

MASTER FILES

ROOM C-120

04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/90

3:00 p.m., June 5, 1985

R. D. Erb, Acting Chairman

Executive DirectorsA. Alfidja
C. H. DallaraM. Finaish
H. Fujino
G. Grosche
J. E. Ismael
R. K. JoyceE. I. M. Mtei
F. L. Nebbia
Y. A. NimatallahC. R. Rye
G. Salehkhoul

N. Wicks

Zhang Z.

Alternate Executive Directors

J. K. Orleans-Lindsay, Temporary

H. G. Schneider
X. Blandin
T. Alhaimus
M. Sugita
B. GoosL. Leonard
J. Hospedales, Temporary
H. Fugmann
A. Abdallah
B. JensenG. Ortiz
J. E. Rodríguez, Temporary
J. de Beaufort WijnholdsA. S. Jayawardena
T. A. Clark
N. Coumbis
Wang E.L. Van Houtven, Secretary
J. M. Oppenheim, Assistant
K. S. Friedman, Assistant

1. Income Position - Review and Related Issues; Publicity
Upon Declaration of Ineligibility; and Overdue Financial
Obligations - Special Charges Page 3

Also Present

Administration Department: L. A. Wolfe. African Department: J. W. Kratz. Asian Department: L. Mendras. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director. External Relations Department: A. F. Mohammed, Director; H. O. Hartmann. Legal Department: J. G. Evans, Jr., Deputy General Counsel; R. C. Effros, W. E. Holder, Ph. Lachman, A. O. Liuksila, S. A. Silard. Middle Eastern Department: F. Drees. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat, B. J. Owen. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. B. C. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Berthet, J. E. Blalock, D. H. Brown, W. L. Coats, Jr., J. C. Corr, S. I. Fawzi, D. Gupta, R. B. Hicks, B. E. Keuppens, J. T. McDonald, Y. Ozeki, G. Wittich. Bureau of Statistics: R. V. Kennedy. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, E. M. Ainley, D. Hammann, S. M. Hassan, G. Nguyen, T. Sirivedhin, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, G. Biron, Bo T., M. B. Chatah, J. J. Dreizzen, G. Ercel, V. Govindarajan, N. Haque, G. D. Hodgson, Z. b. Ismail, A. K. Juusela, S. Kolb, K. Murakami, A. Mustafa, M. Rasyid, J. Reddy, D. J. Robinson, C. A. Salinas, A. A. Scholten, L. Tornetta, E. L. Walker, B. D. White.

1. INCOME POSITION - REVIEW AND RELATED ISSUES; PUBLICITY UPON
DECLARATION OF INELIGIBILITY; AND OVERDUE FINANCIAL OBLIGATIONS -
SPECIAL CHARGES

The Executive Directors resumed from the previous meeting their consideration of staff papers on the review of the Fund's income position for the financial years (FY) 1985 and 1986, and on factors bearing on the adequacy of Fund reserves and on burden sharing in the Fund (EBS/85/104, 4/25/85; Sup. 1, 5/28/85; EBS/85/125, 5/14/85; EBS/85/126, 5/14/85), together with staff papers on the question of publicity upon declaration of ineligibility to use the Fund's general resources (SM/85/12, 1/9/85), and on special charges and the legal aspects of financial remedies in connection with overdue financial obligations to the Fund (EBS/85/121, 5/13/85; and SM/85/131, 5/13/85). They also had before them as background material the six-monthly report on overdue financial obligations to the Fund (EBS/85/73, 3/27/85; and Sup. 1, 5/31/85).

Mr. Blandin commented that the extreme sensitivity of net income projections to assumptions about the underlying SDR interest rate was evident from the fact that a variation of 0.1 percent in the SDR rate, as well as in the rate of charge, led to a variation in net income of roughly 2 points. The SDR rate had fluctuated between 9.67 percent and 7.79 percent and currently stood at 7.7 percent, so that the present uncertainty regarding that rate obviously called for great prudence. The balance between income and expenditure, which was expected on current estimates to result in a net income of 5.3 percent of reserves, could fluctuate widely. Given those uncertainties, a decision to increase the rate of charge did not seem necessary, especially in a period of general decrease in the market rates of interest. Nor did it appear appropriate to lower the rate of charge, which should be maintained at 7 percent.

The fundamental question was whether Rule I-6(4) should be modified to increase the net income target above 3 percent of reserves, Mr. Blandin considered. Such an increase would be painless, in that it could be adopted without an increase in the rate of charge, thanks to the decrease in the SDR interest rate. However, the new rule would become burdensome if the present trend in market rates were reversed, a possibility foreseen by many financial analysts. On the other hand, the arguments in favor of strengthening the Fund's reserves appeared convincing. The increase in overdue obligations and the deterioration in the reserve ratio, compared with other parameters of Fund activities, had highlighted the need for the Fund to strengthen its financial credibility. It should be noted that certain steps had already been taken in that direction by the recent decision to place charges overdue by six months or more on a nonaccrual basis. Although there were good reasons to increase the Fund's reserves, there was still no clear indication of what would be the adequate long-term level of reserves and of what criteria should determine that level. A more general study not only on the adequacy of reserves but also on their role in an institution such as the Fund should be undertaken.

In the present circumstances, the Board could approach the issue of strengthening the Fund's reserves with the necessary flexibility, Mr. Blandin continued. Therefore, in FY 1986, and without changing the 3 percent target, any excess income over that target and up to 8 percent should be added to reserves. Such a policy could be continued on a case-by-case basis in the years ahead. It would not be appropriate to change the present general rule. In a spirit of compromise, however, his authorities could go along with the proposal to raise the net income target from 3 percent to 5 percent, although there would then be no need for the presumption contained in the Managing Director's statement relating to the disposition of income in excess of 5 percent, except perhaps for FY 1986.

The question of burden sharing was extremely complex, Mr. Blandin observed. There was no compelling reason to adopt at the present stage any alternative course of action for sharing the Fund's general expenses. Further research was required to clarify the different shifts in that burden which could occur within the Fund.

The Fund had to increase the means at its disposal to prevent the emergence of payments arrears, Mr. Blandin noted. Although the efficiency of a measure such as active publicity upon declarations of ineligibility was debatable, a press release issued after the Board's decision to declare the member ineligible to use Fund resources might have a deterrent effect and thus contribute to avoiding or reducing the level of overdue obligations to the Fund. That position was a painful departure from his authorities' traditional views, but it was necessary to protect the Fund's financial position. However, a one-month delay between the Board's decision and the issuance of a press release should be allowed to provide the member an opportunity to settle its obligation. Mr. Fujino's proposal to defer any such action until after the publication of the 1985 Annual Report was appropriate.

Mr. Finaish stated that his position had of necessity to reflect both the complexity of the issue and the diversity of his constituency, which contained several kinds of countries--some creditors, some debtors, some users of Fund resources, and even one on the list of members with overdue obligations. He could agree with the staff that the most compelling argument for a possible increase in reserves was to protect the Fund's financial position against the rising incidence of overdue obligations. In deciding upon the magnitude and form of the reserve increase, one had to take into account the other measures that had been implemented or were being contemplated to deal, at least partially, with the problem. The nonaccrual of overdue charges and the possible imposition of special charges were obvious examples. Although the role of reserves as a source of liquidity and a guarantee to creditors and the public was less obvious, it should nevertheless be recognized that creditors seemed to attach great importance to increasing the reserve target. That consideration could not be easily discounted. In light of those diverse considerations and the difficulty of making a judgment at the present time on the duration of the problem of overdue obligations,

he would endorse a temporary increase in the reserve target, such as to 5 percent for two years, on the assumption that the Board decision would state that the present reserve target of 3 percent would be reinstated automatically at the end of the period unless the Board decided otherwise in the light of the circumstances at that time. Any excess over the net income target could be disposed of according to the current practice. That approach would be both balanced and simple.

