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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/90

11:30 a.m., June 8, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
F. Cassell	
	Jiang H.
	E. L. Walker, Temporary
	J. Prader
	G. Seyler, Temporary
A. Donoso	E. V. Feldman
	M. B. Chatah, Temporary
	B. Goos
J. E. Ismael	J. Reddy
A. Kafka	J. R. N. Almeida, Temporary
M. Massé	D. McCormack
	J.-C. Obame, Temporary
	P. D. Péroz, Temporary
	L. Filardo
	M. Fogelholm
	G. Pineau, Temporary
G. A. Posthumus	
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
	A. Vasudevan, Temporary
	S. Yoshikuni
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
M. J. Primorac, Assistant

Also Present

Administration Department: P. J. McClellan. European Department: M. Huybrechts. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; S. B. Brown, R. L. Sheehy. External Relations Department: B. J. Mauprivez. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, General Counsel; R. H. Munzberg, Deputy General Counsel. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, D. H. Brown, J. C. Corr, D. Gupta, S. J. Fennell, R. B. Hicks, B. E. Keuppens, J. A. McLaughlin, G. Wittich. Office of the Managing Director: A. N. Guerrero. Advisors to Executive Directors: S. M. Hassan, K.-H. Kleine, J. E. Zeas. Assistants to Executive Directors: N. Adachi, S. Appetiti, A. A. Badi, D. Barr, R. Comotto, E. C. Demaestri, V. J. Fernández, J. Gold, S. Guribye, M. Hepp, L. Hubloue, C. Y. Legg, T. Morita, W. K. Parmena, L. M. Piantini, A. Rieffel, S. Rouai, C. C. A. van den Berg.

1. ESAF TRUST - LOAN ACCOUNT - BORROWING AGREEMENTS; SUBSIDY ACCOUNT - INVESTMENTS AND ESTABLISHMENT OF ADMINISTERED ACCOUNT

The Executive Directors considered staff papers on borrowing agreements with the Bank of Spain (EBS/88/101, 5/25/88), the Bank of Thailand (EBS/88/110, 6/6/88), and the Government of Canada (EBS/88/105, 5/26/88) for the Loan Account of the ESAF Trust; an agreement for investment by Bank Negara Malaysia with the ESAF Trust Subsidy Account (EBS/88/93, 5/17/88); and the establishment of an administered account for a contribution to the ESAF Trust Subsidy Account by the Austrian National Bank (EBS/88/106, 5/13/88). They also had before them a paper updating the status of contributions to the enhanced structural adjustment facility (EBS/88/111, 6/6/88).

Mr. Prader said that, from the beginning, his authorities had been eager to support the Managing Director's initiative for the enhancement of the structural adjustment facility because they felt that the underlying objective of promoting adjustment with growth in the poorer member countries had a better chance of being attained through the enhanced structural adjustment facility than through the means that had previously been available to the Fund. Accordingly, Austria had been among the first countries to respond to the Managing Director's request with a financial commitment.

The late Governor of the Austrian National Bank, Stephan Koren, had esteemed the role of the Fund and the Managing Director's initiative very highly, and he should receive much of the credit for forming Austria's views on the enhanced structural adjustment facility and on the need for an early commitment, Mr. Prader noted.

In its final form as being presented to the Board, the arrangement for Austria's contribution to the enhanced structural adjustment facility took account of the difficulties generally encountered by central banks wishing to participate in innovative schemes that went beyond the established institutional patterns of monetary cooperation with the Fund, Mr. Prader said. The Austrian authorities were grateful for the Fund's open and constructive approach to the specific institutional problems of enhanced structural adjustment facility participants, an approach which had made it possible for the latter to choose among various technical arrangements. His authorities would also like to thank the staff for their cooperative spirit and for their expertise in finding compromises capable of solving the technical problems that were encountered during the design of the arrangement.

The arrangement would be submitted to Parliament in the fall of 1988 so that the proposed deposit could be made on time, Mr. Prader concluded.

Mr. Abdallah said that he welcomed the current discussion on the status of the enhanced structural adjustment facility and the updated information regarding contributions to the Loan Account and Subsidy Account of the ESAF Trust. The countries in his constituency wanted to express their appreciation to the authorities of Malaysia, Spain, Canada, Austria, and Thailand for their contributions to the financing of the enhanced structural adjustment facility. They hoped that procedures in countries requiring legislative authority would be completed shortly, in order to make the agreements effective as soon as possible. His authorities viewed the contributions as a true reflection of the spirit of cooperation among the members of the Fund in helping those among them who were in difficult situations. It was in the same spirit that he would like to urge, once again, those members who had so far not contributed to the financing of the facility to do so. His authorities were grateful to the management and staff for their continued discussions with donors and lenders in seeking additional loans and subsidy contributions.

While he appreciated the importance and priority of the management and staff attached to enhanced structural adjustment facility operations in the work program, Mr. Abdallah said that he was concerned that almost half a year of the three-year lifetime of the enhanced structural adjustment facility had passed with no program under the facility being considered by the Executive Board. He had in mind the experience under the structural adjustment facility, which was currently in its final year with less than one fourth of the total resources having been disbursed. He was encouraged to note that initial disbursements of enhanced structural adjustment facility loans could be made shortly, and urged the staff to speed up its contacts with potential users of the enhanced structural adjustment facility so as to enable them to make timely use of the available funds in support of their adjustment efforts.

