborate with Sierra Leone under the intensified collaborative approach.

3. The Fund welcomes the recent increased payments to the Fund by Sierra Leone. Nevertheless, the Fund deeply regrets the continued existence of Sierra Leone's overdue financial

obligations to the Fund, which places a financial burden upon other members and reduces Fund resources needed to help others. The Fund stresses that full and prompt settlement of these arrears should be given the highest priority. The Fund notes Sierra Leone's intention to make payments to the Fund sufficient to meet obligations falling due in the coming months.

4. The Fund will review the matter of Sierra Leone's overdue financial obligations to the Fund again at the time of Executive Board consideration of a rights accumulation program for Sierra Leone or within three months from the date of this decision, whichever is earlier. If by the time of the next review policy performance has not been sufficiently strong to proceed with a rights accumulation program and the expected payments to the Fund have not been made by Sierra Leone, the Fund would consider the appropriateness of sending communications to all Governors of the Fund and the President of the African Development Bank at that time regarding Sierra Leone's failure to meet its financial obligations to the Fund.

Decision No. 9906 (92/5), adopted
January 15, 1992

2. OPERATIONAL BUDGET - REVIEW OF GUIDELINES FOR ALLOCATION OF CURRENCIES

The Executive Directors considered a staff paper on the review of guidelines for the allocation of currencies under the operational budget (EBS/91/218, 12/23/91).

Mr. Al-Jasser made the following statement:

The Fund's operational budget is the mechanism through which members with strong external positions make foreign exchange available to members with weak external positions. A member's currency is included in the operational budget if its combined balance of payments and gross reserve position is considered "sufficiently strong." Once a member is deemed "sufficiently strong" for inclusion in the operational budget, the amount of its currency allocated under the budget is determined by "take[ing] into account the balance of payments position and developments in the exchange markets, as well as the desirability of promoting over time balanced positions in the Fund." The issue before us today is the standard by which members' positions in the Fund should be balanced.

As emphasized in the Chairman's summing up of the June 1, 1990 discussion (EBM/90/85 and EBM/90/86), the method used to allocate currencies to be sold by the Fund should not compromise the Fund's liquidity position, nor impair its flexibility in meeting the legitimate financing needs of the membership. The method should also be transparent, stable, and workable, and it should be in line with members' reasonable capacity to finance the operational budget without imposing an unfair or inequitable burden on members. Such a system is best attained through the use of primary reserves as the standard for harmonization, while ensuring that a member's currency is not excessively used.

It is abundantly clear that the external position of members should be the primary determinant of the currencies to be included in the budget and of the amount of those currencies used for transfers in the budget. It follows, therefore, that the standard for balancing positions in the Fund should ensure the allocation of currencies of members with large or rising reserves. This method of allocation is the only way to protect the liquidity of the Fund and satisfy the needs of debtors for foreign exchange without jeopardizing the liquidity of creditor members. Hence, the Fund's traditional approach to allocating currencies under the operational budget, namely, balancing positions in the Fund in relation to a member's gross holdings of gold and foreign exchange reserves, remains the optimal approach.

As I have argued before, the most crucial and attractive feature of this procedure is its inherent flexibility that allows the Fund--and the membership at large--to benefit from, and adjust to, the changing circumstances of individual members. Therefore, it is important to view this system from an intertemporal rather than from a static perspective. The experience of Saudi Arabia provides a helpful illustration of the benefits of this dynamic approach. Saudi Arabia's reserve tranche position increased from 25 percent of quota in 1975 to 83 percent of quota in May 1983 and then gradually declined to 10.7 percent of quota by December 1991. More significantly, Saudi Arabia's reserve tranche position as a proportion of total reserves dramatically increased in the 1980s to reach 58.4 percent in 1986. Hence, over time, Saudi Arabia's active participation in the operational budget has corresponded to its ability to do so. The Fund and the membership, at large, benefitted greatly from this flexibility.

The staff paper lists three drawbacks to this system, which, it is stated, have been pointed out recently. Although these drawbacks have always been acknowledged, the traditional approach to balancing members' positions in the Fund is the only system that minimizes them. First, members may not be indifferent to a shift in the proportions of their reserves held in foreign exchange, in Fund positions, and in SDRs. Second, members choose to hold different levels of reserves. Both these drawbacks would be seriously aggravated in a quota-based system in which the likelihood of the emergence of a large reserve tranche position relative to total reserves is greatest. Third, members' preferences between holding a Fund position and foreign exchange are affected by relative yield considerations. This development, however, is not new. It should be noted that in the recent past, the rate of remuneration has not always been equal to the SDR rate of interest. Indeed, between 1979 and 1987 these rates have diverged significantly. Again, Saudi Arabia held a large share of its reserves with the Fund at a significant cost in forgone income. The difference is that the long-term cooperative nature of the system was considered predominant by the members that had borne the brunt of that burden. Hence, the issue of relative yields predates the present and temporary burden sharing problem.

In light of changes in the international capital markets, some have questioned whether international reserves, as defined by the Fund, remain the best indicator of a member's ability to contribute to the financing of Fund operations. The staff paper provides convincing evidence that shows that, although a country's international liquidity has been improved by access to credit markets, both the access to, and the cost of, borrowing from credit markets deteriorate when the need to borrow increases. Accordingly, a member's need for primary reserves remains "closely" related to its external transactions. Therefore, the staff conclude that "primary reserves continue to be a relevant indicator on which to base the distribution of resources provided to the Fund." I would, however, go further than the staff in this respect, because I believe that primary reserves remain the best indicator, albeit imperfect, on which to base the distribution of resources provided to the Fund. Consequently, I am disappointed that the staff has not placed sufficient emphasis on the Fund's traditional harmonization in relation to gross holdings of gold and foreign exchange reserve as the best option by which to allocate currencies under the budget. Moreover, this exclusion runs counter to the understanding that the adoption of the current transitional arrangements would in no way prejudice the original system or prejudge the final outcome of the Board's deliberations.

During previous discussions, quotas have been proposed as an appropriate standard by which members' positions in the Fund could be balanced. The staff paper develops irrefutable arguments against the use of quotas for such purposes. Indeed, quotas change only infrequently and are not an indicator of a member's ability to make foreign exchange available to the Fund. Also, it should be recalled that the variability of the balance of payments position plays an important role in the determination of a member's quota. Thus, quotas reflect members' potential need for Fund resources. Clearly, the adoption of a quota-based system would lead to members holding a reserve tranche position that would be very large in proportion to their primary reserves, irrespective of their ability to contribute. This position would adversely affect their ability and willingness to provide resources to the Fund. Hence, such a shift in a member's portfolio could lead it to withdraw from the budget and possibly to draw its reserve tranche position. More significantly, this move would dramatically complicate attempts to bring back members into the operational budget. This approach would, therefore, limit the list of members that are included in the budget and intensify the burden placed on the remaining members, thereby unleashing a vicious circle that could only impair the Fund's liquidity position.

The staff paper also suggests that income forgone as a result of burden sharing could be used as a basis for balancing Fund positions. This balancing would be undertaken if there is a desire to incorporate the costs of temporary burden sharing arrangements into the method of allocating currencies under the operational budget. In my view, this proposition is unacceptable, because the burden-sharing arrangements relate to a temporary problem. Indeed, it is both dangerous and illogical. It should be recalled that the burden of financing the Fund's operational budget did not emerge with the present discussion of burden sharing, and I see no reason to tamper with a system that has served this institution well to compensate for a temporary problem. As indicated above, the rate of remuneration and the SDR interest rate have diverged markedly, averaging about 93 basis points between 1979 and 1987 and reaching a peak spread of 172 basis points in 1981. This period coincides with Saudi Arabia's heaviest involvement in the operational budget, which occurred without any complaint with respect to the opportunity cost of providing resources to the Fund. Therefore, it would be unfair to creditors who contributed significantly during that period to change the rules of the game at this stage, without taking into consideration their previous contributions. The point here is that the cost of financing the operational budget is not a new phenomenon.

Moreover, it seems inappropriate to devise a system to equate the contributions of creditors to the burden sharing arrangements without providing an equivalent mechanism for the contributions of the rest of the membership. In the extreme, this alternative is analogous to a system that determines access to Fund resources on the basis of equalizing users' contributions to the burden sharing arrangements in terms of quota, and not in relation to their balance of payments needs. In addition, this method appears to be ad hoc and inconsistent. If we are to take into account the cost of contributing to financing the Fund in allocating currencies in the operational budget, it is inconsistent to consider income forgone on burden sharing, but not on unremunerated resources.

As the staff notes, an income-forgone approach requires some standard for harmonization, involving either primary reserves or quotas. In my view, the only possible standard for harmonization is a member's gross holdings of gold and foreign exchange reserves, which indicate a member's ability at a particular point in time to finance the operational budget. However, the staff rules out this option because it appears to be unworkable. Thus, the staff simulations in this section are all, in effect, quota-based alternatives which the staff has comprehensively and convincingly discredited. Therefore, I see no justification for considering such methods. Consequently, it does not make any sense to adopt an approach that harmonizes income forgone owing to burden sharing.

Needless to say, I do share the staff's concerns that these methods, to varying degrees, would result in a high concentration of transfers on a few members and lead to large ratios of reserve tranche positions to primary reserves for others. Most significantly, members with large or rising reserves and, consequently, the greatest ability to finance the Fund would experience dramatic reductions in their reserve positions with the Fund. This view, of course, assumes that no member would drop out of the operational budget.

The Fund's traditional approach to the allocation of currencies under the operational budget has served it well. Moreover, this approach has proved capable of accommodating the special concerns of individual members. Thus, I see no reason to change this flexible and efficient system because of temporary or transient circumstances. However, if there is insufficient support for this method, I can agree, as a compromise, to maintaining the current system, provided that the floor to the Fund's holdings of a member's currency in terms of its quota is reduced to half of the average holdings.