On the issue of publicity, Mr. Finaish reiterated that he did not favor a press release.

Mr. Nebbia stated that he recognized that the net income target of 3 percent had to be changed if the financial position of the Fund was to be protected. To date the only variable that had been utilized to generate higher net income surpluses had been the rate of charge. It was therefore reassuring to learn that there was no need to change the rate of charge, given the general fall in interest rates. The cooperative nature of the Fund and the notion that any costs or benefits of membership should be shared equitably made it seem unfair that any rise in the level of reserves should be secured solely through a change in the rate of charge. Although a net income target of 3 percent appeared sufficient in present circumstances, an accumulation of reserves up to 5 percent, without a change in Rule I-6(4) would be acceptable.

He opposed active publicity, Mr. Nebbia reiterated; in principle, no press releases should be issued in connection with declarations of ineligibility, although there might be a case for reaching a decision each time on an individual basis.

Mr. Ortiz said that he endorsed the views expressed by Mr. Blandin and that he was prepared to support, as a compromise solution, an increase in the reserve target to 5 percent. The suggestion of a temporary increase was also extremely appealing and appeared to be an acceptable solution to the problem.

No form of publicity upon declarations of ineligibility was acceptable, Mr. Ortiz concluded.

The Treasurer, replying to the point that the overdue obligations were only a temporary phenomenon and that therefore no permanent measure was needed to increase the Fund's reserves, expressed the hope that that was in fact the situation. Although there had been some reduction in arrears, they had continued to rise on a net basis, thereby casting a serious question mark on their temporary nature. On average, and on a weighted basis, overdue obligations--both charges and repurchases--were more than 400 days late. The figure fluctuated sharply; for example, one country had recently entered into arrears but in substantial amounts, thereby shortening the average duration for which overdue obligations were in existence. However, the period, on average, was still longer than one year. Moreover, the number of countries in arrears had risen rather than declined, having reached 15--not an insignificant number

even as a proportion of the number of debtors, 82 at present. Although a good part of the overdue obligations were accounted for by a very small number of countries, it was still not possible to say that the outstanding obligations to the Fund were of a temporary character.

It was true that the world economic situation had improved and that a number of the Fund's major debtors had been able to take advantage of the expansion in world trade, the Treasurer continued. But as a rule, certain Fund members, including those that were in arrears, had not been able to increase their exports in line with the general expansion in the world demand for imports. The reasons were different in each case, but it often seemed that countries in arrears were reluctant to make the necessary adjustments to their economies. If they were able to do so, the issue of overdue obligations might indeed be a temporary one. For that reason, a temporary increase in the reserve target that could be reviewed after a given period might, in fact, be a reasonable decision. For instance, it could be decided that, when all arrears had been settled, there would be an automatic reversion to the 3 percent reserve target. It should also be noted that the Fund's credit expansion was slowing down and that, in several years' time, a net reduction in outstanding liabilities of members to the Fund could be expected. That outlook did not necessarily mean that there would be a pro rata reduction in arrears because it was extremely difficult to predict such an outcome.

Determining the proper level of reserves had been largely a matter of judgment over the years, the Treasurer noted. The staff had attempted to establish criteria for reaching a more considered judgment by looking at, inter alia, the susceptibility of the Fund to deficits; the reasons for members' failure to meet financial obligations; comparisons with other financial institutions; and the relationship between the level of reserves and the credibility of the Fund, an important factor. Many Directors had cast doubt on the validity of comparisons between the Fund and other international financial institutions. The staff itself had pointed out that the Fund's financial structure was very different from that of other institutions, but that fact in no way implied that the Fund could relax its standards. Indeed, the staff paper made it clear that, although the Fund was not directly subject to market constraints or to evaluation by investors in capital markets, it did not follow that such considerations were not relevant for the Fund, particularly in the context of its borrowing program. Whether the Fund borrowed from the private market, from its members, or from an institution such as the BIS, it would be judged by the soundness of its operational performance. The Fund's credibility was measured by the adequacy of its reserves in covering the possibility of default should temporary overdue obligations be transformed into permanent liabilities.

On the issue of burden sharing, first, it was impossible to determine to which specific country or group of countries the Fund's reserves belonged, the Treasurer commented, other than to attribute them to the membership as a whole. Second, in pointing to the worsening relationship between reserves and the amount of loans outstanding to the Fund the

staff had not been making a judgment about the likelihood of repayment of certain overdue obligations or about the appropriate value of any reserve ratio. The staff had simply pointed out that the relevant ratios were worsening, a trend that indicated the need to give strong consideration to an increase in the net reserve target. There was no implication intended that all overdue obligations were bad debts that would not be paid. If that had been the conclusion, compelling principles of accounting would have demanded that a special form of reserves be created to offset the writing off of any loans on the balance sheet. Nor was it accurate to specify a strict relationship between the withdrawal of a member from the Fund and the declaration of a particular overdue obligation as a bad debt. Even if a member withdrew from the Fund, the question of whether or not any obligation that was outstanding should be regarded as a bad loan would remain a matter of judgment.

It was also extremely difficult to assess the opportunity cost of interest-free assets that creditor nations lent to the Fund, the Treasurer added. There were no figures on which to base a comparison between the rate of remuneration and the actual income that central banks could earn elsewhere. It should be noted that the staff was proposing a study on the reserve management policies of the Fund membership and also on the rate of return on reserves, which would have an important bearing on what might be the proper level for the SDR interest rate. It was also important to be aware that the composition of members' reserves was generally very different from the currencies in the SDR basket, making comparative measurement of rates of return extremely difficult, even if the staff had had figures on the earnings of central banks on their reserve holdings.

It ought to be possible to calculate an effective rate of charge, although the rate would differ for each member, in the same way that the effective rate of remuneration had been calculated, the Treasurer continued. For example, the effective rate of charge would depend on whether the member used ordinary resources or borrowed resources, whether it received a subsidy payment, and whether the member earned remuneration at the same time. It was likely that the effective rate of charge for debtors would have a wider variation than the effective rate of remuneration.

A considerable part of the decline in the grant element in Fund lending was due to the fall of the London interbank offered rate (LIBOR), which in 1982 had been 16 percent but was at present 8 percent, the Treasurer noted. In 1982 the rate of charge had been 6.2 percent on ordinary resources, and it was currently 7 percent. Although there had been a reduction in the grant element as a result of the increase in charges, it had been reduced largely as a result of the halving of international interest rates, which were used as the standard, in the same period.

It was questionable whether those members, especially very large members, who held a large proportion of unremunerated positions, perhaps disproportionate to their quotas, could be said to carry the burden of the Fund's administrative expenses, the Treasurer said. First, unremunerated positions did not produce any income with which to pay operating expenses; they simply created no expense and allowed the Fund to levy a lower rate of charge than would otherwise be possible. Second, since burden sharing was a question of sharing the net burden, it was likely that large benefits existed even for members that did not receive remuneration on their Fund positions, in the form largely of an improved functioning of the international monetary system.