He could support the proposed decisions, Mr. Abdallah concluded.

The Executive Board then took the following decisions:

a. <u>ESAF Trust - Bank Negara Malaysia - Subsidy Account - Investment</u>

Pursuant to Section IV, Paragraph 3 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement and promissory note for an investment by Bank Negara Malaysia with the Subsidy Account of the Trust in terms of the draft agreement and promissory note set out in Attachments I and II to EBS/88/93, and authorizes the Managing Director to take such action as is necessary to conclude and implement the agreement and issue the promissory note.

Decision No. 8892-(88/90) ESAF, adopted
June 8, 1988

b. ESAF Trust - Bank of Spain - Loan Account - Borrowing Agreement

Pursuant to Section III, Paragraph 2 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement for borrowing from the Bank of Spain in terms of the draft set out in the Attachment to EBS/88/101, and authorizes the Managing Director to take such action as is necessary to conclude and implement the agreement.

Decision No. 8893-(88/90) ESAF, adopted
June 8, 1988

c. ESAF Trust - Government of Canada - Loan Account - Borrowing Agreement

Pursuant to Section III, Paragraph 2 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement for borrowing from the Government of Canada in terms of the draft set out in the Attachment to EBS/88/105, and authorizes the Managing Director to take such actions as is necessary to conclude and implement the agreement.

Decision No. 8894-(88/90) ESAF, adopted
June 8, 1988

d. ESAF Trust - Austrian National Bank - Establishment of Administered Account

1. Pursuant to Article V, Section 2(b), at the request of the Austrian National Bank (the "Bank") as set forth in its letter dated May 27, 1988 (Annex II), the Fund adopts the Instrument to establish an Account for the administration by the Fund of a deposit to be provided by the Bank on the terms and conditions set forth in the Instrument that is annexed to EBS/88/106 (Annex I).

2. The provisions of the Instrument may be amended only by a decision of the Fund and with the concurrence of the Bank.

3. Pursuant to Article V, Section 2(b), the Managing Director is authorized to accept the proposal by the Bank to deposit to the Account an amount in the equivalent of SDR 60 million on a value date to be agreed between the Fund and the Bank, but in any case not later than January 1, 1989 (Annex III, EBS/88/106). The deposit shall be administered in accordance with the provisions of the Instrument adopted under

paragraph 1 of this decision. The agreement between the Fund and the Bank is subject to a special Austrian Enabling Act. It shall enter into effect on the date on which the Fund acknowledges receipt of the communication by which the Austrian National Bank notifies the Fund of the completion of the required legislative procedures.

Decision No. 8895-(88/90) ESAF, adopted
June 8, 1988

e. ESAF Trust - Bank of Thailand - Subsidy Account - Investment

Pursuant to Section IV, Paragraph 3 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement and promissory note for an investment by the Bank of Thailand with the Subsidy Account of the Trust in terms of the draft agreement and promissory note set out in Attachments I and II to EBS/88/110, and authorizes the Managing Director to take such action as is necessary to conclude and implement the agreement and issue the promissory note.

Decision No. 8896-(88/90) ESAF, adopted
June 8, 1988

2. INCOME POSITION FOR FY 1988 AND FY 1989 - REVIEW; AND RATE OF CHARGE AS OF MAY 1, 1988

The Executive Directors considered staff papers on the review of the Fund's income position for financial years 1988 and 1989 (EBS/88/81, 4/12/88), and on the actual outcome for FY 1988 and the basic rate of charge for FY 1989 (EBS/88/81, Sup. 1, 5/27/88).

Mr. Abdallah said that he was in agreement with the thrust of the staff recommendations, but wished to make one proposal. While the income proposed by the staff for FY 1989 could be aimed at, the portion earmarked as target income should be slightly reduced in order to bring down the basic rate of charge moderately while increasing the adjustable portion that was related to burden sharing for generating the precautionary balances.

Borrowing countries were going through a difficult period, with some countries carrying extremely heavy external debt service burdens, especially with respect to those obligations to multilateral institutions that could not be rescheduled, Mr. Abdallah went on. What such countries needed most, therefore, was an easing of that burden whenever it could be secured. The staff had recommended that with the income target of

5 percent to be added to reserves in FY 1989, a basic rate of charge of 5.33 percent would be required. He did not agree with the suggestion that the rate could be raised to 5.5 percent.

It was well known that, in addition to the basic rate of charge of 5.33 percent, there would be an adjustment based on the principles of burden sharing between creditors and borrowers, generating another 5 percent to be added to the Special Contingent Account; a second adjustment to generate SDR 11.3 million, which was the shortfall from the target income of FY 1988; and other adjustments for charges that would be deferred in the course of FY 1989, Mr. Abdallah said. In the final analysis, therefore, the adjusted rate of charge for FY 1989 could well be above 6 percent.

The departure from the target for net income of 3 percent of reserves that was normally aimed at until only recently was due primarily to precautionary balances that had been added progressively to general reserves and to the Special Contingent Account as a result of the continuing problem of overdue financial obligations, which were most worrisome, Mr. Abdallah recalled. As action-oriented proposals were being formulated for presentation to the forthcoming meeting of the Interim Committee, it was advisable not to take further action until the new proposals were considered by the Board.