Mr. Peretz made the following statement:

The Board has discussed the issue of the allocation of currencies for the operational budget frequently--probably too frequently. I have the disadvantage of coming to this appallingly complex subject with a relatively fresh mind. Or perhaps it is an advantage. Either way, I was comforted by finding myself coming to much the same conclusions as Mr. Al-Jasser, who has much more experience. My conclusion is that it is a mistake to ask the allocation system to do too much. Above all, we should concentrate on the key issue, which is to provide liquid resources to borrowers without compromising the liquidity of creditors.

If in achieving this objective, we also achieve other objectives--such as an equitable division of costs--so much the better. But it is a mistake to burden the allocation system with these essentially second order objectives--particularly because, as Mr. Al-Jasser points out, the members that gain and the ones that lose are likely to vary to some degree over time.

Meeting the main objective involves first drawing up a list of usable currencies of members with sufficiently strong liquidity, and, second, ensuring that the Fund's use of these currencies is not disproportionate to the countries' levels of liquidity. I accept that the level of foreign exchange reserves is a far from perfect measure of liquidity, particularly in these days of free international capital markets. But I agree with the staff that in most cases it is probably as useful a measure as any. There are, indeed, many other sources of day-to-day liquidity for a country in normal conditions. But when liquidity is most needed and confidence in a country's credit is weak, it is the level of reserves that counts. Despite worldwide capital liberalization, the United States remains in a unique position. But for all other countries, the use of reserves as the measure of liquidity is still best.

Despite the logic of this argument, it has been suggested by some that the correct reading of the reference in the Articles of Agreement to the desirability of promoting "balanced Fund positions" is that positions should be harmonized as proportions of quota. This chair continues to reject this interpretation. It makes no sense: there is no guarantee that a country with a large quota will be in a position to allow its currency to be used to the extent that the size of the quota would indicate. And our reading of the discussions leading up to the Second Amendment, which inserted this clause, suggests that it was the ratio of Fund positions to reserves--not to quotas--that was more on Directors' minds.

The next issue is whether the allocation system should take account of the objective of balancing out costs among Fund members. As I have already said, I doubt whether we can or should expect the allocation system to achieve this secondary objective, alongside the main aim. But if we did want to deal with this cost-sharing objective, I have no doubt at all that the options offered in the staff paper are inadequate, because they address only one element of costs--that is, burden sharing. I am clear that any attempt to measure and balance costs would have to take full account as well of the unremunerated reserve tranche position of member countries. Neither staff alternative tries to balance costs in this fuller sense. Indeed, their effects on the distribution of total costs may well be perverse for many members; they certainly are for the United Kingdom. These perverse effects occur because a number of members with the lowest remuneration norms--and, therefore, with the largest unremunerated tranche to quota ratios--also happen to have low reserve to quota ratios and would, hence, bear still larger costs under the new methods.

The question of unremunerated reserve tranches is no mere quibble. In fact, the aggregate cost to creditors from this source is larger than the cost borne in aggregate by creditors through burden sharing--SDR 420 million for unremunerated reserve tranches versus SDR 240 million in 1991. If either of these factors is to be dealt with, then the unremunerated reserve tranche should, if anything, take precedence.

Here I come to what the staff paper asserts is a legal point. It says that the costs of unremunerated tranches cannot be taken into account in the operational budget, because such a move would be contrary to Article V, Section 9, which mandates equal rates of remuneration and equal criteria for determining remuneration norms.

I simply do not understand, or accept, this argument. The Article only refers to the rate to be paid on reserve tranche positions. It says nothing at all about whether or not it is permissible to take the unremunerated reserve tranche into account in determining policies on matters such as we are discussing today. In any case, if Article V, Section 9 were relevant, it would also rule out attempting to correct for burden sharing, because it is the equal rate of remuneration for all members mandated by Article V, Section 9(a), that directly creates the costs of burden sharing.

Therefore, I come to the same conclusion as Mr. Al-Jasser. I would like to return to a simple system, in which currency allocations are proportional to reserves. That approach seems to me to be by far the best option and would be my first choice. Failing that, I would, as a second-best option, be prepared to retain the current basic method of allocating currencies, namely, allocating transfers by foreign currency reserve size and receipts by reserve tranche size. This method, of course, already represents a compromise between taking account of reserves size and quota size.

On the other element of the current allocation system--the floor on currency holdings--as you know, my authorities had severe misgivings about the decision in 1991 to raise the floor temporarily from one half to two thirds of the average position. I did not press those misgivings at the time to the point of requesting a Board discussion, because this review was coming up, which would give Directors a chance to revisit the issue. Indeed, we thought the review might have something interesting to say on the subject. There is nothing in the review to change the conclusion that we had reached.

The case given for raising the floor to two thirds was the increasing use of Fund credit and consequent depletion of creditors' currency positions. But the assumption of a need for working balances of currency as high as 10 per cent of quota is overcautious, given past experience of demand for specific currencies. In any case, we would continue to be well above that 10 per cent figure, even if the one-half floor were still being used. In so far as the raising of the floor to two thirds was meant to put right the unequal distribution of costs between members, I would point out that the inequities are likely to be lower, not higher, when use of Fund credit is high.

Therefore, I favor a return to a floor of a half, as the staff suggests in one of its alternatives. Short of a return to a pure system based only on reserve levels, that change from the current system is the only one that I would deem necessary.

Mr. Landau made the following statement:

We welcome the opportunity to review the main rules governing the allocation of currencies under the operational budget. In concluding a similar discussion, the Chairman had stated that what was needed was "a reasonable system which, while not perfect, would broadly meet the needs of the Fund and individual members in the light of changing conditions." Therefore, we have to choose --as is often the case both within and outside this institution-- between the relative advantages and drawbacks of different, imperfect mechanisms. In this respect, although I find strong rationales on either side of the debate, I see compelling advantages, first, in retaining the reference to reserves in the allocation of currencies and, second, in trying to find ways other than those described in the paper to take into account contributions to burden sharing. I would like to elaborate on those two aspects of the matter respectively, before concluding with my specific proposals.

Reserves can still be considered a valid indicator of changes in members' international liquidity and, therefore, have an appropriate role in the allocation of currencies under the operational budget. Their significance in these issues may well have decreased to a relative degree, but it remains substantial. There are two main arguments in support of this view.

First, reserves are highly liquid assets, owned solely by monetary authorities, who may, therefore, use them to settle international imbalances and intervene in the exchange market. A growing number of countries--for instance, in Eastern Europe--are showing interest in adopting fixed or semi-fixed exchange rate policies that are naturally linked to a relatively higher level of reserves. Moreover, even for countries that have adopted flexible exchange rate policies, the need for reserves remains significant. Indeed, Table 1 of the staff paper shows that, despite the changes experienced over the past quarter century, there is no trend showing a uniform decline in the proportion of reserves to either members' quotas or members' imports.

Second, reserves are indisputably not only readily available, but also a criterion that is both relatively easily calculated and the most closely related to members' ability to contribute to the Fund's operational budget. Indeed, by using another criterion--for example, quotas--we would have no safeguard against situations in which bigger proportions of some members' reserves would consist of their reserve tranche position with the Fund. I am thus fully convinced by the staff's arguments that such situations would be detrimental to the members' ability to intervene smoothly on exchange markets and to the Fund's liquidity position. This argument seems all the more relevant in a context characterized by the reduction in the number of countries included in the operational budget.

The search for ways to equalize members' contributions to the cost of Fund operations certainly goes in the right direction. However, the specific methods discussed in the staff paper to equalize progressively members' contribution to burden sharing, raise a number of difficult problems. Basically, the operational budget is not the right framework within which to deal with this issue. The question of costs is by no means limited to burden sharing. We agree with the staff that contributions to the Fund's activity take various forms--such as unremunerated reserves, participation in the financing of the enhanced structural adjustment facility, and other mechanisms. All these contributions would be well worth taking into account. Although the staff's proposals--especially the one based on the second simulation--point to a real problem, they translate into complicated and obscure mechanisms.

Finally and, most important, I note--from the comparison between Tables 3 and 4, on the one hand, and Table A2, on the other hand--that the two proposed alternatives to the current system substantially increase the discrepancies between members, as far as the proportion of their reserve tranche position to the total of their reserves is concerned. More countries would hold larger proportions of their reserves in positions with the Fund, which, again, raises problems--both for the ability of these countries to answer sudden challenges to their external position and for the liquidity position of the Fund.

In this context, my conclusion is threefold. The Fund's liquidity is a paramount consideration in any discussion of these matters. To carry out its mission, the Fund should be able to include in its operational budget the most available currencies, and rules should not lead to situations in which countries would be reluctant to participate. Therefore, for the time being--given pressures on the Fund's liquidity position, owing to the long delayed conclusion of the quota increase--I propose to retain our current flexible and pragmatic system. Indeed, elements of reference to the quotas and the necessity to reduce excessive reserve tranche positions are already built into the system. On the transfer side of the budget, currencies are allocated with due regard to the rule that the Fund's holding of a member's currency must not be reduced below two thirds of the average level expressed in terms of quotas. On the receipt side, currencies are allocated according to reserve tranche positions, an approach which also tends to reduce discrepancies. And Table A2 shows that, as imperfect as the system certainly is, it has made considerable strides toward meeting the concerns about differences in the proportions of reserve tranche positions to quotas.