Mr. Salehkhrou asked whether it would be possible to attribute the expenditure of various functions of the Fund to specific countries.

The Treasurer explained that although the Fund recognized the concept of special services, requested by the membership or by one member, and had the right to charge a special fee for them, it had so far refrained from doing so. The benefits of the services were sufficiently diffused over many members that it was difficult to say that only a small number had benefited. More important, most of the tasks that the Fund had undertaken in connection with special services were closely related to its general purposes in improving the international payments system. For example, the Fund had not charged extra fees for use of the Trust Fund or the Subsidy Account, on the basis that they served the general purposes of the organization. There might, however, be circumstances in which the services rendered by the Fund were so specific that it would be desirable and practical to isolate the function and the cost and to charge countries on an individual basis. That had not yet been done with the exception of cost recovery for management of the SDR Department.

Mr. Salehkhrou commented that it might be possible to use a time series analysis in order to attribute different functions and costs of the Fund to specific groups of countries.

The Treasurer observed that the general administrative and operating expenses of the Fund were borne out of its general income.

Mr. Fujino reiterated his view that there was no reason to support any proposal advocating additional burden sharing.

Mr. Dallara remarked that he could agree that although the Fund was not directly subject to market constraints, considerations of importance to the market might well have validity for the Fund, especially in the context of its borrowing programs. He had had in mind, in his remarks at EBM/85/89, the fact that creditors lent to the Fund not only through special lending arrangements but also through quota subscriptions. The possibility of establishing a special provisioning account had been mentioned in the staff paper (EBS/85/32, 2/5/85) prepared for the Board discussion of overdue obligations (EBM/85/40 and EBM/85/41, 3/13/85).

He asked whether the case for provisioning had been strengthened in the past four months and whether or not a decision regarding provisioning required a special majority.

Mr. Jayawardena pointed out that irrespective of the interest rate used, there had been a significant decline in the grant element of Fund lending. The question of burden sharing, even though it was extremely complex, was one that the institution should be continuously considering from different viewpoints. There was a close parallel between that question and the determination of quotas--the difficulty of determining the relative economic position of industrial countries. Similarly, the question of burden sharing had a very intimate connection with the distribution of costs and benefits in an institution for international cooperation.

The Treasurer explained that special provisioning should not be compared with the accounting procedure of nonaccrual whereby charges that were long overdue were excluded from accrued income. The deferred charges were still regarded as collectible, but they were no longer part of current income. Time was the critical determinant in deciding whether an overdue charge should be considered part of current or deferred income. In the case of provisioning, on the other hand, the issue was not one of timing but rather of whether a loss was probable. If a loss was probable and its extent could be determined, the Fund might be obliged by general accounting standards to make a provision for that loss in the income statement and balance sheet. Although time played a part in the assessment of the probability of loss, it did not play a critical role. If a member were simply to say that it would not pay a debt at the outset, that loss might be considered probable. At the present time, there was no basis on which to determine, from the perspective of the Fund, whether any loss was probable and what the extent of that loss might be. It would be important to establish certain criteria on which to base those judgments.

The Deputy General Counsel added that provisioning was more akin to nonaccrual than to a reserve in that it set aside an amount from income before an actual loss occurred, and the amount so set aside would not be part of the income subject to disposition at the end of that financial year, by either distribution or the placing of the net income to reserves. While the Articles contained provisions for establishing reserves, that did not preclude the application of other generally accepted accounting practices, such as provisioning, if that were considered desirable. The adoption of a normal accounting practice, such as nonaccrual, could be taken by a simple majority of the votes cast.

The Acting Chairman noted that the sense of the meeting was strongly in favor of publicity upon declaration of ineligibility, starting after the publication of the 1985 Annual Report. A number of Directors had also stressed the need for publicity whenever a member reacquired eligibility.

On the central issue of the Fund's income position, the Acting Chairman continued, there was widespread support for an increase in reserves and in the net income target. There were, however, differences on the degree and duration of the increase. At the same time, there was not the necessary support for a change in the rate of charge from 7 percent, nor for an increase in reserves that would be exactly compatible with the rate of charge of 7 percent. There was support for building into any decision a presumption, along the lines suggested by the Managing Director, that any income in excess of the new reserve target would be added to reserves up to a ceiling of 7 or 8 percent.

No objection had been expressed by any Executive Director, the Acting Chairman noted, to the preferred method of making the projection of the amount of income that might be deferred as set forth on pages 10 and 11 of EBS/85/104, for the purpose of the estimates of income and expense in the determination of the rate of charge to be made in accordance with Rule I-6(4)(a) and (b).

Mr. Clark reiterated that the present financial circumstances of the Fund pointed to the need for a deliberate and clear response from the Board. If a consensus could not be reached on a substantial increase in the reserve target, perhaps in the range of 6-8 percent, then perhaps it would be appropriate to consider the case for making provisions against specific overdue obligations to the Fund. A target of at least 6 percent would be optimal, on the basis that it would not require an increase in the rate of charge.

Mr. Dallara asked whether there would be a sufficient majority in support of an increase in the reserve target from 3 percent to 5 percent, if that majority included all those Directors who had indicated a preference for at least a 5 percent target.

The Secretary replied that the 7 Directors who were opposed to any increase in the reserve target beyond the present 3 percent commanded less than 20 percent of the voting power in the Fund.

Mr. Alfidja asked on what basis the Secretary had distinguished between those Directors who favored a temporary increase and those who supported a permanent increase.

The Secretary replied that in addition to the 7 Directors who could not accept any increase in the reserve target, there was 1 Director who could accept only a temporary increase and 1 who was not prepared to support a change in the Rule. The 9 Directors together held about 25 percent of the voting power in the Fund.

In reply to a question on publicity, the Secretary stated that the 12 Directors who favored publicity held about 68 percent of the voting power.

Mr. Dallara asked whether, if one excluded from the majority group those in favor of only a temporary increase in the reserve target, there would still be a sufficient majority in support of a permanent change to a 5 percent net income target.

The Secretary replied that there would still be a sufficient majority for a permanent change in the Rule.

The Acting Chairman asked whether a reserve target of either 5 percent or 6 percent would be consistent with the present rate of charge of 7 percent.

The Treasurer pointed out that the difference between a 5 percent and a 6 percent target increase in reserves would be only 5 basis points. A decision to maintain the 7 percent rate of charge was still a matter of judgment. The Executive Board had once before taken the risk of proceeding without a complete match between the target for net income and the rate of charge. Furthermore, if it transpired that there was any significant deviation from the assumptions made, there existed a safeguard clause permitting an adjustment to be made. On balance, if a 6 percent rate of reserve increase were adopted as a target, a rate of charge of 7 percent could almost undoubtedly be maintained.

Mr. Salehkhoul stated that he was prepared to go along with a 5 percent reserve target on a permanent basis.

Mr. Finaish said that the increase in the target could be adopted for FY 1986 only, but he was prepared to go along with a permanent increase to 5 percent.

Mr. Fujino stated that he preferred the highest possible net income target but was prepared to go along with a 5 percent target to achieve the necessary consensus.

Mr. Alfidja suggested that it would be useful to have a clearer idea of the various qualifications relating to the preference of many Directors for a 5 percent reserve target.

The Secretary noted that it would be difficult to reflect the provisos with precision. There were 5 Directors who had a clear preference for an 8 percent target, 3 Directors who, as their first preference, desired an increase to 6 percent, and several Directors who were prepared to move to the 5 percent net income target on a permanent basis. Two Directors were willing to accept a temporary increase to 5 percent. The 7 Directors who preferred not to move from the present 3 percent net income target had a combined voting power of between 19 and 20 percent.