In the meantime, the Fund should return to a net income target of 3 percent, with burden sharing of the precautionary amount additional to that, Mr. Abdallah said. In fact, a number of Directors had recommended a return to that target income on the occasion of the review of the implementation of the principles of burden sharing. In terms of FY 1989, burden sharing would apply to 7 percent of reserves, instead of 5 percent, thus leading to some reduction in the basic rate of charge.

Mr. Goos reiterated his concern about the actual shortfall in the income target, which was in rather stark contrast to the increasing strains on the Fund's financial position. Every effort should be made to avoid a recurrence of such a shortfall.

He was in broad agreement with the analysis presented in the paper on the basic rate of charge to be set for the current financial year, Mr. Goos indicated. He could also support the staff's view that it would be advisable to add a margin to the calculated rate of charge, so as to take account of the substantial uncertainties surrounding the projections including, in particular, possible increases in the SDR interest rate. He even considered that it would be prudent to provide for a higher margin than proposed by the staff by setting the basic rate of charge at, say, 5.7 percent--a rate which would be consistent with the high sensitivity of net income to small changes in the SDR interest rate. He understood that an increase in the SDR interest rate by 10 basis points would reduce net income by $13 million. A higher rate of charge would also be appropriate in view of the income shortfall suffered by the Fund the previous year. The existing decision to use any excess income to retroactively reduce the rate of charge for FY 1989 should make it possible for borrowing members to accept such a higher rate in the interest of protecting the financial integrity of the Fund.

Mr. Pineau said that the disposition of excess income for FY 1988 had already been taken care of through a retroactive reduction in the rate of charge. The decision made the previous month also provided for a transfer of deferred charges not covered by burden sharing from FY 1988 to FY 1989. Such a carrying over would add to the constraints under which burden sharing had to work. That implied that, when necessary, new steps would have to be contemplated to facilitate a satisfactory working of the principles of burden sharing, including a lowering of the 85 percent floor on the rate of remuneration.

The staff suggested that the basic rate of charge for FY 1989 be set at 5.50 percent, Mr. Pineau observed. That implied a 17 basis point margin above the 5.33 percent that was the basic rate of charge required to generate the net income target under customary assumptions. If his calculation was correct, a 17 basis point increase would give rise to excess income equivalent to SDR 29.4 million. In other words, the actual net income target would be 7.3 percent of reserves, instead of 5 percent. He was aware that, in 1988, a compromise had been reached on a basic rate of charge higher than what had been strictly necessary to achieve the income target. However, considering the substantial excess income that had had to be refunded to debtor countries at the end of FY 1988, partly because the basic rate of charge had been set too high, his preference was to retain the rate of 5.33 percent as calculated.

Mr. Zecchini asked the staff to confirm Mr. Pineau's estimate of the excess income that would be generated if the rate of charge as proposed by the staff were approved.

The Treasurer indicated that, assuming that the SDR interest rate and market rates remained constant, and given the assumptions with regard to the use of Fund resources, excess income would indeed be achieved with a basic rate of charge of 5.50 percent. However, as the staff had indicated in the paper, there were certain uncertainties being faced by the Fund with regard to the development of the SDR interest rate--the largest uncertainty to which the financial situation of the Fund was exposed.

Mr. Ismael said that he was basically satisfied with the financial outcome for FY 1988. The precautionary balances accumulated during that year came to SDR 109.5 million, which increased the total precautionary balance to SDR 1,344.1 million, an improvement that had strengthened the Fund's ability to deal with the problem of overdue obligations.

The main issue to be decided at the current meeting was the rate of charge to be applied for FY 1989, Mr. Ismael noted. Based on the net income target adopted by the Board, the basic rate of charge would have to be established at 5.33 percent in order to generate a net income of

SDR 63.4 million. He considered that the rate of charge should be established at 5.33 percent for at least three reasons. First, that was the outcome of the accepted method of determining charges after allowing for reserve accumulation of 5 percent. Second, it was premature to assume that the interest rate risks were only in one direction--upward. Third, the Fund had an established procedure for a midyear review, which could be used to make whatever adjustment was necessary to the rate of charge as experience was gained in the first six months of FY 1989. In view of the foregoing reasons, he supported the establishment of the basic rate of charge for FY 1989 at 5.33 percent.

Mrs. Walker observed that the staff had calculated, in the usual procedure, the rate of charge that would be necessary to meet the Fund's income target, based on projections for a number of variables affecting Fund income in the coming fiscal year. Those projections, of course, were subject to a wide margin of error. The calculated rate of charge based on those assumptions would be 5.33 percent; however, the staff had urged the Board to be on the safe side and set the rate of charge slightly higher--at 5.5 percent--in order to be more conservative and help ensure that the Fund did meet its income target.

Setting the rate of charge slightly higher than was actually necessary based on current estimates for FY 1989 income was, in her chair's view, a prudent course of action, Mrs. Walker continued. Indeed, she agreed with Mr. Goos that it might be safer to go somewhat higher than 5.5 percent, up to 5.7 percent--the current SDR interest rate--in order to provide a somewhat greater assurance that the Fund would meet its income target. First, there was considerable uncertainty in many of the variables used to project Fund income for FY 1989, particularly interest rates; and second, her chair did not wish to see the Fund fall short of its income target as had occurred in the previous year.