Finally, my authorities would continue to consider proposals aimed at reducing the discrepancies in the contributions to burden sharing. Mr. Arora made an interesting suggestion in that connection during the June 1, 1990 discussion. Members could also try to devise solutions that would tend to equalize the contributions of all members, irrespective of whether those members are included in the operational budget or whether they are users or non-users of Fund resources. But this consideration could best be done in a broader framework, taking into account all the different contributions made by members to the Fund in addition to the question of the appropriate level of the rate of charge. Directors had planned to deal with this issue at their last retreat. I am, therefore, looking forward to any possibility of doing so in the future.

Mr. Prader made the following statement:

We welcome today's review of the guidelines for the allocation of currencies under the operational budget. I do not want to rehash all the arguments about the role of quotas in the Fund as the measure of all rights and obligations, except for obligations connected with the financing of the Fund. We have to recognize that the June 1990 revision of the guidelines goes some way toward acceptance of the case for a quota-based operational budget. Nonetheless, it is obvious that the staff paper still reflects the staff's decided preference to retain primary reserves as the basis for allocating currencies.

The assumption underlying this preference seems to be that it is easier to secure smooth financing of the Fund by relying on member countries with relatively high reserves that are already used to giving more than countries with relatively high quotas but relatively low reserves, because the latter might raise difficulties when asked to give more than they have become accustomed to. Everyone is sympathetic to the staff's anxieties and responsibilities, but one of the staff's main conclusions, namely that changing to a quota-based allocation system could threaten the financing of the Fund, is simply not convincing. In fact, if satisfactory Fund financing cannot be guaranteed with a purely quota-based operational budget, then quotas are not what they are supposed to be--that is, a measure of a country's role in the world economy and the international monetary system.

The change that a quota-based system would introduce into Fund financing would basically mean that a number of industrial countries would have to lend more to the Fund while other industrial countries would lend less. Can we seriously argue that Fund financing would run into trouble because some G-10 countries would have to lend more and others less? As most of the countries being asked for more are G-10 members with sufficient primary reserves, they have ample access to secondary reserves and should have no problem at all in shifting a larger share of their reserves into Fund positions, even in the event of a significant increase in Fund credit. In this context, I should like to say that Belgium, which would have to shoulder a larger financing burden, is not opposed to changes in the operational budget that would better harmonize the allocation of currencies in terms of quotas.

I suspect that the real issue is not the difficulties that the Fund would face as a result of redistributing the operational budget among industrial countries, but the perceived reluctance of industrial countries to change the composition of their reserve assets by increasing the share of Fund-related assets. Obviously, as hinted in one of the Legal Department's papers, Fund-related assets might be perceived as having lower quality than other monetary assets. If this perception--which I do not share--did not exist, I could imagine no reason for creditor countries to hesitate to accept more Fund-related assets.

We are mindful of the staff's willingness to consider the implications of changes in the behavior of central banks in addition to the implicit consequences of the operational budget for burden sharing and for the income position of the monetary authorities participating in the operational budget. I have listened with great interest to the proposals of the previous speakers to construct alternative schemes to address cost considerations. Unfortunately, the operational budget seems to be the only viable instrument to deal with this problem. Moreover, one major disadvantage of proposals such as Mr. Arora's is that they are based on voluntary contributions and, therefore, have not led to any results.

While taking note of the legal constraints, my authorities are undecided about whether one should take into account the income forgone on unremunerated resources. Before taking a firm position on this issue, we would like to learn from the staff how the distribution of contributions to Fund financing would look if allowance were made for unremunerated resources. For some Fund members, the income forgone on the unremunerated reserve tranche position would seem to be far more important than that under the burden sharing mechanism. We would, however, support the view that it is not permissible to commingle contributions to the General Resources Account with financial contributions to other accounts, such as subsidy accounts and the like. For good reason, the funds in the General Resources Account have a different quality and are not to be compared with funds invested in other accounts.

One member of our constituency would have preferred to see members' burden sharing-related contributions and income forgone, respectively, harmonized by means of an alternative approach using quotas. At the same time, this member also understands the problems of countries that would face substantial shifts in their Fund positions, and it is equally comprehensible that they would be prepared to accept only a gradual approach to a more quota-based system. In the interest of consensus--and because resistance to a quota-based scheme may be difficult to overcome anyway--that member might be able to accept a compromise approach along the lines outlined in Table 4.

An issue that remains open, however, is the staff's proposal to lower the floor on the Fund's holdings of members' currencies to 50 percent. Such a move would seem only productive if in fact it were based on the distribution of one-sixth of transfers and receipts in proportion to quotas. Otherwise, the floor would have to be raised even above the present level of 66 percent to obtain the desired equalization of members' contributions to burden sharing.

On the timing of the introduction of a change in the guidelines to accommodate cost considerations, I take note of the staff's preference for delaying any change until after the quota increases have come into effect and after this Board has reviewed the Fund's SDR holdings. I could be flexible in this matter.

Mr. Prader, in reply to Mr. Al-jasser's request for clarification, remarked that, with respect to members' financial obligations to the Fund, quotas as a measure had only been partially adopted, but in terms of members' rights to draw on Fund resources, quotas were the sole basis for calculating the amount to which members were entitled.

Mr. Al-Jasser responded that that statement was analogous to saying that all users of resources would have a constant access based on quotas; every user would be entitled to draw a specific percentage. In actuality, there was some variability and flexibility in deciding the amount that could be drawn. Hence, quotas were not the determining factor in deciding access; nor, by extension, should they be a determining factor in estimating the currencies to be used in the budgeting system for a certain period.

Mr. Tanase made the following statement:

It is a legitimate question to ask whether the system of allocation of currencies for use in the operational budget--based largely on members' official holdings of gold and foreign exchange--is still the optimal one under present circumstances. When I refer to the optimal system, I mean a system that optimally provides the Fund with the liquidity that it needs. The conclusion of the staff after its examination of reserves and liquidity can be briefly summarized as "primary reserves still matter." This conclusion means that, even under the present circumstances of easy access to private financial markets and floating exchange regimes, a member's ability and willingness to make resources available for the Fund's operations are closely related to its official holdings of gold and foreign exchange. Therefore, to ensure that under the operational budget the currencies of countries with strong external positions--and, hence, sufficient reserves--are transferred by the Fund, the relationship between the allocation of a member's currency and its reserve position should be maintained.

Linking the use of currencies more closely with quotas would run the risk that an individual country's reserve position in the Fund would become an unduly large share of its total reserves. This outcome might diminish countries' willingness to participate in quota increases and raise the likelihood of a country drawing its reserve tranche position. The Fund's liquidity position might, therefore, be endangered. Of course, this effect would be stronger in the future, with the net use of Fund resources projected to increase.

The staff paper has touched upon the cost incurred by members in their financing of the Fund's operations. It is said that central banks have become more concerned about the rates of return on their assets than they were in the past. This view may be true. But we should not define these rates of return too narrowly. The benefits of a more stable international financial system, to which Fund operations can give rise, cannot be ignored.

I cannot agree with the suggestion to take individual contributions under the burden sharing arrangements into account when assessing members' contributions to the operational budget. First, this practice would further increase the complexity of the Fund's financial structure. Second, we have to recognize that there is much diversity in countries' contributions to other costs of Fund activities, such as the different unremunerated reserve tranche positions, which, as the staff rightly points out, cannot be equalized without modifying the Articles of Agreement. Furthermore, there are burdens on members that are taken up voluntarily, such as the unequal contributions to the ESAF and the subsidy and technical assistance accounts. Equalizing separate cost components among the Fund's creditors could not, and should not, be a primary objective.

Third, the staff has carried out two simulations that harmonize burden sharing contributions to a certain extent on the basis of quotas. These simulations show that this approach would only result in an adjustment for a small group of countries, whereby the currencies of some of the strongest creditors would be used significantly less in the operational budget. It would be wrong to solve a problem related to burden sharing--in principle, a temporary affair--by changing the method according to which currencies are allocated for the Fund's operations in such a way that the Fund's liquidity position could be adversely affected and, as a result, a core activity of the Fund could be endangered.

I agree with the staff that the present guidelines on the allocation of currencies in the Fund's operational budget have worked reasonably well. These guidelines have succeeded in achieving a satisfactory balance between the influence of a member's reserve position, as desired leading principle, and its quota on the selection of its currency. As such they are acceptable as a compromise.

Mr. Torres made the following statement:

In the staff paper, the staff implicitly supports the continuation of the present interim system for the allocation of currencies under the operational budget that was agreed on a trial basis on June 1, 1990. The staff considers that the present system, which gives greater weight to quotas, seems to have worked well. I appreciate and share these remarks, especially because of their source. I would only add that there is no reason why they should not have worked well, given the more solid foundation on which they were based. One constant feature in all bureaucracies seems to be support for the status quo, even if the status quo changes from time to time. The present staff paper is no exception. The new element in today's discussion is whether to deal through the operational budget with the costs--that is, income forgone--to creditors derived from unremunerated reserve tranches and burden sharing. The paper rules out on legal grounds any possibility of considering the first source of costs. It appears feasible to deal with the second source, and several options are presented. The staff's options are again an example of another constant feature of most bureaucracies, although this time a feature more specific to the Fund: why simplify procedures if you can complicate them? Let me now abandon the domain of "light remarks" and react to these topics.

We continue today a discussion that has been going on for some time. My hope is that, after the present discussion, we can reach a lasting agreement on the guidelines that may serve in the near future as a pillar of stability for the Fund, before the role of this institution expands throughout the globe. Precisely because we are on the eve of a major transformation of the Fund, I am fully convinced that the time has come to end this interim period of trial operational budgets. More than three years have passed since this constituency challenged the criteria then used in the guidelines. Three years is a sufficiently long period of time to study and test different alternatives, so it is time to end the provisionality. Both staff and management and the Board should in the future minimize the time required to elaborate and approve operational budgets.