Mr. Joyce stated that he could be counted as supporting a 5 percent reserve target.

Mr. Dallara noted that the majority required for a change in the reserve target was different from that needed for a decision relating to the Managing Director's presumption regarding excess income and stated that he was prepared, in order to build a consensus, to support an increase in the net income target to only 5 percent, provided that it would be on a permanent basis.

Mr. Jensen, speaking on behalf of Mr. Nebbia, reiterated that there should be no change in the present 3 percent reserve target, but that excess net income above that target could be deemed to be an increase in the target, with the decisions on the amounts and their disposition to be taken at the end of the financial year.

The Deputy General Counsel noted that Mr. Nebbia's position in effect meant no change in the 3 percent target and an assumption that any excess income above the target would be placed to reserves, by decision to be adopted at the end of the financial year.

The Secretary stated that any decision to change the reserve target would have to be taken by a 70 percent majority of the voting power in the institution; 1.59 percent of that voting power was not represented on the Board. The Executive Directors who supported a permanent increase in the reserve target represented more than the required 70 percent of the voting power.

The Acting Chairman said that, as he understood his position, Mr. Finaish could accept a temporary increase in the target to 5 percent, with an automatic reinstatement of the present 3 percent target after two years.

Mr. Rodríguez explained that his chair was also prepared to go along with a temporary increase in the reserve target to 5 percent.

Mr. Schneider stated that because of his interest in obtaining a majority for a permanent change in the Rules, he would not insist on the special provisions that he had mentioned at the previous meeting. The decision on the use of excess income could be left until the Fund's income position was reviewed.

Mr. Blandin said that he could go along with an increase in the reserve target on a permanent basis from 3 percent to 5 percent, but that he could accept the presumption contained in the Managing Director's statement only for FY 1986.

The Acting Chairman asked Executive Directors to indicate whether they could support the presumption in the Managing Director's statement. That presumption was that any income in excess of the new target, which would be 5 percent, would be added to reserves provided that unanticipated net income would not result in a reserve increase beyond an agreed ceiling of 7 or 8 percent of the reserve level at the beginning of the financial year.

Mr. Dallara noted that there was a qualified majority in support of a change in the target from 3 percent to 5 percent of reserves and stated that he would support the presumption of the Managing Director.

Mr. Fujino asked whether, if no decision was made on the presumption, the disposition of surplus income would be decided on the basis of a simple majority vote at the end of the financial year.

The Deputy General Counsel stated that a decision which merely laid out a presumption could be taken by a simple majority. If the Board were, however, to take decisions to reduce charges or increase the rate of remuneration either directly or automatically, those decisions would require a 70 percent majority. If the decision was that all or part of the net income placed to reserves at the end of the past financial year would be deemed to be income for the following financial year for the purpose of the calculation of the rate of charge for the following year, then that decision to do so would also require a 70 percent majority.

In response to a question by Mr. Dallara, the Deputy General Counsel said that a presumption was not equivalent to an effective decision to change either the rate of charge or the rate of remuneration; a decision to effect the change would have to be taken by a 70 percent majority.

Mr. Qureshi stated that he was in favor of the Managing Director's proposal.

Mr. Wijnholds indicated that he too could go along with the Managing Director's presumption that income in excess of the new target be added to reserves up to a ceiling of 7 or 8 percent.

Mr. Zhang, Mr. Jayawardena, and Mr. Rodríguez stated that any income in excess of the 5 percent target should be used to reduce charges.

Mr. Nimatallah said that he supported the Managing Director's proposal, together with the presumption, on the understanding that the ceiling should be 8 percent of the reserve level.

Mr. Rye stated that he was in favor of the presumption.

Mr. Hospedales commented that the disposition of any income in excess of the established target should be considered at the midterm review of the Fund's income position, with the reduction of the rate of charge being one option.

Mr. Clark stated that he could accept the Managing Director's proposal, on the understanding that the margin between 5 percent and 8 percent would be allocated to reserves.

The Acting Chairman noted that there was support for a permanent increase in the net income target to 5 percent. The decision on how to allocate any excess of income above 5 percent should be left until later in the year.

Mr. Alfidja stated that he did not want his position to be counted as accepting a permanent increase of the net income target from 3 percent to 5 percent, although apparently the required majority had been reached.

The Secretary confirmed that there was a sufficient majority to move the reserve target from 3 percent to 5 percent. There also seemed to be the necessary simple majority in favor of accepting the Managing Director's presumption that income in excess of the target be added to reserves, provided that any such unanticipated net income would not exceed an agreed ceiling of 7 or 8 percent.

Mr. Joyce asked whether the presumption would be permanent or temporary.

The Treasurer explained that both the increase in the reserve target and the presumption were meant to coexist until the Executive Board decided otherwise.

Mr. Joyce stated that he would support the presumption for one year only; it would be premature for it to be other than temporary.

Mr. Blandin agreed that he too was in favor of the presumption for only one year.

Mr. Clark suggested that in practice it would make little difference whether the presumption was permanent or temporary. The decision to be taken at the end of the year with respect to the allocation of the excess income would have to be taken by the necessary majority.

The Deputy General Counsel remarked that the adoption of the presumption would be a factor to be considered by the Executive Board when taking its decisions at the end of financial year 1986.

Mr. Zhang asked under what conditions in the future it would be reasonable to assume that the rate of charge could be reduced.

The Treasurer commented that the presumption would not have to be exercised, but it was unlikely that the Board would reverse its presumption. However, if there was a substantial excess of net income over the reserve target--if overdue obligations were eliminated and income deferred became actual income--then the surplus of net income might exceed a ceiling rate of 7 or 8 percent. Under those circumstances, it might be possible to envisage a reduction in charges.

Mr. Fugmann said that he would agree, with reluctance, to a temporary presumption--for one year--that net income in excess of the new target up to a ceiling of 7 or 8 percent should be added to reserves.

Mr. Coumbis stated his support for the Managing Director's presumption.

Mr. Fujino said that, assuming an increase in the net income target to 5 percent of reserves, he was in favor of the Managing Director's presumption.

Mr. Joyce considered that it was necessary to achieve as much equity as possible and to build a consensus that was not solely dependent on the weight of voting power. Therefore, he asked whether it could be implied, from the Managing Director's presumption, that any unanticipated net income beyond the 8 percent ceiling would be used specifically for a reduction of charges, for an increase in the remuneration coefficient, or for deeming as income for the subsequent financial year.

The Deputy General Counsel remarked that while the Board could create a presumption by a majority of the votes cast, even with respect to a decision that required a higher majority, the problem would be whether that necessary majority of 70 percent of the total voting power would be available at the end of the year.

The Treasurer added that although the presumption was not binding, it was nevertheless a moral commitment. It was a fine judgment whether a simple majority should create a moral commitment to reduce charges in a subsequent year, which would require a 70 percent majority, if the surplus were to exceed 8 percent of reserves. Prima facie, the presumption was best interpreted as leaving open the question of how to allocate any net income that might accrue beyond a ceiling of 7 or 8 percent.

Mr. Ismael stated that if the presumption were to include the notion that any unanticipated net income over the 7 percent ceiling were to be used to reduce the rate of charge, then he could support it.