While it might not be appealing to some Directors to take a moderately more conservative approach to financial planning than suggested by the staff, there were two factors that should mitigate their concerns, Mrs. Walker indicated. First, the Board had already agreed in the context of the burden-sharing arrangement to return any excess income that might be generated to the debtors at the end of the year. Second, it would be a much more prudent course of action to meet the Fund's income target for FY 1989 than to be faced with a deficit at the end of the year and have to make up the difference the following year, which might require an even higher rate of charge.

She was broadly satisfied with the financial outcome for FY 1988, particularly the strengthening of the Special Contingent Account, Mrs. Walker said. In that connection, she was aware that the World Bank was in the process of taking some new decisions on its reserves and provisioning procedures and she would be interested in receiving information and analysis on those decisions at the upcoming Board meeting reviewing the Fund's arrears problem.

Mr. Seyler observed that the previous year's decision to increase the proportion of the Fund's income target subject to burden sharing was putting additional strain on the system, since the floor of the remuneration coefficient had been reached. In that connection, he noted that increasing the resources of the Special Contingent Account had been given priority over increasing the Fund's reserves. Even though there was no direct link between the Special Contingent Account and overdues, the priority assigned to the Account could give the impression that the Fund was provisioning. In any case, it was a step in the opposite direction from the course originally set when the Board decided to allocate only the excess income from FY 1987 to the newly created Special Contingent Account. Of course, the question of whether or not priority should be given to the Special Contingent Account during the distribution of disposable income would not even have arisen, were it not for the emergence of shortfalls in the Fund's income position.

He was aware that those income shortfalls could be eliminated by lowering the floor of the rate of remuneration to 80 percent, Mr. Seyler went on. He would oppose a proposal to do that, however, because any such move would be perceived by the financial community as a sign that the Fund was having increasing difficulty in coming to grips with the arrears problem. At the same time, he failed to see how the quality of the Fund's asset portfolio could be improved if a still heavier burden were placed on the Fund's debtors through a higher rate of charge. The Board should avoid the temptation to overreact to the current situation by increasing the already high income target even more.

His chair continued to favor an income target of 5 percent of reserves, with an amount equal to an additional 5 percent of reserves to be generated by the burden-sharing mechanism, Mr. Seyler stated. If it turned out to be impossible to reach the latter target through burden sharing because of adverse developments in the area of overdues, he would prefer to deliberate further and have the Board meet again before making a decision.

On the question of the basic rate of charge, he could go along with the proposed 5.5 percent figure, which was slightly higher than the calculated rate but should help cushion the Fund against unforeseen contingencies, Mr. Seyler indicated. In any event, if there should be any excess income at the end of FY 1989, the rate of charge would be lowered retroactively, as had been done most recently at the end of FY 1988.

Mrs. Filardo made the following statement:

> This chair, notwithstanding the importance it places on the problem of overdues, is opposed to the general principle of raising precautionary balances as the major response to arrears. In its paper, the staff considers that an addition to precautionary balances in FY 1989 of a similar magnitude as had been made in FY 1988 would be warranted, and from that amount half should be added to the Special Contingent Account and to

reserves at the beginning of the financial year. As the staff has always stated, the income projections are surrounded by uncertainties, as can be noted from the differences observed between EBS/88/81 and its Supplement 1. Accordingly, we should not prejudge a continued increase in arrears. The decision related to this matter should be taken at the end of FY 1989, when the results for the year are finally known. The Fund should not give the impression that it is about to acknowledge an impairment of the value of its overdue claims, an unacceptable position to this chair, which therefore cannot support the proposal.

Regarding the rate of charge for FY 1989, in the decision related to burden sharing it was agreed that the Fund's income target for FY 1989 would be 5 percent of the Fund's reserves at the beginning of the financial year; that the remuneration coefficient would be maintained at 85 percent; and that if the remuneration coefficient reached the floor in any quarter, a review by the Board would be held. It was also agreed that if large shortfalls occurred, the Board would have the flexibility to adjust the remuneration coefficient to below 85 percent, subject to the limitation of 80 percent as set out in the Articles of Agreement.

In this regard, I have several questions for the staff. First, in EBS/88/81 it is stated that "on present indications, it seems likely that charges deferred during the quarter ending April 30 would exceed the amount that can be financed by a simultaneous and symmetrical adjustment of the rate of charge and the rate of remuneration. It would then be necessary for the Executive Board to review the situation in accordance with Section V, paragraph 2(f) of the decision on "Principles of Burden Sharing." The staff will report the actual amount of deferred charges and propose alternative courses of action for consideration by the Executive Board promptly after the end of the financial year.

In EBS/88/81, Supplement 1, the staff informs us that the actual net income at the end of FY 1988 was 4.1 percent of reserves, as a result of various adjustments, among which was the deferred charges of SDR 11.3 million. Does that amount of net income have to be adjusted according to the principle of burden sharing in order to reach the 5 percent that has been established? If, in the view of the staff, the remuneration coefficient floor has been reached, would it be necessary to review it? On the remuneration coefficient itself, could it not be adjusted to an amount lower than 85 percent, subject to the limit of 80 percent established in the Articles of Agreement? Why should we increase the rate of charge instead?