I cannot agree with the interpretation made by Mr. Al-Jasser in his statement that primary reserves are the best--and sole--standard to select currencies to be included in the operational budget, to determine the amounts to be used, and to promote over time balanced positions in the Fund. Moreover, according to the Legal Department (EBS/90/87, 5/7/90), this interpretation is inconsistent with the Articles of Agreement. The conclusions in that report stressed that there are three elements to be considered: the balance of payments and reserve position;

developments in the exchange markets; and the so-called "harmonization principle." All three elements were deemed relevant to select not only the currencies to be used, but also the amounts. Finally, it was emphasized that quotas were the relevant criterion for the determination of balanced positions in the Fund, both on the transfer and the receipt sides of the operational budget. On these grounds, any alternative relying exclusively on primary reserves does not merit further consideration.

To avoid misunderstandings, let me briefly review the essence of the system that has been consistently proposed by this chair over the past three years. We have proposed a mixed system, combining both reserves and quotas. The strength of the external position is used to identify those currencies sufficiently strong to be included in the operational budget. The quota is then taken into account to calculate the amounts to be used. We believe--and the Legal Department shares this opinion--that this approach is the best way to ensure that "the effects of the Fund's selection of currencies and their amounts will be distributed in a rational and equitable manner over time."

The rationale of this approach can be traced to the cooperative nature of this institution and the revolving character of its resources. Let me again quote the Legal Department, incomplete this time, to clarify this point: " ...Since members' legal obligation to contribute to the Fund's financing is limited to the size of their respective quotas [so]...it is logical that members' actual contributions to such financing should be computed in relation to quotas." From this perspective, I cannot understand, and cannot agree with, the staff's point that the use of a quota-based system to balance positions in the operational budget may have negative effects on the Fund's liquidity by affecting members' willingness to provide resources; on the contrary, it is the perception that the system is inequitable if quotas are not used that may have such negative effects at this historical juncture of the Fund's expansion.

In addition to being equitable, a quota-based system to balance positions in the Fund is also efficient in meeting the basic purpose of the operational budget: to provide resources to the Fund, according to short-term changes in members' ability/capacity to finance reserve tranche positions. Hence, relatively strong members' currencies are used to finance weaker members with balance of payments needs. Again, I cannot agree with Mr. Al-Jasser's remarks that the staff paper develops irrefutable arguments against the use of quotas for "harmonization."

The concerns that we have had in the past, and that we still have, on the role of reserves as an appropriate indicator of members' relative ability to contribute to the operational budget are not an essential element of our position. We have already mentioned in previous discussions that we do believe that primary reserves could be used as an indicator of a member's external position. We are not seeking to change reserves as an indicator, but rather seeking to determine an operational budget that takes due account of the rights and obligations of each member to contribute resources to maintain a strong Fund. I agree with the staff that the relationship between reserves and liquidity is now more complex than in the past, as members' international liquidity position now comprises a broad spectrum of different assets. I also agree that primary reserves continue to be a relevant indicator on which to base Fund financing.

There is one other point that I wish to raise in this context, related to the risk that a quota-based system for harmonization may result in larger variance in the ratio of reserve tranche positions to primary reserves or in ratios that may be considered excessive, particularly for those members included in the operational budget with comparatively low reserves in relation to their quotas. This risk, it is said, may negatively affect members' ability and/or willingness to provide resources to the Fund through the operational budget.

What is meant by "excessive" should be clarified. In another staff paper (EBS/90/66, 3/30/90) that was discussed on June 1, 1990, there are two tables on pages 4 and 13 in which, for those members participating in the operational budget during the period 1981-89--a period of Fund credit contraction--the actual reserve positions as percentages of gold and foreign exchange may be compared to those that would have resulted if creditors' positions in the Fund had been balanced in proportion to quotas. By the end of the period, one can obviously observe an increase in the variance of Fund positions to reserve ratios; in fact, the coefficient of variation, which is not calculated, increases from .68 to .74, but neither the increase in variance nor the single ratios could be considered as "excessive."

Similar information is not available for the period after 1989, a period of Fund credit expansion. It may be useful, however, to look at table A2 of the present staff paper, which shows changes in those ratios between June 1, 1990, under the previous operational budget system, and December 1, 1991, under the present system, when the role of quotas was increased to balance positions in the Fund. In this case, greater harmonization in terms of quota is achieved with less variance and only small changes in reserve tranche positions in relation to primary reserves. It does not appear then that "excessive" weight should be given to "excessive" proportions of primary reserves held as

Fund assets as an undesirable outcome to be used against a quota-based approach to harmonization.

Nevertheless, if the outcome were still considered inadequate, it would be possible--as the staff recognizes in a footnote on page 18 of the staff paper--to introduce constraints to ensure that the reserve position for any member does not exceed a certain proportion of the member's primary reserves. In short, we should not overemphasize something that need not necessarily be a problem, particularly if combined with the flexibility and pragmatism that the staff has shown in implementing the operational budget.

As I have mentioned, a system of balancing positions in the operational budget based on quotas is equitable and efficient. But it should also be universal--that is, applicable to all members of this cooperative institution on the same basis, with no exceptions. The current system cannot be applied to the entire membership--the exception being the United States. I am convinced that the United States would not oppose being included in the budget on the same conditions as the rest of the membership under a more equitable system. The United States will continue to have a pre-eminent role in the Fund, but the door of new possible ad hoc exceptions would have been closed for other members tempted to demand that treatment temporarily. The cooperative nature of the Fund would be reinforced.

From the above considerations, I remain fully convinced that a quota-based system to achieve harmonization--as we have proposed--would be more consistent with our Articles of Agreement. It would not compromise the Fund's liquidity nor impose an inequitable burden on individual creditor members. The system's universality will make it more transparent and, because it will be based on each member's legal obligation to contribute to the Fund's financing, it will be more stable.

As to whether to take into account the cost of acquiring a Fund position in the system of allocating currencies under the operational budget and how to do so, concern with costs--that is, income forgone--from burden sharing or other sources strengthens the case for a quota-based approach to harmonize Fund positions. However, such an approach does not necessarily imply that those positions have to be dealt with through the operational budget. The system becomes more complex instead of simpler, and less transparent. The attainment of too many objectives is being demanded from a single instrument. As Directors know, this strategy is not usually efficient.

Moreover, it is only a partial solution to the problem, because it does not take into account other costs of financing the Fund and excludes from it the majority of our membership--the non-creditor members. In addition, I am convinced that it is possible to find a simpler solution for burden sharing by distributing the amounts contributed quarterly through these adjustments in proportion to quotas for all members--and independently of whether they are users of Fund resources.

Having said this, if there is enough support, I could go along with the first simulation presented by the staff in which harmonization of income forgone in relation to quotas is presented. Even if partial, this solution is consistent with the principle we have supported in past burden sharing discussions.

We should choose a system of allocation of currencies for the operational budget that we are sure will reinforce the Fund's financial position. Such a system should be as simple and stable as possible. One that selects participating member countries according to the strength of their external sector is reasonable and acceptable. Gold and foreign exchange holdings, even though they have lost an essential part of their meaning in representing the liquidity or external strength of a country, are a satisfactory indicator to us. We see no benefits in trying to change this criterion for another one that will prolong Board discussions indefinitely and unsuccessfully.

Once participating countries have been selected, harmonization of positions should be based on quotas. That interpretation is the legal one, and we remain firmly attached to it. To avoid undesirable shifts in the proportion of reserve tranche positions to primary reserves, we are ready to consider alternative ways to smooth the transition process if deemed necessary.

Mr. Goos made the following statement:

As you will recall at our previous discussion of the issue almost two years ago, I expressed my strong preference for retaining the existing guidelines for the operational budget. And even though I sympathized with the fundamental considerations presented at that time by Mr. Torres's predecessor, I made a strong plea to his chair to withdraw the proposals of introducing cost considerations into the currency selection process of the operational budget.

While my position has remained basically unchanged, I have received from the Bundesbank quite thought-provoking comments on the staff paper before us, which I should like to outline briefly.

Needless to say, these comments have been fully endorsed by my Government. The Bundesbank has expressed the view that the burden sharing system has imposed costs on Fund creditors that can no longer be ignored. Countries with relatively large contributions to the operational budget in terms of quota are being penalized by having to make correspondingly large contributions to burden sharing. Quoting the Bundesbank, "this unsatisfactory situation calls for correction."

The Bundesbank, therefore, welcomes and, indeed, endorses the staff proposals to harmonize the costs arising from burden sharing contributions in relation to quotas in the context of their operational budget, and it expresses the preference for the second version as illustrated in Table 4. To be sure, the Bundesbank is by no means insensitive to the potential drawbacks of the proposals with respect to the willingness of members to provide resources and, hence, the potential effect on the Fund's liquidity position. However, they believe that they cannot ignore the costs involved in Fund financing, particularly at a time when the attitude of other members toward the Fund seems to be governed increasingly by cost considerations. Moreover, in such an environment, the Bundesbank finds it difficult to explain to the German taxpayer why it would reject procedures that would provide considerable savings.

The Bundesbank does not find members' increased cost or yield consciousness in the context of Fund operations particularly surprising. This attitude, according to the Bundesbank, is related to the continuing shift in the Fund's financing activities away from its monetary mandate toward the provision of development assistance as reflected, inter alia, in its prolonged emphasis on structural adjustment. In view of this shift, the Bundesbank finds it natural that monetary authorities have adopted a different view of the quality of their Fund positions, which are no longer perceived as a perfect substitute for other reserve assets. Consequently, there is an obvious incentive to limit financial contributions to the Fund, or, to the extent that such contributions constitute mandatory obligations, to emphasize equal treatment in relation to quotas. The Bundesbank continues, "Fund management and staff would be, in large measure, responsible if these developments were allowed to gain further momentum."