The Acting Chairman observed that there was a majority in favor of an amendment to Rule I-6(4)(a), and pointed out that the Board could already make a determination under that Rule at the end of the year, if there were an excess of income above the reserve target, to reduce charges, to increase remuneration, or even to use that income to augment reserves further. Although it appeared that there was sufficiently strong support for adding net income up to a ceiling of 7 or 8 percent to reserves at the end of financial year 1986, that decision could be made following the end-of-year review of the Fund's income position. However, to write a presumption in specific language that would be incorporated into a decision at the present time would be a complicated and time-consuming process. The most convenient solution would be to take the decision to raise the reserve target from 3 percent to 5 percent and,

based on the record of the present discussion, consider the disposition of any excess income at the end of each financial year; the rate of charge would remain unchanged at 7 percent.

The Executive Board agreed to the Acting Chairman's recommendation.

The Executive Board has reviewed, in accordance with Rules I-6(4)(a) and (c), I-10(c), and T-1(d), the rate of charge on the Fund's holdings of currency, the Fund's income position, the operation of I-10(b) with respect to the remuneration coefficient, and the rate of interest on holdings of SDRs, and adopts the following decisions:

a. Amendment to Rule I-6(4)(a)

Rule I-6(4)(a) is amended, effective May 1, 1985, by replacing in the second sentence "3 percent" with "5 percent."

Decision No. 7997-(85/90), adopted
June 5, 1985

b. Rate of Charge

In accordance with Rule I-6(4)(a), the Fund determines that, effective May 1, 1985, the rate of charge on the Fund's holdings of currency covered by Rule I-6(4) shall be 7 percent per annum.

Decision No. 7998-(85/90), adopted
June 5, 1985

The Executive Board then took the following decision:

Publicity upon Declaration of Ineligibility

Effective following the publication of the Annual Report for 1985, the Fund shall issue a press release upon the declaration of a member's ineligibility to use the general resources of the Fund and thereafter upon the restoration of the member's eligibility to use the Fund's general resources, and shall also include the information contained in such press releases, where pertinent, in the Annual Report for the year concerned.

Decision No. 7999-(85/90), adopted
June 5, 1985

The Executive Directors turned to the staff papers on special charges and the legal aspects of financial remedies in connection with overdue financial obligations to the Fund (EBS/85/121, 5/13/85; and SM/85/131, 5/13/85).

Mr. Hospedales considered that the level of charges was not a major influence on member countries in their decision whether or not to meet their obligations to the Fund. The norm had been for countries to settle their obligations promptly despite the fact that it would have been to their advantage to do otherwise. The imposition, therefore, of special or penalty charges on overdue payments would not be an incentive to members to become current with the Fund in order to avoid being deemed ineligible to use Fund resources. The only consequence of such charges would be to impose additional hardship on members, thereby compounding their already difficult balance of payments and debt problems and complicating domestic and international efforts to overcome a crisis.

Mr. Schneider observed that a mechanism was needed to recover the costs to the Fund arising from delays in payments of charges and repurchases. However, in devising the mechanism the Executive Board must take care to avoid impairing members' ability to discharge their obligations. Special charges should be designed merely to recover the financial costs incurred by the Fund as a result of overdue obligations in the General Department.

The system of special charges should be free of technical and administrative complications and obstacles and should avoid increasing the problems facing member countries with substantial and deep-seated payments imbalances, Mr. Schneider continued. Accordingly, he favored the first of the four alternative systems described on pages 18-20 of EBS/85/121. The system should be applied uniformly to all member countries as soon as obligations to the Fund became overdue, and the special charges should be based on the SDR interest rate. Given the need to avoid imposing a system that would produce unintended results, special charges should not be permitted to increase over time. A system similar to the one for the General Department could be designed for overdue Trust Fund obligations.

Mr. Mtei remarked that overdue financial obligations to the Fund were a cause for concern, and appropriate means of eliminating them as soon as possible should be found. The Fund admittedly had virtually unlimited power to adopt measures it deemed necessary to recover overdue financial obligations, but the implications of such measures should be carefully considered before they were adopted. After all, members did not deliberately become overdue in their financial obligations to the Fund. Most members in arrears faced particularly difficult payments problems that would be exacerbated by the imposition of the proposed special charges. Indeed, such charges might well delay repayment to the Fund or make such repayment virtually impossible.

Instead of taking steps that would almost certainly have negative results, the Fund should help to create the conditions that would enable members to eliminate their overdue obligations, Mr. Mtei stated. The drafters of Article V, Sections 7(g) and 8(e) had foreseen that members might become overdue in their financial obligations to the Fund, and they had described the way in which such a situation should be handled. He did not intend to exercise his privilege to call for a formal interpretation of those particular provisions, but the adoption of a decision to apply the Articles in a selective manner obviously would not be helpful. Any penalty charges on overdue financial obligations would be unacceptable.

Mr. Jayawardena said that he shared the doubts expressed in the staff paper regarding the effectiveness of special charges as a means of encouraging members facing prolonged balance of payments difficulties to become current in their financial obligations to the Fund. Any system of special charges would be unacceptable. He had been increasingly concerned about the gradual transformation of the Fund from a cooperative international institution into something akin to a commercial operation.

Even if special charges were approved, some member countries would be unable to eliminate their overdue financial obligations immediately, and the additional charges and outstanding obligations would not be accrued as income to the Fund, Mr. Jayawardena remarked. Unpaid special charges might add to the burden on the Fund's membership of maintaining an adequate income position for the Fund, thereby leading to increases in regular charges.

Mr. Ismael considered that the rapid growth in overdue obligations was alarming. Although the Executive Board should presume that members were making every effort to eliminate their overdue obligations, the arrears obviously involved financial and nonfinancial costs to the Fund. It would be unfair to permit the membership at large to bear the burden of an increase in charges to offset the costs to the Fund of overdue obligations.

Of the four main reasons mentioned by the staff for imposing a special charge on overdue obligations, the most important one was the need to recover the financial costs to the Fund, Mr. Ismael continued. Since it could be safely assumed that members with overdue obligations were making every effort to eliminate those obligations as soon as possible, there was no need for a penalty or special charge specifically to encourage them to become current. A penalty sufficiently large to eliminate the concessional element in Fund credit in arrears might well prove excessively burdensome and counterproductive. The SDR interest rate was a reasonable basis on which to establish a system of special charges designed to recover the financial costs to the Fund arising from arrears. He was open to the possibility of making special charges sufficiently high to cover the cost involved in administering the system. Treatment should be uniform for all members, and special charges should

be imposed immediately after an obligation became overdue or perhaps after a short period during which any technical problems could be dealt with; that period should not be seen as a grace period.

He was not convinced that Article XII, Section 2(g) was intended to permit the Fund to impose special charges, Mr. Ismael remarked. That particular provision seemed to cover purely administrative matters. Any decision affecting the financial position of member countries should require approval by more than a simple majority.

The staff mentioned on page 4 of SM/85/131 that a participant in the SDR Department was required to pay charges on any negative balance it might have, Mr. Ismael noted, but on page 5 the staff stated that the Fund had no authority to "establish a negative balance for the participant." The staff should comment on those statements and on the possibility of applying a member's payments to the settlement of its overdue charges even when it still had overdue repurchases.

Mr. Fujino considered that a system of special charges mentioned in EBS/85/121 should reflect all the objectives mentioned in that paper. At present the Fund had no means of recovering the costs to it arising from delays in payments of charges and repurchases. That shortcoming should be rectified, and the main objective of the present discussion should be to reach a consensus on the need for a system of special charges. To that end, he generally supported the staff proposals and was prepared to be flexible in reaching agreement on the detailed aspects of a new system.