The staff has made a projection of Fund income by deeming the shortfall in deferred charges in the last quarter of FY 1988 as deferred charges in 1989, which results in a rate of 6.17 percent. It has estimated the basic rate of charge at 5.33 percent. A third alternative is to increase the basic rate to 5.5 percent as a cushion against unforeseen developments. If the proposal is to increase the rate of charge arbitrarily, we cannot go along with the proposal. We cannot accept prejudgment of a future situation that is difficult to assess.

Mr. Almeida said that he agreed with the staff that it was very difficult to provide objective criteria or even compelling arguments for any specific level of precautionary balances. However, the staff was aiming at an addition of precautionary balances for FY 1989 of a similar magnitude to that reached for FY 1988. Borrower countries had paid an additional 63 basis points for burden sharing in FY 1988 and were currently very vulnerable. It was therefore important for the Fund to show sensitivity to their difficulties by reducing interest rates as much as allowed by prudent standards. Consequently, he agreed with the staff suggestion that the rate of charge be reduced to 5.33 percent, which was the rate needed to achieve the net income target for FY 1989 of 5 percent of reserves at the beginning of the financial year.

Mr. Obame said that although he understood that the financial outcome of FY 1988 was due to a number of factors that were, to a certain degree, offsetting, it was nevertheless gratifying to note that the actual net income for that year was far in excess of target. In dealing with that excess amount, in accordance with his chair's previous statement as well as with the Board's decision at EBM/88/12, 1/29/88, regarding disposition of additions made to the Special Contingent Account in FY 1988, he considered that those additions should be returned to those who had contributed by paying increased charges.

The net income for FY 1989 would be on the order of SDR 209 million, or SDR 134 million in excess of the target, Mr. Obame noted. On the question of additions to the Special Contingent Account and to the Fund's reserves, he reiterated his chair's position on the need for the Fund, as a financial institution, to strengthen its financial position. Therefore, he could generally continue to support steps and measures taken in that respect.

However, the level of, and additions to, those balances should continue to be a matter of judgment and should not be linked to specific criteria, Mr. Obame went on. In particular, any attempt to establish a direct link between the level of precautionary reserves and the level of overdue obligations to the Fund should be avoided. While he shared the concerns regarding the increase in arrears, he did not consider that the solution was to impose higher charges on debtor countries. Since the problem of overdue obligations was concentrated on only a few countries, his chair continued to believe that every coordinated effort should be made to help those countries build up their economies and discharge their obligations.

In any case, if the majority of the Board agreed on a further strengthening of the precautionary reserves in FY 1989, his chair could broadly endorse the proposal made by the staff, Mr. Obame stated. However, he would have preferred a return to the net income target of 3 percent, with burden sharing of the precautionary amount beyond that. Such a policy would have led to some reduction in the basic rate of charge. His chair could agree to set the current basic rate of charge of 5.33 percent for FY 1989 as calculated by the staff.

Mr. Cassell remarked that the recommendation to increase the basic rate of charge from 5.33 percent to 5.5 percent was in line with the Board's decision of the previous year, but one had to ask whether it was appropriately prudent in light of interest rate uncertainties. While he did not want to add unnecessarily to the rate of charge, it was likely that interest rates would increase, rather than decrease. Therefore, the staff recommendation of 5.5 percent was the minimum that his chair could prudently support, since that would only cover an increase in the interest rate of 20 basis points. A provision of that sort could help to smooth the evolution of the rate of charge in the coming financial years, and if the additional amount were not required, it would certainly be reimbursed to the debtors. Although adjustments could be made at the midyear review, it was preferable to err on the side of prudence. He would be prepared to support a higher rate of charge, such as 5.7 percent as mentioned by Mr. Goos and Mrs. Walker.

Mr. Yoshikuni said that the rate of charge in effect at the end of FY 1988--6.17 percent--was higher than necessary to achieve the targeted level of income as determined in April. On the other hand, given the uncertainty of the staff's assumptions, particularly in the area of interest rates, the rate of charge should be set higher than the calculated 5.33 percent. He supported the proposal of Mr. Goos to set the rate at 5.7 percent, although he could go along with the majority as long as that view did not differ significantly from Mr. Goos's proposal.

Mr. Salehkhou indicated that he could support a basic rate of 5.33 percent for FY 1989. The Board had laboriously reached a decision regarding the method of determining the rate of charge and remuneration, and that decision should be respected. There was therefore no need, at the current time, to increase the rate of charge to 5.5 percent, all the more so since the Board continued to regularly review the Fund's income position.

He reiterated his chair's position that setting rates of charge and remuneration on the basis of an unrealistically high income target was most unfair to, and in fact penalized, those member countries that managed to discharge their obligations to the Fund on a timely basis despite the tremendous difficulties that they continued to face, Mr. Salehkhou went on. Among the disadvantages of the system was the asymmetry inherent in Rule I-6(4), in that there was a floor for the rate of remuneration, while the rate of charge had no ceiling and therefore could easily be increased.

He also continued to support the current practices by which amounts in excess of the net income target were used to retroactively reduce the rate of charge, Mr. Salehkhou said. Any reversal of that practice would considerably worsen the already inequitable system for setting the rates of charge and remuneration. In order to make the system equitable and more acceptable to debtor countries, the Board should impose a ceiling on the rate of charge, or find ways to reduce the rate of remuneration below the floor of 85 percent of the SDR interest rate.