There are some similarities between these concerns expressed by the Bundesbank and the views that I expressed at the previous discussion of the budget and at the Board's retreat. I would like to see the Fund take these concerns more seriously.

To add two further points made by my authorities, they would first endorse an immediate change in the guidelines as proposed by the staff. Second, they stress--and I think rightly so--that a reassessment or revaluation of members' gold holdings for the Fund's operational purposes should be avoided by all means. The Fund should not lend its hand to a revival of the role of gold in the international monetary system. In the context of the operational budget, my authorities believe it would be even more appropriate to exclude gold holdings altogether, even at the nominal value of SDR 35 an ounce, considering the difficulties in mobilizing such holdings on short notice.

What conclusion should we reach on the issues before us? I indicated earlier that the Bundesbank is, indeed, unhappy about the idea of explicitly introducing cost considerations into the operational budget--and here they fully agree with previous speakers--which are alien to the objective of ensuring the liquidity of the Fund in its lending operations. The Bundesbank felt compelled to accept the staff's proposals in the first place only in the expectation that these proposals would find wide support in today's discussion. However, if this expectation should not materialize, I think it would be perfectly consistent with the views expressed by the Bundesbank that I endorse the maintenance of the existing guidelines for the operational budget.

Mr. Solheim made the following statement:

When today's topic was discussed in June 1990, this chair supported the modification of the principles specifying how contributions to the financing of the Fund's operations would be shared. The proposal subsequently put forward by the staff, struck, in our opinion, a reasonable balance between the relative merits of a system that took reserves into account and one that gave the role of quotas a somewhat greater prominence. However, we considered it essential that the system should be flexible enough to accommodate the need for Fund resources, as the liquidity of the Fund must not be compromised.

We note the staff's assessment that the new guidelines have generally worked well under conditions of rapidly rising demand for Fund credit and that the Fund has exercised considerable flexibility and pragmatism in the methods used in allocating currencies under the operational budget. The result has been a more reasonable harmonization of members' reserve positions in the Fund, relative both to their holdings of reserves and to their quotas.

The analysis of reserves is taken a step further in the staff paper before us. We would tend to agree with the staff's conclusion that there is little evidence that primary reserves have ceased to be a major indicator of a member's ability to acquire a reserve position in the Fund. Reserves are the most readily available indicator of a member's short-term capacity to contribute to the financing of the Fund. Hence, although the relationship between a member's holdings of reserves and its liquidity position certainly has become complex, reserves continue to remain a relevant indicator on which to base the distribution of Fund financing.

But, by the same token, what is a fair share for members of holding a Fund position raises questions of increasing complexity. From the staff paper, one would be inclined to see the task of finding one formula that takes into account all relevant aspects and produces an equitable distribution of the burden of financing the Fund's operations as impossible. Any scheme that introduces income forgone as a factor, but remains partial in the sense of, for instance, considering the burden sharing mechanism, but leaving unremunerated resources unaccounted for, clearly cannot be satisfactory. Consequently, the simulations in the paper must be regarded as serving only an illustrative purpose.

This chair continues to be in favor of a mixed system, which is largely based on primary reserves positions, but, like the present system, also takes the importance of quotas into account. We are in agreement with the staff's cautions against changes in the guidelines at a time when major currency composition reallocations are to take place. The proper time to reassess the guidelines is, in our view, when the ninth quota increase has come into effect, and we endorse the approach of postponing any further considerations until that time. Accordingly, for the time being we are in favor of maintaining the present system.

Mr. Dawson made the following statement:

The issue of currency allocation in the operational budget has been discussed several times over the past two years, with the result that the views of most chairs, including my own, have already been explained at some length. Our basic position continues to be that the method of currency allocation should strike a reasonable balance between the objectives of assuring adequate Fund liquidity and a more equitable distribution of the costs associated with the provision of resources to the Fund.

Mr. Al-Jasser's statement eloquently describes the drawbacks of basing currency allocation purely on quota size. Obviously, this course of action would not be appropriate, because a member's quota size does not necessarily bear any relation to its ability to make foreign exchange available to the Fund. At the same time, however, the staff paper overplays the appropriateness of basing currency allocation on the level of a country's primary reserves. For all of the reasons that are outlined in the staff paper, but that are for some reason dismissed in the conclusion of the sections on reserves and liquidity, the size of a member's primary reserves has declined in importance as a determinant of a country's ability to contribute to Fund resources.

As we have stated on previous occasions, we have some sympathy for the view that the distribution of the cost of financing the Fund borne by creditor countries should, in principle, be based on quotas, and not primarily on reserves. Arrears impose a burden on the whole membership. Although this burden is divided equally between the group of debtors and the group of creditors, it is not divided equally within the creditor group. Consequently, those providing greatest support have wound up paying the heaviest price for burden sharing. This situation is hardly in keeping with the cooperative nature of the Fund. In our view, using a quota-based approach for burden sharing would be much more consistent with the principle that members' rights and obligations ought to bear some relation to quota size.

Regrettably, one of the membership's current obligations is to bear the cost of overdue obligations. Mr. Al-Jasser suggests that the resulting financial cost should not be of great concern, because the arrears problem is meant to be "temporary." We certainly hope that it will be temporary. The Board is doing its best to provide a combination of incentives and sanctions that will encourage countries to settle their arrears. However, because we have yet to see the light at the end of the tunnel, we are not disinterested in the way in which the financial burden of arrears is handled. Moreover, even if the arrears problem does prove to be a temporary one, the interest forgone on the forgone income will never be recouped.

The question on our minds, then, is whether there is a reasonable way to harmonize the cost of burden sharing on the basis of quota share, while continuing to ensure that adequate resources are provided through the operational budget. For the United States, which currently bears a somewhat larger arrears burden than a purely quota-based distribution of the costs would suggest, this approach should mean reducing the size of our remunerated reserve tranche through lower transfers and/or higher receipts.

The illustrative calculations in Tables 3 and 4 indicate that different results emerge, depending on the harmonization method chosen. For example, rather than "harmonize" the burden on the United States, Alternative Method One--shown in Table 3--would actually have the reverse effect of increasing the U.S. burden. Needless to say, my authorities would not be enthusiastic about an approach which, in the name of equity, actually increased the inequity of the U.S. contribution to burden sharing. Indeed, from our perspective, the status quo would be preferable.

Alternative Method Two, on the other hand, would at least adjust transfers and receipts in the appropriate directions, and, hence, it would reduce the U.S. burden. Therefore, if other Directors want, we could support implementing Alternative Method Two in Table 4 now. Alternatively, if no consensus on Method Two emerges today, we could support some further work by the staff to explore other possible alternative methods that might meet with broader support. Indeed, having seen only one alternative method that, in our view, results in a more equitable burden sharing, it is hard to make a judgment as to whether this particular method is the best one. All we can say is that it is the better of the two presented so far.

In closing, I would like to deal with the issue of the unremunerated reserve tranches, which Mr. Peretz, among others, has argued is the main source of inequity. If it is possible to take a broader approach that adjusts for the varying burdens associated with unequal unremunerated reserve tranches, we would be happy to do so. However, for reasons that are rather obscure in the staff paper and that we need to understand more fully, taking account of the unremunerated reserve tranche in the allocation of currencies would apparently be inconsistent with the Articles. I would appreciate some clarification on this legal point from the staff. If, indeed, it is not possible to harmonize income forgone on unremunerated resources, then we believe the Board should at least deal with the inequity that it can affect--namely, the burden sharing issue.

Mr. Santos made the following statement:

In reviewing the guidelines for the allocation of currencies under the operational budget, let me emphasize the following points. First, this chair accords great importance to preserving the Fund's ability to provide financial support to member countries experiencing balance of payments difficulties and to safeguarding Fund liquidity. The time-honored principle that countries with the strongest external position provide resources to the Fund to help members with weak external positions is what makes the Fund such a unique institution. It underpins its cooperative nature and constitutes the Fund's raison d'être. Moreover, that principle has served the membership well for several decades. Second, equity and evenhandedness are the ingredients that strengthen members' commitment to the spirit of cooperation in this institution.

Third, it has to be recognized that in pursuing its goals, the Fund does not always achieve equity. Indeed, the asymmetrical nature of the surveillance exercise has been highlighted time and again by a number of Directors. Moreover, it can hardly be said that equity is served when the weakest members of the cooperative--that is, those members using Fund resources--are contributing the most to the financing of its operations and are bearing 50 percent of the financial burden as a consequence of the arrears problem.

We are of the view that the issue of allocation of currencies under the operational budget and that of burden sharing as a consequence of the arrears situation should be kept separate, the latter being a temporary problem which, we hope, would be resolved under our strengthened arrears strategy. We should, therefore, strengthen our resolve to address the issue of overdue financial obligations to the Fund through the implementation of that strategy and not attempt to change the method of allocating currencies under the operational budget in order to accommodate the cost of arrears to the institution.

Achieving and maintaining balanced positions in the context of the operational budget while safeguarding the Fund's ability to provide resources are at the heart of the matter of equity in the allocation of currencies under the operational budget. But obviously, in such an undertaking, the highest priority should be given to preserving the Fund's liquidity. In this regard, we note on page 11 that the Fund has exercised, over the years, considerable flexibility and pragmatism in the methods used to allocate currencies, bearing in mind the need to balance members' positions in the Fund. I will not dwell on the pros and cons of the different methods of harmonization as these methods are well covered in the paper. Suffice it to recall the staff's conclusion that any system to equalize members' contributions has the potential to cause, in the short term, large shifts in members' positions in the Fund, which, in turn, could affect their willingness to provide resources. This possible outcome suggests that we should be cautious in how we approach dealing with the issue of harmonization of members' positions.