While the approach to special charges should be flexible, the charges should be sufficient to encourage members to eliminate their overdue obligations, Mr. Fujino continued. However, an excessively strong penalty at the initial stages of delays in payments of charges and repurchases could have the unintended effect of weakening members' resolution to settle their overdue obligations. Hence, for arrears in payments of charges, the special charge should be based on the SDR interest rate plus a margin and should not be increased over time. Special charges on overdue repurchases could be increased in step with the application of legal procedures to deal with such overdue obligations. However, special charges that were substantially higher than the current market rate would undermine members' efforts to eliminate their arrears rather than encourage prompt settlement. He could accept a system of graduated rates of special charges that were not well in excess of the current market rate. The Executive Board should further consider the matter of special charges as soon as possible.

Mr. Nimatallah noted that overdue payments had caused the Fund to lose income. The Fund should protect its income position by imposing special charges on overdue payments. The Fund had the legal authority to impose such charges, had done so in the past, and should do so at the present time when the situation was much more serious.

The current need for special charges was particularly great for several reasons, Mr. Nimatallah stated. It was essential for the Fund to recover the financial costs to it arising from delays in payments of charges and repurchases. At present, those costs were borne by the entire membership, thereby weakening the Fund. It was the duty of the Executive Board to take steps to recover those costs. Failure to do so would be inconsistent with sound management.

Another important objective of a system of special charges was to eliminate the concessional element in Fund credit for members in arrears, Mr. Nimatallah continued. Members with arrears were not fulfilling their obligations to the Fund; indeed, they were causing the institution considerable problems and should not be allowed to enjoy the benefit of the concessionality of overdue credit. That benefit should be reserved for members that were fulfilling their obligations, often at some sacrifice.

Another objective of special charges was to give members in arrears a clear financial incentive to repay the Fund sooner rather than later, Mr. Nimatallah commented. It was difficult to say how effective such an incentive would be. Some Executive Directors believed that special charges could encourage the elimination of arrears, but others had argued that such charges would not do so because members with arrears were unable--rather than unwilling--to repay the Fund. A system of graduated special charges could reinforce existing procedures and could be a useful deterrent to payment delays in some cases. At the least, the Executive Board should retain the flexibility to apply special charges on an ad hoc basis when member countries had been declared ineligible to use Fund resources and were clearly recalcitrant. The Fund would then have a further sanction available before initiating the serious step of requiring a country to withdraw its membership in the Fund.

He preferred the system of special charges described in paragraph c in EBS/85/121, Mr. Nimatallah stated. Special charges should begin to apply as soon as an obligation became overdue and should be increased when a decision to limit a member's use of the Fund's resources was taken and again when a member was declared ineligible to use those resources. Such a system in the General Department should be accompanied by appropriate steps to recover the financial costs to the Fund arising from members' failure to meet their obligations in the SDR Department and to the Trust Fund. The Fund would then be acting effectively to protect its income position. Special charges should not be accrued until they were actually paid. The staff should prepare specific proposals for a system of special charges, preferably by no later than end-July 1985.

Mr. Rye said that he had not yet reached final conclusions on the staff proposals. In considering them it was helpful to bear in mind two kinds of representative cases--short-term arrears caused merely by administrative difficulties, and long-term arrears that reflected serious financial problems in a member. A country with prolonged arrears was probably beyond the stage at which financial sanctions would be effective. The breakdown of a member's financial relations with the Fund

invariably had a greater effect on a member's financial relations with other creditors than any direct financial sanctions the Fund could impose. Little if anything would be gained by making a member's difficult situation even more so; special charges would merely add to the amounts already overdue. Accordingly, he was reluctant to accept cumulative or progressive special charges.

Nevertheless, the point that arrears involved financial costs to the Fund was well taken, and the fact that more than one fourth of all payments to the Fund in FY 1985 were late was worrying, Mr. Rye went on. Occasional errors leading to overpayments understandably occurred, but the experience in FY 1985 might well be taken to mean that the principle of prompt payment to the Fund had come to be lightly regarded, in which event an appropriate charge--perhaps a flat late fee--might be useful. A danger inherent in that solution was that the provision for late fees might legitimize overdue payments. Thought should be given to imposing a cumulative charge up to a certain point--perhaps upon the issuance of a complaint by the Managing Director--after which the charge would become fixed and more compelling sanctions could be imposed.

Further thought should also be given to the precise time when a system of special charges would begin to be applied to a member, Mr. Rye remarked. Presumably there would have to be a grace period, particularly where payments had become overdue through no fault of the member. Judgment would have to be exercised in deciding when to apply charges, and disputes were therefore likely to arise. In the circumstances, he wondered whether the idea of special charges was worth any further examination. Could the staff say whether it had in mind any alternatives to special charges? For instance, the date of the issuance of a complaint could be advanced, or other formal or informal steps with a deterrent effect could be taken before a complaint was issued. Additional information was needed before final conclusions on the matter of special charges could be drawn.

Mr. Salehkhoul considered that the staff papers adequately dealt with the technical and legal issues largely in the manner suggested by Executive Directors who favored imposing special charges. However, although there had been no majority view in the Executive Board in favor of introducing such charges or about their purposes and criteria, the papers concentrated on the penalty aspect of special charges and on the need to recover losses to the Fund of overdue obligations; little attention was paid to ways of tackling the causes of the overdue financial obligations. Moreover, the staff papers failed to note that eliminating the concessional element in Fund credit in arrears and imposing relatively high charges as an incentive for members to settle overdue obligations would compound the payments problems facing the members concerned while jeopardizing their efforts to solve those problems and to restore their good standing with the Fund. Financial incentives seemed irrelevant: the main reason for members' arrears to the Fund was the countries' acute shortage of foreign exchange reserves. Indeed, there was evidence that debtor members gave priority to payments to the

Fund even though it was to their advantage financially to settle more expensive obligations first. The experience with the legal actions recently taken against some members was too limited to warrant making a judgment about their effectiveness or to support the staff argument that such actions would be enhanced by the introduction of special charges.

The various possible systems of special charges described on pages 18-20 in EBS/85/121 were designed to do more than merely recover the financial costs to the Fund arising from delays in payments of charges and repurchases, Mr. Salehkhoul noted. Under the second system, the concessional element in Fund credit in arrears would be eliminated and stiff penalties could be imposed. Moreover, although the staff had referred to Article V, Section 8(e), which permitted a member to pay charges in its own currency in exceptional circumstances, the staff had argued that that provision was "not intended to overcome the Fund's lack of authority to levy charges...and could not serve as a basis for a generally applicable system designed to achieve that purpose." Payment in a member's own currency in exceptional circumstances warranted favorable consideration by the Executive Board, as it would give members time to face their payments problems and enable the Fund to recover losses arising from delays in payments. Previous discussions had clearly established the exceptional nature of the hardship and problems facing many members with overdue obligations to the Fund. The provision permitting members to pay charges in their own currency should be applicable at least to members that had clearly demonstrated their willingness to cooperate with the Fund to find a solution to their payments problems and whose reserve position precluded immediate settlement of their overdue obligations. He wondered whether that option had been used in the past and had been considered by the staff for application at least in extreme cases.