Mr. Vasudevan recalled that the Board had already addressed, in previous discussions, a number of issues that had an important bearing on the income position for FY 1989. The only matter that remained to be resolved was to fix the basic rate of charge for FY 1989 in order to attain the net income target of 5 percent of reserves at the beginning of the year. The staff had indicated that under the customary assumption of a constant SDR rate of 5.7 percent throughout the year, the net income target could be realized with a basic rate of charge of 5.33 percent, a rate of charge which he would support. The argument that the Fund should be cushioned from unforeseen developments in the SDR interest rate by setting a higher basic rate of charge had little basis in current economic conditions. That argument had been advanced every year, but SDR interest rates in the past three years had been declining. Analytically speaking, it was difficult to argue that SDR interest rates would necessarily move upward in the future.

More important, policy coordination efforts in the major industrial countries involved interest rate coordination in such a manner that helped sustain their adjustment efforts, Mr. Vasudevan continued. In that context, determination of the basic rate of charge above the level consistent with the staff's calculation would give the wrong signal that interest rates would increase. It might also be incorrectly interpreted that the Fund had no confidence in the interest rate coordination efforts of the major industrial countries--an interpretation that should be guarded against. The income position was well protected by the basic rate of charge of 5.33 percent, and if the realizable net income were reduced significantly because of that basic rate, the problem could be addressed at the time of the midyear review--which had been provided for in the rules precisely for the purpose of taking care of unforeseen developments. For those reasons, he strongly urged Directors to support a basic rate of charge of 5.33 percent for FY 1989.

Mr. Sliper said that he supported the staff proposal of 5.5 percent as the rate of charge for FY 1989. The question came down to a matter of judgment and weighing the risks in the various assumptions upon which the calculations were based. His chair's original reaction had been to support a somewhat higher rate of charge than 5.5 percent, for the reasons advanced by Mrs. Walker and Mr. Goos, especially given the risks attached to the SDR interest rate. However, upon reflection, he had come to the view that the staff proposal of 5.5 percent struck a reasonable balance among the various risks identified in the paper. The proposal was reasonable given the other contingency mechanisms that existed, particularly since the matter could be reviewed once again at the time of the midyear review.

Mr. Donoso recalled that in FY 1988 the Fund was unable to meet its income target because of the floor to the remuneration coefficient. As a result, there developed a preference for accumulating resources in the Special Contingent Account, to which the equivalent of 5 percent of reserves was deposited, instead of accumulating resources in the form of reserves. If that were the preferred situation, the target net income should perhaps be lower, with resources being accumulated at a faster rate in the Special Contingent Account. However, if the trend were only a transitory and undesired consequence of the floor to the remuneration coefficient, then that should be reviewed. He looked forward to discussing that in the Board's next review of the burden-sharing mechanism.

As to the rate of charge for 1989, he favored a rate of 5.33 percent with retroactive adjustment if the net income target of 5 percent of reserves were exceeded, Mr. Donoso stated.

Mr. McCormack noted that the main issue to be resolved was the rate of charge for FY 1989. He agreed that it would be prudent, in view of the uncertainties, to set a somewhat higher basic rate of charge than the exact calculated rate, in order to cushion the Fund from unforeseen developments. He could agree, therefore, to a rate of 5.5 percent, as suggested by the staff. It was a question of judgment whether a somewhat higher figure would be warranted. On the one hand, one did not wish to risk overkill, while on the other hand, he was sensitive to the considerations advanced by Mr. Cassell, and could go along with a slightly higher figure were a consensus to that effect to emerge in the Board. In doing so, he attached importance to the fact that, were income to be in excess of the target amount, the rate of charge could be reduced retroactively.

Mr. Chatah said that he preferred the basic rate of charge for FY 1989 to be set at 5.33 percent. While there was always a degree of uncertainty in the forecasts, he preferred as a matter of principle to set the rate at the level that would lead to the agreed income target, given that a safeguard mechanism existed in the system. If the safeguard mechanism were not sufficient in the view of the Board then it was that, and not the rate of charge, that should be discussed.

He did not dispute the fact that the rate at the end of FY 1988--6.17 percent--would be carried over automatically to FY 1989 in the absence of a Board decision, Mr. Chatah remarked, since the Rules and Regulations provided that the rate of charge enforced at the end of the fiscal year was automatically carried over to the subsequent year, and the burden-sharing decision mentioned that the rate to be carried over was the rate of charge after adjustments due to burden sharing. However, there did seem to be some asymmetry in the sense that the adjusted rate was being treated as a basic rate, on top of which there would be additional adjustments. That point, as far as he could remember, had not been discussed in the Board, and he would welcome further examination of the issue in the context of a future discussion on burden sharing.

Mr. Péroz said that he could support setting the rate of charge at 5.5 percent for the reasons already stated by other Directors.

Mr. Posthumus noted that most decisions regarding income targets and the like for FY 1989 had already been taken. The only decision remaining was on the rate of charge, on which he supported the proposal, together with the supporting arguments, of Mr. Goos, Mrs. Walker, and others.