As clearly indicated in the staff paper, the present guidelines ensure a relatively well-balanced use of both reserves and quotas in the allocation of currencies that has worked well under conditions of rapidly rising demand for Fund credit. Therefore, we do not feel comfortable with the proposal to alter the present guidelines, at least at this stage. The impending implementation of the Ninth General Review of Quotas and the subsequent large inflows of SDRs into the General Resources Account are reasons not to modify the present guidelines. We are open to the suggestion that this issue be revisited after the quota increase has been completed and in the light of the Fund's policy on the level of its SDR holdings.

Finally, we are of the view that, when considering the issue of burden sharing, all facets of sharing the burden of the cost of financing Fund operations--including the issue of charges and unremunerated reserve tranche positions--should be discussed. We look forward to the upcoming seminar on this issue.

Mr. Fukui recalled that when the Board had considered the guidelines for currency allocation under the operational budget in June 1990, his chair had supported the current guidelines as a good compromise to achieve a balance between the two objectives of liquidity and equity. He shared the staff's appraisal that the new guidelines had generally worked well in the trial period ending December 31, 1991. During that time, the Fund's credit had expanded significantly. In that light and with the quota increase under the Ninth General Review still pending, the precise impact of the quota increase on the Fund's liquidity position was unknown; therefore, his authorities did not see any convincing reason to make any further amendment to the current guidelines, and he endorsed the main thrust of the staff paper, including the staff's analysis of the criteria for the allocation of currencies. Primary reserves continued to be an appropriate indicator of a member's ability to contribute to the operational budget and, hence, could reasonably be relied on as a criterion for the distribution of the currency.

The staff's simulations of the possible schemes to harmonize the income forgone owing to burden sharing were interesting, but, as the staff had noted, they had shortcomings, Mr. Fukui remarked. Under those mechanisms, some countries would face a rapid decrease in their reserve tranche position, and the net transfers required to attain harmonization would be provided by a few countries. His authorities were not in a position to accept adjustments of that nature. Such a decrease in the reserve tranche position of a member country would not necessarily conform with the level of the reserve tranche desired by the country. Given the current system of burden sharing, the ultimate solution to the issue should be found in the speedy elimination of overdue obligations to the Fund.

His chair was prepared to support lowering the floor for the Fund's holdings of a member's currency in terms of its quota to half of the average holdings, Mr. Fukui commented. Lowering the floor would surely enhance the flexibility of the operational budget, which was particularly important when the Fund's credit was increasing substantially.

Mr. Végh stated that he agreed in general with many of the points made by Mr. Prader, Mr. Torres, and Mr. Dawson. The process of allocating currencies under the operational budget should be simple, equitable, and stable. Those criteria were not met by either the current mixed system of allocation or the two alternative methods proposed in the staff paper that attempted to take into account the cost of contributing to financing Fund operations.

He supported the view that the system based on members' quotas appeared to be more in line with those criteria, Mr. Végh remarked. It essentially implied, as Mr. Torres had pointed out, that once the members able to participate in the operational budget had been chosen by using relevant indicators like reserves, the allocation should be directly related to the member's quota. Quotas were more appropriate measures of members' relative economic capacity or their capacity to contribute to financing Fund operations. In addition, quotas were more stable indicators of that capacity, because they did not respond to short-term changes in external financial positions. As to timing, the changes in the guidelines for the allocation of currencies should be introduced immediately after the quota increase.

Mr. Mohammed said that he was not convinced that the principles that had governed the Fund's practice on the allocation of currencies should be modified to redistribute the cost of burden sharing among members included in the currency budget. The choice of a particular formula for the allocation of currencies would certainly have an effect on the distribution of the arrears burden. Members might, in part, be motivated to favor a quota-based system that would more evenly distribute the costs--that is, income forgone--of financing Fund operations.

But such second-order considerations should not form the basis of the currency allocation system, Mr. Mohammed remarked. The system should continue to be based on more general considerations, the foremost of which was members' ability to provide resources. Reserve holdings remained a reasonable indicator of that ability. Other general considerations, such as the relative quota size, could still be incorporated into the system. The current guidelines incorporated quotas to some extent. Indeed, the staff's rather complicated proposal could have yielded the same net effect by increasing somewhat the weight of quotas in the allocation formula, with the balance continuing to be distributed on the basis of the existing guidelines. The staff might have felt, on the basis of the discussion of June 1, 1990, that the Board as a whole was not inclined to look at the quota criterion with favor. The current debate indicated a greater willingness to look with a more open mind at more extensive use of quotas as a criterion in the currency allocation.

Currently, there was no compelling reason to change the existing allocation system, Mr. Mohammed commented. However, the issue of how much weight should be assigned to quotas should be pursued in the next few months. The staff had correctly described the implications of the increase in quota and the associated payment in reserve assets, including SDRs. However, as Mr. Landau and others had pointed out, the probability of a delay in bringing the quota increase into effect might be even more pertinent in a situation of growing net transfers and a declining liquidity ratio over the next few months. In such a context, it would be inappropriate to introduce guidelines entailing large changes in creditor positions. Doing so would put at risk both the liquidity of the Fund and the flexibility and pragmatism with which it was managed under the current procedures.

Mr. Filosa made the following statement:

> Let me summarize at the outset this chair's position on the issue under discussion today. We would like to emphasize that we continue to believe in the fundamental role that members' official reserves play in determining the allocation of currencies under the Fund's operational budget. As on past occasions, we hold the view that, to the extent possible, greater equity in sharing the costs of financing the Fund should be achieved through appropriate adjustments in the currency allocation method. For such adjustments to increase effectively the equity of the system, all the relevant costs shared by members should be properly taken into account.
>
> Although we appreciate the efforts made by the staff in working out reasonable alternative methods to harmonize the costs of membership, we believe that still more has to be done on the technical side if the principle of equity is to be dealt with satisfactorily. None of the alternative methods proposed by the staff at this stage seems valid enough to increase the equity in the allocation system. Should the Board agree on the need to modify the present allocation method to improve equity in cost sharing, this chair would prefer that the introduction of the modified system be delayed until after the ninth quota increases come into effect.
>
> Since 1962, the methods adopted by the Fund to allocate currencies under the operational budget have followed the fundamental principle of safeguarding the Fund's liquidity, while attempting to harmonize members' reserve tranche positions with respect to their holdings of gold and foreign exchange. We believe that this principle, which has been implemented with an appropriate degree of pragmatism has so far served the Fund well.
>
> In particular, we continue to support the use of members' official holdings of gold and foreign exchange as the basic indicator to allocate currency to be transferred by the Fund. The relationship between countries' primary reserves and their liquidity position has become complex with the increasing sophistication of the international monetary system; however, reserves

still play a predominant role, reflecting the external relative strength of members' economies and their short-term variations. In this connection, I endorse the remarks made by Mr. Landau.

Indeed, we concur with Mr. Al-Jasser that primary reserves remain the best indicator, however imperfect, on which to base the distribution of resources provided to the Fund. Certainly they reflect much better than quota the members' capacity to finance Fund operations, and we again share Mr. Al-Jasser's view that a quota-based system could lead to members holding a reserve tranche position that would be large in proportion to their primary reserves, irrespective of their ability to contribute resources to the Fund.

Therefore, with respect to the desirability expressed by some Directors of placing more emphasis on the relationship between currency allocations and quota sizes, we believe that the June 1990 modification of the currency allocation system has already moved a considerable distance toward the achievement of that objective. We reaffirm the principle that a correct method of currency allocation under the operational budget must be centered on members' official reserves as the indicator of their ability to provide resources.

In past discussions on currency allocation, this chair has taken the view that a case could be made for some adjustment in the allocation method to achieve a higher degree of equity in the sharing of the costs involved in financing the Fund. On those same occasions, we pointed out, however, that any move in this direction would have to be gradual. We are grateful to the staff for the efforts made in trying to work out alternative approaches that, while aimed at achieving cost harmonization, purport to do so gradually.

Considering the specific merit of each approach, we, like Mr. Goos, have some sympathy for the third scheme proposed by the staff and illustrated in Table 4, whereby part of the allocation of currency transfers and receipts would be based on the current method and the remainder would be allocated to equalize members' income forgone under burden sharing as a proportion of quota. This approach--more than the others described in the staff paper--preserves the use of official reserves as the basis to allocate currencies under the operational budget.

We do, however, have some reservations that would call for further analysis of the issue before the problem of equity can be dealt with satisfactorily. The alternative approaches proposed by the staff appear to be built with large degrees of arbitrariness to establish the parameters necessary to combine the different methods, such as the weight attached to quotas under the system presently in use and the proportion of the proposed use of currencies that is to be determined by one or the other method. Before a decision on any new approach can be taken, it is important to assess the sensitivity of the reallocations to changes in these parameters. Similarly, the simulations could be rerun by using alternative estimates of income forgone.

Our second set of reservations goes to the very essence of the exercise and relates to the equity-improving effect of the alternatives proposed by the staff. As noted by the staff and previous speakers, the cost of overdue obligations and burden sharing is only one--though a major one--of the cost components of members' contribution to Fund resources. As the relative costs of financing the Fund differ from one member to another, owing to the existence of strong asymmetries between contributions to the burden sharing mechanism and to the existence of other costs unevenly borne by members, any remedy that would aim at cost equalizing should, in principle, take into account all kinds of asymmetries.

The staff has limited their exercise to the burden sharing cost component. However, trying to harmonize costs by focusing on one cost component only while disregarding the other may, in fact, turn out to be equitable only if those members that bear a relatively larger share with respect to one cost component also bear a relatively larger share with respect to the other component. A redistribution of the costs of either component would unambiguously relieve the burden from those who are "paying" more, so to speak, and shift it to those who are "paying" less. Conversely, adjustment to only one component--for example, if members sustain higher costs under one component and lower costs under the other--could make a member worse off after such an adjustment. In other words, the consideration of only one cost component could well increase rather than diminish the unevenness of financing costs between members. In more technical terms, the improvement in cost sharing crucially depends on the proper consideration of all elements of cost, including those implied by the size of the unremunerated reserve tranche position, and on the loss function to be minimized. I am not sure that all these aspects of the problem have been fully explored.