Mr. Goos said that he favored introducing special charges on overdue payments of charges and repurchases to provide an effective incentive for members to become and remain current with the Fund. Special charges would solve the problem of noncompliance by some members with their financial obligations to the Fund. All the various purposes for introducing special charges described by the staff in Section III of EBS/85/121 could be justified on the common ground that they were aimed at remedying the noncompliance of certain members with their obligations to the Fund. Accordingly, he would find it difficult to single out one or two purposes as the main objectives as requested by the staff in the concluding section of its paper. Nevertheless, his authorities attached particular importance to providing incentives for prompt settlement of overdue obligations. Since that goal would probably be achieved under all the systems of special charges the staff had proposed, he could go along with the system preferred by the majority of Executive Directors. However, introducing unduly high special charges might exacerbate the problems facing members whose overdue obligations to the Fund were a reflection of the serious economic and financial problems they faced. In those cases, unduly high charges could be counterproductive.

His first preference, Mr. Goos continued, was for a system that would provide for a uniform special charge of 2 percentage points on all overdue repurchase obligations, as described in paragraph d on pages 19-20 of EBS/85/121; his second preference was for the system described in paragraph a on page 18. Those systems should be applied uniformly to all members in arrears. At the same time, the option of imposing further charges on an ad hoc basis in particular cases should be preserved. Special charges should be applied as soon as an obligation became overdue and should be applied to outstanding and new arrears as soon as possible following the formal adoption of a system by the Executive Board. The proposals concerning the treatment of special charges in the computation of the Fund's income were acceptable.

Special charges should also be levied on overdue Trust Fund payments, Mr. Goos said, but the rates proposed by the staff for that purpose appeared too high. In considering the rate it was important to remember that special charges on overdue Trust Fund payments would have to be borne by the poorest developing countries; imposing higher special charges on those overdue obligations than on obligations that were overdue in the General Department proved difficult to justify. The options proposed by the staff in paragraphs a and d covering overdue payments in the General Department would base special charges on the SDR interest rate; charges on overdue Trust Fund obligations also should be based on the SDR interest rate.

Mr. Leonard commented that the Fund incurred financial costs arising from delays in payments of charges and repurchases. Obliging members in good standing in effect to subsidize members that were unable or unwilling to fulfill their financial obligations to the Fund was inequitable. Nevertheless, it was difficult to distinguish between overdue obligations due to a country's own decisions and arrears caused by external factors. He believed that, on balance, external factors had been the main cause of overdue obligations to the Fund. He also had difficulty in differentiating between the treatment of short-term and long-term arrears. He was not convinced that a system of special charges could effectively deal with overdue obligations, particularly large or protracted arrears. Hence, he did not favor introducing any system of special charges at present. In taking that position he wished it to be clearly understood that he continued to believe that all members should remain current in their obligations to the Fund. He was prepared to return to the matter of special charges if the situation with respect to those charges did not improve in the coming period.

Mr. Clark considered that a system of special charges could have a definite, although perhaps a limited, role to play. The proposed charges were indeed special in nature and should not be regarded as being wholly or even mainly punitive. There was a need to reinforce the signal to members that financial obligations to the Fund must be met on time and that failure to do so involved a cost to members that were current in those obligations. Members admittedly gave a high priority to meeting their financial obligations to the Fund, but there should be no possible

financial advantage in delaying payments to the institution. Indeed, members should be certain that there was a clear financial disadvantage to late payments. Hence, in principle, he could accept the application of limited special charges designed to eliminate the concessional element in Fund credit in arrears, perhaps plus a small margin.

Special charges should be levied on overdue charges, Mr. Clark said. It would be anomalous to have different treatment for overdue repurchases and overdue charges.

Any system of charges should be applied uniformly, Mr. Clark considered. Ad hoc arrangements for charges would not be appropriate. Moreover, special charges should be applied as soon as payments became overdue, although he was prepared to accept a moderate delay in the introduction of a new system so that members would have an opportunity to review their arrangements for making payments to the Fund.

He did not have a firm position on the basis for calculating special charges, Mr. Clark said. For example, special charges at a margin above the SDR interest rate, or at a premium of, say, 1 percent over the normal rate of charge, might be appropriate. He could also support a provision for future increases at a later stage in the procedures governing overdue charges, or a premium of perhaps 2 percent. The Executive Board should return to the subject of special charges on another occasion.

Mr. Dallara remarked that the volume of arrears to the Fund had been growing, and the present discussion was an indication of the heightened seriousness with which the Fund regarded the problem. An increasing amount of Executive Board time had been taken to discuss the complex issues related to arrears.

Applying special charges mainly to recover the financial costs to the Fund arising from delays in payments of charges and repurchases as outlined in the option in paragraph a on page 18 of EBS/85/121 was attractive for several reasons. In the absence of any system of special charges the obvious financial costs to the Fund from overdue obligations had to be borne by the membership at large, including lenders to the Fund and members that were remaining current in their obligations to the Fund. Roughly half the membership had outstanding financial obligations to the Fund, and the great majority of those countries were current in their obligations even though some of them faced continuing, difficult payments problems. Accordingly, introducing a system of special charges like the one described in paragraph a was desirable on the ground of ensuring equitable treatment of all members.

The other options described on pages 18-20 of EBS/85/121 were also attractive in certain respects, Mr. Dallara continued. For example, it was sensible to design a system of special charges not only to recover the cost to the Fund of overdue payments but also to eliminate the concessional element in Fund credit in arrears. However, there was some uncertainty about the likely effect of the options in paragraphs b, c,

and d. For example, he was not fully confident that they would have a substantial incentive effect on members with overdue obligations. The number of members that had briefly delayed meeting their financial obligations to the Fund was a cause for concern, and the system of special charges in paragraph a had a potentially positive incentive effect. The proposed system of special charges that was related to the legal steps that the Executive Board could take in response to members with overdue financial obligations was also attractive in certain respects but might not have a significantly positive incentive effect. Indeed, that system might well make it even more difficult for the Executive Board to reach necessary conclusions about the situation in member countries with overdue Fund obligations.

The system of special charges should be applied uniformly to all members, Mr. Dallara stated. However, acceptance of that principle should not preclude the application of further charges on an ad hoc basis. Moreover, any system of special charges should be applied both to current and future outstanding overdue obligations, although a system of special charges need not be implemented immediately after its approval by the Executive Board. A period of perhaps two months would give all members time to understand fully the implications of a new system. Finally, he looked forward to holding a more detailed discussion on the basis of comments at the present meeting.

Mr. Zhang said that while in principle he was not against imposing special charges, applying them at present would aggravate the difficult situation in many members. The question of special charges should be studied further. Any such charges should be applied only on an ad hoc basis. Finally, the staff should further study the applicability of Article V to the possible imposition of special charges.

Mr. Wijnholds considered that special charges were needed to safeguard the Fund's position and to ensure equitable treatment of members. Such charges should be designed merely to recover the financial costs to the Fund arising from overdue payments. Penalty charges would not serve a useful purpose. Indeed, they could be counterproductive. Of the various options described by the staff in EBS/85/121, only the one in paragraph a was acceptable.

Mr. Orleans-Lindsay stated that he opposed any system of special charges on overdue obligations to the Fund.

Mr. Hospedales commented that given the need to maintain the Fund's financial integrity, the growth of overdue obligations was a cause for great concern. At the same time, Executive Directors had received clear evidence of the extenuating circumstances that had led members to become overdue in their obligations to the Fund. The level of charges had not strongly influenced members to meet their obligations to the Fund. Indeed, members had typically settled their obligations promptly even though they would have reaped a financial benefit by delaying payments to the Fund. Imposing special or penalty charges on overdue payments

would not deter members from becoming overdue in their obligations to the Fund and from being deemed ineligible to use the Fund's resources. The only effect of such charges would be to impose additional hardship on members, thereby compounding their already difficult balance of payments and debt problems and complicating domestic and international efforts to solve those problems. Special or penalty charges on overdue payments to the Fund should not be imposed.