Mr. Jiang said that his authorities were very much concerned with the recent developments in the Fund's rate of charge on the use of ordinary resources. It seemed that the Fund's financial facilities had been losing their concessional nature in recent years, since the rate of charge occasionally was near or even higher than the prevailing SDR interest rate for that period. It was his chair's view that the Fund, as an international cooperative institution, should not allow the rate of charge on the use of its ordinary resources to go beyond the market rate as represented by the SDR interest rate. Based on that belief, he supported the proposal of Mr. Reddy, as put forward during the Board's review of burden sharing, that it was necessary to set a ceiling on the rate of charge equal to the SDR interest rate. Whenever it was necessary to go beyond that rate, the amount should be burden shared. That proposal was quite reasonable since there was a floor to the rate of remuneration to protect the interests of the creditor nations; the interests of the debtor members should also be protected. Also worthy of the Board's serious consideration was the proposal by Mrs. Ploix that a ceiling be set on the Fund's reserves, and that the net income target be returned to 3 percent. As for the rate of charge for FY 1989, his chair supported a rate of 5.33 percent, as calculated by the staff.

Mr. Zecchini noted that there was little ground for extensive discussions on the Fund's 1988 income position, since decisions had already been taken. The income outcome for FY 1988 reflected very closely the projections made by the staff for the last Board meeting on the income position (EBM/88/72, 5/6/88) and the decisions taken at that time, and there was no reason to change the predetermined course of action with regard to the utilization of the excess income.

On the projections for FY 1989, the staff paper called for a decision with regard to the level of the rate of charge, which otherwise would remain at 6.17 percent, Mr. Zecchini continued. According to the staff's projection, the basic rate consistent with the predetermined income target for FY 1989 was 5.33 percent, if the assumptions on which the income projections were based turned out to be accurate.

In order to cushion against the possible deviation from the estimated values affecting income, the staff suggested setting the basic rate of charge at 5.5 percent, Mr. Zecchini noted. In that respect, two concerns appeared important. On the one hand, it was evident that the actual outcome of income depended on a number of uncertain factors, and that it was very sensitive to deviations from the projected evolution of those factors. On the other hand, there was a need to enhance the concessionality element in the Fund's credit in view of the long-term nature of the balance of payments difficulties of the users of Fund resources, as well as their limited ability to service external debt.

The 5.5 percent proposed by the staff seemed to be a good compromise between prudence, in assessing the likelihood of future events, and the desirability of a higher concessionality in setting the rate of charge, Mr. Zecchini said. Moreover, that rate better met the objective of avoiding sharp fluctuations in the rate of charge over short periods of time than would the rate of 5.33 percent. The rate of charge could be revised downward at the time of the midyear review should the future course of events justify it. In that respect, he stressed that the rate of charge could not be increased retroactively at the time of the midyear review.

Mr. Fogelholm said that he could support the consensus that was emerging around a rate of charge of 5.5 percent as proposed by the staff, particularly as the rate of charge could be changed at the time of the midyear review.

The Treasurer indicated that the previous year's rate of charge would be carried over into the next year if the Board did not come to a decision with the required majority for changing the rate of charge in order to avoid a vacuum. The rate carried over was the adjusted rate, which could be higher or lower than the last "basic"--i.e., unadjusted--rate. There was always the possibility for the Executive Board to retroactively reduce the rate of charge, while it was not possible to retroactively increase that rate.

The assumptions upon which the staff had based its calculation of a basic rate of charge of 5.33 percent did not involve any projection, the Treasurer indicated, but rather were based on the SDR interest rate prevailing at the moment that the projections for the Fund's income were made. The staff's proposal to add a small margin to that calculated rate was guided by the consideration that there were uncertainties with regard to interest rate developments, as well as with respect to the use of Fund resources and income flowing from that use of Fund resources. The decision was also guided by the fact that the Board had already decided to return to debtors any excess income that might be achieved in FY 1989 through a retroactive reduction of the rate of charge. Therefore, if it turned out that the rate of charge of 5.5 percent produced income in excess of the income target, the surplus would not be lost to the users of Fund resources and those who paid charges but rather, they would receive retroactive compensation for that amount.

Based on the decisions at the last meeting on the Fund's income position (EBM/88/72, 5/6/88), two adjustments would have to be made to both the rate of charge and the rate of remuneration, the Treasurer noted. The first adjustment would have to be made for the allocation to the Special Contingent Account that had been decided by the Board; that adjustment would require about 20 basis points. The adjustment for deferred charges would require about 50 basis points, on the assumption that the countries now in arrears would continue to stay in arrears, while no additional countries would fall into arrears during the financial year.

An additional adjustment would have to be made to take account of the Board's decision at the end of April with regard to deferred charges for the fourth quarter of FY 1988--referred to as "deeming," the Treasurer said. That deeming would require that, in the first quarter of FY 1989, an adjustment be made to the rate of charge of 14 basis points. All in all, those adjustments would add up to slightly more than 80 basis points, and could result in the 85 percent floor to the coefficient for the rate of remuneration being reached.

Mr. Chatah remarked that, by carrying over a rate that had been adjusted for deferred income and would once again be adjusted for the subsequent deferrals in the subsequent income year, the rate of charge would be adjusted not only for the current deferral but also for those of the preceding year. It was that double counting of adjustments that he had suggested be reflected upon and discussed at a later date.

Mr. Vasudevan said that, as he saw it, one could not transfer a basic rate of charge, but only a rate of charge. Therefore, if the rate of charge of a previous year were transferred to the following year, that should become the actual rate of charge for that year, and not the basic rate of charge.