Our view is that any method to improve equity would have to include all major cost components. Once the array of the relevant cost components has been defined, taking into account the legal constraints, and the different overall cost shares for each member in relation to quota have been estimated, it should be technically feasible to design a reserve-based currency allocation system that, while holding as a constraint the Fund's overall resource needs for operations, would identify the net transfers from individual members that would minimize for each the difference between its actual cost share relative to quota and the average share for the membership.

In conclusion, although this chair appreciates the spirit of the staff's presentation, as it shows within a consistent framework the several elements of judgment involved in this type of exercise, we still believe that more information is needed to take an appropriate decision, should this Board agree that a modification to the current system is desirable. One thing we emphasized at the outset and would like to reiterate at this stage is that we favor those methods that, while trying to address the problem of equity, do preserve a central role for the fundamental characteristic of the current method--that is, the use of official international reserves as a basis to allocate currencies under the operational budget. Finally, as we think more study would be necessary should this Board decide to introduce modifications to the system, we would deem it preferable that the discussion be taken up again when the staff has considered more technical elements. Moreover, should any modification eventually be approved, it should only be introduced after the ninth quota increase comes into effect. In the meantime, our preference is to retain the present system.

Mr. Evans recalled that in June 1990 he had spoken at unusual length in support of the position put forward during the current discussion by Mr. Prader and Mr. Torres--a position that they had also put forward at that earlier meeting. If the issue under discussion was simply one of liquidity, it would be easy to agree with the position taken by the staff and Mr. Peretz. However, a large reserve tranche position in the Fund was not a highly prized asset. Therefore, the question of allocation arose, in recognition of which there had always been a harmonization system. That system was sustainable only if it was based on members' obligations--that is, their quotas. It might not matter much, given a flexible and pragmatic approach, whether the system was based on reserves with quota constraints or on quotas with reserve constraints; however, there was something to be said for getting the basics right, and the basics demanded that the system should be based on quotas.

Choosing countries according to their external position should be retained as a first step to guard against the problem cases that cropped up in simulations, Mr. Evans said. However, the allocation should be based on quotas, with harmonization being achieved over time on the basis of countries' reserve positions. In his intervention in June 1990, he had suggested that no system would work satisfactorily in the long run unless a broad consensus was behind it. That consensus would come with the recognition--such as that by the Bundesbank mentioned during the current discussion--that the costs would eventually become sufficiently significant that they could not be ignored. The issue of the Fund liquidity would not be solved by concentrating on reserves, but on a position that members could support--in other words, a position that involved equity.

Mr. Peretz said that he wanted to make it clear that he supported Mr. Landau's proposal. He wondered whether there was a consensus that the issue of the distribution of costs, which a number of speakers believed important, would be better dealt with in the context of the wider discussion scheduled for next month, rather than in the specific context currently being considered.

Ms. Powell made the following statement:

We all agree on the need to maintain the Fund's effectiveness through procedures that ensure it has adequate resources to draw upon and that they are available on a timely basis. At issue is whether this objective can be met in a way that would ameliorate concerns about the equity of burden sharing.

We continue to believe that a system of allocating currencies under the Fund's operational budget based principally on members' official holdings of gold and foreign exchange has, on the whole and over time, served its purpose well. As the staff analysis shows, there are still reasons to consider primary reserves as a relevant indicator of the relative strength of members' external financial position and of their capacity to contribute to the financing of Fund operations. At the same time, the staff cites a number of shortcomings in using quotas in allocating currencies, notably the fact that quotas are reviewed only infrequently and do not reflect changing short-term trends in members' liquidity positions.

We do have sympathy for the concerns of certain members with large official primary reserves relative to quotas, whose currencies may, at times, have figured prominently, perhaps even disproportionately, in the operational budget. However, we see no compelling reason to change the system appreciably at this point in time.

Because we hope that the burden sharing arrangements we have set up will prove temporary, we would do well to avoid changes to address relatively short-term concerns, particularly if such changes might pose risks to the smooth functioning of the currency budget. In this respect, we note that the modifications explored in the staff's simulations would lead both to a concentration of the use of currencies of a small group of countries in the operational budget and to less use of the currencies of some of the strongest creditors. We are not convinced that such a shift would be beneficial to the Fund's liquidity position over the longer term.

The method adopted in July 1990 seems to be striking a reasonable balance between the need to ensure that the system remains responsive to potential increases in the demand for Fund credit and the need to mitigate the effects of the system on those members whose reserves are high in relation to quota. Nevertheless, the changes have not been without at least one undesirable effect, in that the current mixed approach combining quota criteria and liquidity considerations has complicated the procedure of allocating currencies, rendering it less transparent. The addition of even more criteria would certainly exacerbate this problem.

Given that, on balance, the interim system for the allocation of currencies has been working reasonably well, we are of the view that it would be preferable to delay any change in the prevailing guidelines until after the increase in quotas under the Ninth Review becomes effective. This approach would allow the Board to review the situation within the context of new parameters, notably the currency composition of reserve asset payments resulting from increases in quotas and the extent to which the Fund chooses to sell SDRs. In the meantime, we think it appropriate to extend the interim system, as agreed in 1990, until completion of the Ninth Review.

Mrs. Sirivedhin stated that official reserves were a good, although admittedly imperfect, indicator of members' ability to contribute to the financing of the Fund, because they reflected members' external positions. However, the use of reserves as the sole indicator to determine the allocation of currencies would ignore the principle of equity in Fund operations, whereby quotas governed members' voting power, rights, and obligations. The system adopted in June 1990 took into account members' primary reserves in allocating the total amount of transfers, with a floor based on currency holdings in terms of quotas, whereas receipts were allocated in proportion to reserve tranche positions. That system combined the two principles well. Moreover, it had the added advantage of a certain degree of symmetry with members' use of Fund resources, whereby members' drawings on the Fund were based on need, as determined by the balance of payments and reserves position, but were subject to limits that were expressed in terms of quota. Keeping the current floor for Fund holdings of a member's currency in terms of quota at two thirds of the average level and a minimum of at least 10 percent of quota would be preferable.

Although she favored a more equitable distribution of the income forgone from the temporary burden sharing, she was mindful of the complexities and the uncertainties in determining the calculation of income forgone, Mrs. Sirivedhin indicated. Therefore, if there was no majority support for the inclusion of income forgone, she was willing to accept the proposed decision. In the event that a change was deemed necessary, some members inevitably would be subjected to large amounts of transfers and receipts. A phasing of the scheme over a reasonable period was warranted in the light of the ensuing difficulties faced by some members that could put in doubt the availability of Fund's resources. As to the timing, any change in the current guidelines should be delayed until the quota increases came into effect.

Mr. Fernando remarked that he agreed with those speakers who had said that the allocation of currencies on the transfer side of the currency budget should not be overburdened with too many goals. Safeguarding the Fund's liquidity position in the years ahead was of paramount importance, not least in light of the difficulties that the Fund perceived for augmentation of Fund resources through future quota increases and the Fund's sentiment that it should remain essentially a quota-based institution. The objective of achieving greater harmonization in sharing the cost of Fund financing through operations in the currency budget only partially dealt with the issue. Pending further legal clarification, it would not be possible to take into account the imputed cost of contributions arising from unremunerated reserve tranche positions--as pointedly noted by the staff.

The cost of financing Fund operations related not only to the income forgone on unremunerated reserve tranche positions and burden sharing, but also to contributions such as those made to technical assistance accounts and to the enhanced structural adjustment facility (ESAF), Mr. Fernando commented. Moreover, the contribution made by the Fund's noncreditor community to compensate the Fund for deferred charges and contributions to the special contingency accounts I and II should be kept in mind. Even with respect to income forgone by creditor countries owing to burden sharing, the estimates relied on assumptions that lacked the precision with which central banks were beginning to look at the relative yields on their reserve asset portfolios.

He had not been persuaded by the arguments to reconsider allocations to the transfer side of the budget based on quotas, Mr. Fernando remarked. The current system, which identified and allocated currencies to the currency budget on the basis of members' official reserves with a cap for Fund holdings in terms of quota at two thirds of the average level, should continue. It would enable the Fund to fulfil its objectives of meeting the legitimate financing needs of its members, while limiting the burden on individual creditor members.

The Treasurer recalled that, five years earlier, the first Board meeting that the Managing Director had chaired had dealt with that same topic in the context of dealing with mitigation for the United States under its perceived heavy responsibility under the new and then developing burden sharing. The system currently in place for allocating currencies under the operational budget had been agreed by the Board, and the guidelines had been put into effect early in 1979 and had been revived in 1989/90. They had worked well then, and it was reasonable to expect that they would continue to work, as circumstances had not fundamentally changed.

If the staff had appeared to propose an alternative method for the allocation of currencies under the operational budget in the staff paper, that was not intended, the Treasurer explained. Instead, the staff had been asked to examine the possibility of bringing in yet another variable of cost to mitigate or to redistribute the cost element in burden sharing. As many Directors had noted, the issue of cost in determining the allocation of currencies did not properly belong in the operational budget. However, the allocation of currencies could be considered from a cost point of view because remuneration was being paid on reserve tranche positions, which were being affected daily as a result of the Fund's operations, as the yield on reinvested positions was affected by the burden sharing arrangements. Therefore, the adjustment of the amount of remuneration paid on reserve tranche positions through Fund operations had been put forward for discussion as a matter of necessity, not complexity.