Mr. Blandin said that he hoped that a member country with overdue financial obligations would continue to give the Fund first priority in settling its obligations when its economic situation had improved. Such member countries often settled their overdue obligations to the Fund when their economic recovery was fragile. It seemed counterproductive for the Fund to impair the recovery by imposing a special charge designed to recover the financial costs to the Fund arising from delays in the members' payments. Any special charge should be applied flexibly to permit such charges to be carried forward or spread over time.

His authorities were prepared to study further the possibility of imposing special charges, Mr. Blandin remarked. Without such charges member countries in arrears to the Fund would have a financial advantage over members that remained current in their obligations to the institution. His authorities had not reached a firm conclusion on the precise system of special charges that would be most appropriate. The question of special charges should be brought back to the agenda on another occasion.

Mr. Rodríguez considered that special charges required further careful examination by the staff and the Executive Board. The recent increase in overdue obligations to the Fund was a cause for concern. Overdue payments undermined the credibility of the Fund and Fund-supported adjustment programs and damaged the institution's financial position. However, the imposition of the proposed special charges would merely complicate the efforts of members to solve critical balance of payments problems. Special charges would increase the burden of outstanding payments on members, thereby reducing their ability to repay the Fund. In the present circumstances, the imposition of any special charges would be inappropriate.

The Treasurer said that the imposition of special charges would not lead to an increase in the charge for ordinary resources because the income from special charges would not be included in the projections of the Fund's income. Collected special charges would be an addition to the Fund's originally estimated income. Uncollected special charges would not worsen the Fund's income position. The staff had suggested that special charges should be accrued just as ordinary charges were. Accordingly, for the purposes of accrual, unpaid special charges would not adversely affect the Fund's income. In the absence of decisions to exclude special charges from income projections and to treat special charges like ordinary charges for accrual purposes, special charges could lead to an increase in the charge on ordinary resources that might

otherwise be unnecessary. In any event, it was inequitable for members to gain a financial benefit from delaying payments to the Fund while other members made every effort to remain current in their obligations.

It was difficult to say whether the increasing volume of overdue obligations to the Fund was an indication that members were not taking their obligations to the Fund as seriously as they should, the Treasurer remarked. Members clearly were less committed than hitherto to paying the Fund on time. In earlier years members had faced difficult payments problems but had made the effort to remain current in their obligations to the Fund. At the same time, it could be argued that conditions in many member countries in recent years had been more difficult than conditions in earlier years. It could also be argued that member countries that had a scarcity of reserves and had to limit their payments of overdue obligations would naturally feel a particular incentive to settle overdue obligations to which a special charge was attached. Ideally, the authorities of a member in arrears to the Fund would give priority to settling those arrears because the Fund was a collaborative institution, rather than because there was a financial incentive to pay. In fact, however, reserve managers with various overdue obligations might well be tempted to decide to delay settling the least costly of the obligations, although the staff doubted whether that was a strong argument in favor of special charges.

The staff had assumed that the present discussion would be a preliminary one, the Treasurer remarked. Accordingly, the staff papers did not contain proposed decisions. As the staff understood it, the Executive Directors would wish to return to the subject of special charges on another occasion.

Since the adoption of the Second Amendment no member had been allowed to pay charges in its own currency, the Treasurer said.

The Deputy General Counsel, in response to an earlier comment, said that Article XII, Section 2(g) gave the Board of Governors and the Executive Board authority to adopt such rules and regulations as might be necessary or appropriate to conduct the business of the Fund. That business was not limited to such matters as the administration of the staff; it encompassed all the Fund's transactions and operations.

The proposed "special charges" that were to be applied to those members that had failed to pay their regular charges would not be genuine charges in the same sense as that word is used in the Articles, the Deputy General Counsel explained. The proposals provided for the collection of damages to the Fund under the name of "special charges." The "special charges" did not constitute a new legal obligation. Ordinary charges had been properly levied under Article V, Section 8 on the basis of decisions taken by the required 70 percent majority of the total voting power. The failure by a member to pay those charges not only deprived the Fund of the income and caused damage to the Fund but was beneficial to the member in that it continued to earn income on the

amount it should have paid to the Fund. Under all systems of law there was an obligation to make good the damage caused by the failure to fulfill a legal obligation. From the viewpoint of both the member and the Fund, making good the damages caused by the member's failure to fulfill its outstanding obligation to the Fund did not constitute a new obligation in any sense. The assessment of those damages to the Fund under the name of "special charges" was merely the method by which the member would fulfill its outstanding obligations to the Fund.

Article XX, Sections 1-4 dealt with charges, interest, and assessments in the SDR Department, the Deputy General Counsel explained. The Fund was required to pay interest due to holders of SDRs whether or not it received sufficient amounts in charges to meet those payments; thus, if the amount of SDRs in a participant's account was insufficient to meet its charges due to the Fund, the Fund was obligated to create an amount of SDRs equal to the shortfall. At the same time, the relevant Article provided that the same member would have to apply its subsequently acquired SDRs to the settlement of the negative balance created by its overdue charges. The Articles did not provide for a similar arrangement if the amount of SDRs in a participant's account was insufficient to pay the assessment levied on the participant for its share in covering the General Department's costs in running the SDR Department. However, the different treatment of interest and assessments in the SDR Department was not an oversight: the drafters of the First Amendment had assumed that assessments on participants would be very small and that participants would be able to acquire the needed amounts if they had zero balances. In any event, a special provision similar to the one governing interest in the SDR Department had not been considered necessary. As a result, the General Department could sustain losses if the Fund was not permitted to offset the effects of a participant's inability to pay the assessment levied on it. The staff proposals could overcome the anomaly of the different treatment of assessments, interest, and charges in the SDR Department.

The Treasurer said that since the adoption of the Second Amendment the possibility of permitting a member to pay charges in local currency had been considered by the Executive Board in one or two special cases. In those instances, some Executive Directors had raised the question of whether there were not special circumstances that should lead the Fund to permit payment of charges in local currency. In each case, the Executive Board had decided not to use that option. There had never been a general discussion of the option; there was no Executive Board decision permitting that option to be applied.

The Deputy General Counsel added that under the original Articles members had paid charges in gold, unless a member's reserves were less than half of its quota, in which event the member paid in gold only that proportion of the charges that the amount of its reserves bore to one half its quota, and the remainder was paid in its own currency. Hence, before the adoption of the Second Amendment, members with very low reserves had been able to pay charges both in their own currency and

in gold. Subsequently, under the Second Amendment, charges were not collected in gold, but rather were to be paid in SDRs. At the same time, provision had to be made for members who were not yet participants in the SDR Department to pay charges in assets other than SDRs. That provision might also have reflected the feeling that a return to the system similar to that under the original Articles was still conceivable.

The Acting Chairman remarked that Executive Directors' comments clearly showed that there was interest in considering the issue of special charges. The staff would prepare an additional paper on the subject based on the present discussion.

The Executive Directors concluded for the time being their consideration of special charges on overdue obligations to the Fund.

APPROVED: March 25, 1986

LEO VAN HOUTVEN
Secretary