The staff representative from the Legal Department said that the continued application of the adjusted rate of charge had been prescribed by the original burden-sharing decision. That decision had been adopted for two years. There had been a risk that the decision would lapse without adoption of a new decision on a burden-sharing mechanism that would cover the cost of deferred income. For that reason it had been decided to provide for continuation of the adjusted rate of charge. Now that the new burden-sharing decision was in place, the adjusted rate would apply under the existing rules in the absence of agreement on a new rate of charge.

It was true that there was no reference to a basic rate of charge in the Rules, the staff representative from the Legal Department agreed. Rather, the decision on burden sharing of 1986 stated that the rate of charge that would apply in the absence of an agreement on a new rate of charge referred to in Rule I-6(4) would be the adjusted rate at the end of the previous financial year.

Mr. Chatah said that he was aware of the wording of the existing burden-sharing decision, but simply was requesting that the issue that he had raised be considered explicitly. There was obviously asymmetry to carrying over an adjusted rate. His understanding was that if the decision on burden sharing lapsed, then the rate of charge would carry the burden of adjustment alone.

The Secretary, in response to a request by the Acting Chairman to summarize the results of the discussion, stated that eleven Directors wished to have the basic rate of charge set at 5.33 percent; together, those Directors had approximately 34 percent of the voting power. Four Directors had as their first preference a basic rate of charge of 5.7 percent; they also held about 34 percent of the voting power. One of those four Directors had indicated that he could go to a somewhat lower figure. Seven Directors had expressed as their first choice their readiness to accept a 5.5 percent rate of charge; those seven Directors had approximately 30 percent of the voting power. Two of those seven Directors indicated that they could go somewhat higher than 5.5 percent. About 2 percent of the voting power was not represented in the Board.

Mr. Fogelholm suggested that the Board settle on a rate of 5.5 percent, since that appeared to be the most likely consensus.

Mrs. Walker said that she preferred to go somewhat higher than 5.5 percent for the reasons already stated, as well as in light of the comments that the Treasurer had made on the possibility of the 85 percent floor on the rate of remuneration being reached. She proposed a rate of 5.6 percent.

Mr. Donoso noted that it had already been decided for FY 1989 that if there were an excess of net income with respect to the target, the rate of charge would be retroactively adjusted. However, that decision had not been taken for FY 1990. If the Board could agree on principle to maintain such a system for future years, then he would have no difficulty with supporting a rate of charge of 5.5 percent.

The Acting Chairman observed that 5.5 percent was the rate of charge that best reflected the views of the Board.

The staff representative from the Treasurer's Department noted that, as in past years, the net income for FY 1988 would be added to the Special Reserve.

Mr. Vasudevan said that his chair's position had for years been a preference for placing the net income to general reserves and wished to have that preference recorded.

Mr. Zecchini asked whether placing net income to special reserves implied that the net income target of 5 percent was special, and that eventually a return would be made to a lower income target.

Mr. Posthumus asked whether the proposal to place the net income to special reserves, rather than general reserves, was in the staff paper.

The Treasurer explained that in past years net income had usually been placed to the special reserve, which was available to cover a loss that the Fund might experience in a financial year, while general reserves could also be distributed to the membership on the basis of the quota structure. If net income were added to special reserves again, that amount would not be available for distribution, but it could be used to cover potential losses of the Fund. The proposal to add net income for FY 1988 to special reserves was not explicitly in the paper.

The Acting Chairman explained that placing the net income for FY 1988 to the special reserve could be decided on a lapse of time basis. 1/

The Executive Board then took the following decision:

Rate of Charge as of May 1, 1988

Effective May 1, 1988, the rate of charge referred to in Rule I-6(4), determined in accordance with the provisions of Section II.1(a) and (b) of Decision No. 8861-(88/67), adopted April 27, 1988, as amended, shall be 5.5 percent.

Decision No. 8898-(88/90), adopted
June 8, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/89 (6/6/88) and EBM/88/90 (6/8/88).

3. EXECUTIVE BOARD - MOVEMENT OF QUORUM TO BERLIN (WEST)

The Executive Board approves the proposed arrangements for the movement of a quorum to Berlin (West) during the Annual Meetings and for its return to Washington, as set forth in EBAP/88/134 (6/1/88).

Adopted June 6, 1988

1/ Decision No. 8901-(88/92), adopted June 14, 1988 (EBS/88/81, Sup. 2, 6/10/88)

4. ARAB MONETARY FUND - TECHNICAL ASSISTANCE

In response to a request from the Arab Monetary Fund for technical assistance from the Fund in the area of data processing, the Executive Board approves the proposal set forth in EBD/88/145 and Correction 1 (6/1/88).

Adopted June 6, 1988

5. KENYA - TECHNICAL ASSISTANCE

In response to a request from the Central Bank of Kenya for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/88/146 (6/1/88).

Adopted June 6, 1988

6. ASSISTANTS TO EXECUTIVE DIRECTOR

The Executive Board approves the proposal to appoint two Assistants to an Executive Director, as set forth in EBAP/88/135 (6/2/88).

Adopted June 6, 1988

7. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 87/151 are approved. (EBD/88/143, 5/31/88)

Adopted June 6, 1988

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/91, Supplement 1 (4/13/88), EBAP/88/138 (6/3/88), and EBAP/88/139 (6/6/88) is approved.

APPROVED: January 18, 1989

LEO VAN HOUTVEN
Secretary