The first draft of the staff paper had been written on the basis that both the remunerated and unremunerated reserve tranches could be taken into account in determining the cost of carrying reserve tranche positions, the Treasurer said. However, that law gave rise to legal difficulties, and a short paragraph in the staff paper explained the legal position, with which the Treasurer's Department fully concurred. But if Directors wished to have the information as regards the unremunerated reserve tranche analysis, it could be produced promptly, as it had been part of the first draft of the paper. Perhaps a more detailed legal analysis would be helpful for Directors' subsequent consideration of the issue.

The guidelines that were currently in place had been first introduced in September 1979, except for a change in the floor from a half to two thirds, the Treasurer observed. The Board reviewed those guidelines every quarter in the context of the operational budget. If anything untoward was happening in the distribution of reserve tranches, it might well be useful to add a paragraph to the quarterly operational budget as regards the operation of the guidelines on a quarterly basis. The allocation of currencies in the operational budget would then in practice be reviewed on a continuing basis, particularly in relation to the floor, and that review might be useful in light of the substantial increase in the demand for Fund credit and the particularly large expected drop in the Fund's total absolute level of liquidity that were now projected. That liquidity depended on only 29 countries. Some of the members included in the operational budget had extremely small quotas, and, therefore, the Fund had quite small holdings of a number of currencies.

The General Counsel confirmed that the first draft of the staff paper, before it was reviewed by the Legal Department, had taken a position on the unremunerated reserve tranche that was not currently included in the staff paper, owing to legal considerations; therefore, the view of the Legal Department should be explained. The Department's view was not limited to the question of the unremunerated position. A more general issue was whether members could be compensated, through the currency budget, for the costs incurred by them in the operation of the Fund. First, Mr. Peretz and then Mr. Landau had suggested that, if costs were relevant, as the staff paper seemed to have indicated, those cost considerations should not be limited to burden sharing, but should also be extended to the unremunerated reserve tranche and possibly to income forgone on contributions to the ESAF Trust or to other accounts administered by the Fund. Perhaps even compensation for costs not associated with the Fund could be envisaged.

However, it could not be assumed that the Fund could use the currency budget for almost any purpose, the General Counsel continued. The Fund had to exercise its powers to achieve relevant purposes, both general and specific to certain powers. With the permission of the Board, all that examination should be supported by a separate legal paper, as it was not possible to have a meaningful discussion of all those questions in a short period of time. However, the substance of the legal position could be summarized as follows. The source of the difficulty was that the provision on the currency budget was drafted in flexible and nonexhaustive terms. First, the provision listed several elements that were all relevant to the establishment of the currency budget, but the manner in which those different elements were implemented was determined by the Executive Board. For instance, the balancing of Fund positions was to take place over time; there was no firm indication of what "over time" meant. Second, those elements deemed relevant for the establishment of the currency budget had to be "taken into account," which meant that the list was not exhaustive. Therefore, the Board could include other elements in its consideration of the currency budget. For instance, an additional consideration that had been found relevant was the widespread use of the U.S. dollar in international payments--a practice that was not specifically mentioned in the list of elements in the provision, but had been added by the Executive Board.

The question had been asked whether other elements, such as compensation for the unremunerated tranche position, were relevant, the General Counsel recalled. The fact that the provision was illustrative rather than exhaustive did not mean that there was total freedom in its application. As any other provision drafted in similar terms, it had to be applied consistently both with its own purposes and with the other provisions of the Articles of Agreement. Therefore, the precise issue was whether compensation for the unremunerated reserve tranche was a relevant and admissible element in the adoption of the operational budget. An examination of the Articles revealed that differences in members' remunerated positions were the result of a deliberate decision taken at the time of the Second Amendment and reflected in the Articles. The system known as "the norm" had been based essentially on the extent of the gold contribution that had been made by members prior to the Second Amendment. The underlying idea was that the gold contribution should not be remunerated. Instead, should the Fund be liquidated in the future, those members that had contributed gold would have the right to have to share in the capital gain that had been realized on their gold subscriptions. One could discuss whether that system was fair or unfair, wise, or unwise, but it had been a deliberate decision based on certain considerations that had been taken at a time when gold had been a special component that perhaps had not deserved to be treated like other parts of members' contributions.

In the interpretation of treaties, the General Counsel said, each provision had to be given a meaning, and it was not possible to negate a particular provision through the interpretation of another. Therefore, the Fund's broad powers in the adoption of the operational budget had to be understood in the context of all other relevant provisions, one of which specifically excluded remunerating a certain part of members' tranche positions in the Fund. That situation had led to the short and somewhat cryptic paragraph that the Legal Department had drafted together with the Treasurer's Department. It might be helpful at a later date to deal more fully not only with the question of the unremunerated reserve tranche, but also with the question of the other purposes that might be relevant to the establishment of the currency budget.

Mr. Al-Jasser recalled that the legal issues raised by the General Counsel had been considered at length during the Board discussion in June 1990. However, as a result of that discussion, Directors had been given information that would at least caution them against making conclusions about the legal basis that should be used and the balancing work that needed to be done for the budget.

Members' external positions were used to determine whether they entered into the budget, which meant that Directors should acknowledge that the cyclical positions of members' economies were critical in determining which countries should enter that budget, Mr. Al-Jasser commented. Therefore, once a member was determined to be sufficiently strong and entered into the budget, it would be difficult to say that the external position was irrelevant. Such a system would mean that all contributions should eventually be based on a fixed proportion of quota. Therefore, either the list of the participants in the budget would be short most of the time--increasing the burden on members that were already included--or an amendment might be necessary to say that every member that did not have a program with the Fund should be in that operational budget and should contribute at a fixed ratio to its quota. From a practical point of view, such a system would not be workable.

Mr. Filosa remarked that he welcomed the General Counsel's suggestion that all the cost elements needed to be considered. That had been the main point of his own intervention. A full understanding of the importance of each cost element would be useful in assessing the inequity in members' contributions to financing Fund operations. Once all those cost components had been appraised, Directors would need to evaluate the sensitivity of the proposed adjustments to different parameters.

One such parameter was whether the floor should be set at two thirds or one half, Mr. Filosa stated. The simple standard deviation coefficient might not be the best tool for determining whether there was an improvement in equity depending on which floor was used. There were a number of other alternative criteria for harmonization of members' contributions that needed to be explored. Once all the elements of cost had been considered and all the sensitivities to the parameters on the implication of different loss functions had been tested, an evaluation of what was equitable--given the constraint that the Fund's liquidity position must be maintained--could be made. Therefore, he would appreciate having an indication of how relevant different costs were to members and what costs should reasonably be included. Having a broad range of possibilities would help Directors reach a consensus on the appropriate course of action.

Mr. Thorne said that he supported Mr. Filosa's request for more details on the dispersion of all the different costs involved. He welcomed the staff paper on the legal implications that the General Counsel had offered to prepare before any change was made in the allocation of currencies.

The Chairman made the following concluding remarks:

I would draw the following conclusions from our debate:

First, the present guidelines on the allocation of currencies under the operational budget that we agreed in June 1990 have, in practice, worked relatively well. These guidelines have brought about a better distribution of reserve tranche positions in relation to members' quotas and reserves without causing distortions in the distribution of reserve tranche positions. Above all, the Fund has financed a rapid expansion in Fund lending in a generally smooth and efficient manner, and we all agree that the paramount need is to ensure that the Fund's liquidity position is managed in such a way as to be able to finance members' use of the Fund's resources in as smoothly and equitable a manner as possible.

Second, although the present mixed system for allocating currencies has worked well, several Directors believe that we should increase the relative importance of quotas in allocating currencies, while a number of other Directors believe that the relative importance of gold and foreign exchange could be increased in the allocation process. The arguments for and against these positions are now well appreciated.

Third, many Directors commented on the staff's analysis of the issues that arise in an attempt to achieve a more equitable distribution in the cost of financing the Fund because of the burden of financing overdue obligations and the role of the unremunerated reserve tranche positions. There is no doubt that under the burden sharing arrangements, the cost of acquiring a Fund position has risen relative to the cost of acquiring other reserve assets, including SDRs. Some Directors have taken the view that this cost should be taken into consideration in the determination of the distribution of reserve tranche positions. Others are less convinced, bearing in mind that the burden sharing arrangements are, in principle, temporary and that a different role is played in the Fund by the unremunerated reserve tranche positions. In the light of today's discussion, I do not believe that the Board has come to firm views on burden sharing issues, and I note that a number of Directors wish to see further staff work. As suggested by Mr. Peretz, we will have an opportunity to come back to these issues in the forthcoming seminar on financing the Fund and the cost of Fund credit on February 21, 1992.

On balance, Directors can go along with maintaining the present guidelines for the time being, with the understanding that the Board will return to the guidelines in the light of the payments made for the increases in quotas under the Ninth Review. And I understand that Directors wish to see this further delay in clarifying these guidelines shortened by an early conclusion of the Ninth Review.

If agreeable with Executive Directors, we will circulate a draft decision for adoption on a lapse of time basis to extend the present guidelines until payments have been made for the increase in quotas or, in any event, until no later than the end of this year.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/4 (1/10/92) and EBM/92/5 (1/15/92).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/90 and 91/94 through 91/97 are approved.

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/91/281, Supplement 2 (1/10/92), EBAP/92/4 (1/9/92) and EBAP/92/7 (1/13/92), by Advisors to Executive Directors as set forth in EBAP/92/4 (1/9/92) and EBAP/92/7 (1/13/92), and by an Assistant to Executive Director as set forth in EBAP/92/5 (1/9/92) is approved.

APPROVED: July 27, 1992

JOSEPH W. LANG, JR.
Acting Secretary