

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/11

10:00 a.m., January 29, 1988

R. D. Erb, Acting Chairman

Executive Directors

Dai Q.
C. H. Dallara
A. Donoso

G. Grosche

Mwakani Samba
Y. A. Nimatallah
G. Ortiz
J. Ovi
H. Ploix
G. A. Posthumus
C. R. Rye
G. Salehkhov
A. K. Sengupta

Alternate Executive Directors

J. A. K. Munthali, Temporary
C. Enoch

J. Prader
A. M. Othman

J. Reddy
J. Hospedales
D. McCormack

L. Filardo
M. Fogelholm
D. Marcel
G. P. J. Hogeweg
C.-Y. Lim
O. Kabbaj

S. Yoshikuni
N. Kyriazidis

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

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Also Present

Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; R. H. Munzberg. Treasurer's Department: F. G. Laske, Treasurer; D. Berthet, J. E. Blalock, D. H. Brown, J. A. McLaughlin. Office of the Managing Director: R. Noë, Internal Auditor; C. P. McCoy. Assistants to Executive Directors: G. D. Hodgson, K.-H. Kleine, A. Ouanes, G. Pineau, J. E. Zeas. Assistants to Executive Directors: R. Comotto, M. A. Hammoudi, M. Hepp, G. K. Hodges, A. Iljas, J. M. Jones, S. King, K. Kpetigo, T. Morita, D. V. Nhien, C. Noriega, S. Rebecchini, D. Saha, C. C. A. van den Berg, E. L. Walker.

1. SPECIAL CONTINGENT ACCOUNT - FURTHER CONSIDERATIONS

The Executive Directors considered a supplement to a staff paper on additions to the Special Contingent Account (EBS/87/241, Sup. 1, 1/20/88).

Mr. Rye made the following statement:

As I indicated at the Board meeting on December 15, 1987, I agree with the staff that the continuing rise in overdue obligations, both absolutely and relative to Fund reserves, requires a strengthening of the Fund's "precautionary" balances. In my view, additions to the Special Contingent Account are the best means to achieve this. The Special Contingent Account offers more flexibility than do reserves; contributions are refundable; and use of the Account would protect the Fund's income position whereas reserves can protect only the Fund's capital base.

The staff presents a convincing case for contribution in the financial year to the Special Contingent Account in addition to the 2.5 percent of reserves already included in the FY 1988 target for net income, which is to be diverted from reserves to the Account, in this financial year. The main advantage in taking a decision now, rather than delaying until the end of FY 1988 or until the burden-sharing agreement is re-examined, is that the additional contribution for FY 1988 could then be burden shared.

Although we would prefer that contributions to the Account be related, in some objective way, to the increase in overdue obligations to the Fund, we would be prepared to proceed initially on a judgmental basis if the majority of the Board so agreed.

Of the two options presented in the paper for determining additions to the Special Contingent Account for the current financial year, we prefer alternative (a). However, we are not altogether happy with the proposal that the FY 1987 contribution to the Account "be deemed to have been derived from charges." We do not accept the proposition that creditors did not contribute any of the FY 1987 contribution to the Account because the rate of remuneration was below 100 percent for part of FY 1987. We would not wish to stand aside from a consensus on this issue, should one develop, but the outcome should be seen clearly as a decision by the Board to deem the 1987 Special Contingent Account contribution to have been made by debtors rather than a confirmation that the FY 1987 contribution was in fact derived from charges alone.

This latter point is relevant to the staff's alternative (b). That alternative is based on two main premises: first, that the FY 1987 contribution was derived from charges, and, second, that to provide for equal treatment, there should be a parallel adjustment of the rate of remuneration in FY 1988. As noted above, we do not accept the first premise; therefore, in our view, the second one

does not apply. In any case, however, there seems to be no compelling reason why the two years should be linked in this fashion. Moreover, to generate contributions to the Special Contingent Account entirely through an adjustment to remuneration would lead to an unacceptably large reduction in the rate of remuneration--one which could reopen the whole burden-sharing debate.

Finally, on disbursements from the Account, we do not agree with the staff's view--as expressed in footnote 2 on page 4 of the staff paper--that a method of disbursement in which refunds were handled according to first-in-first-out method and losses were attributed on a proportional basis would be less equitable than proportional allocations of both refunds and losses. It is clear that no method of disbursement from the Account would be entirely free of inequities. (This is also true for contributions to the Account; even where there is burden sharing, countries with neither net debtor nor net creditor status in the Fund do not contribute to the establishment of precautionary balances.) The staff acknowledges that refunds based on the first-in-first-out method would be more equitable; such a system "would have the advantage of taking into account the length of time over which members made precautionary resources available to the Fund." That is, it would recognize the relative costs to members in terms of income forgone. However, they reject the use of a first-in-first-out/proportional method because it "could be considered somewhat less equitable if losses were to occur after refunds had been made." In my view, this question is largely one of judgment. It seems unlikely that refunds will be made at a time when there is any significant prospect of losses. Also relevant is whether we are more likely to see refunds or losses; if the former, as we all hope, then the method which deals most equitably with refunds--i.e., first in first out--would seem preferable.

Mrs. Ploix made the following statement:

As the staff and management are again asking the Board to give consideration to the Special Contingent Account issue, I will first restate the major elements of our position and then address several difficulties arising from the staff proposals.

My authorities' basic stance remains that the question of additions to the Special Contingent Account is not a matter of urgency. Moreover, they consider that a continuous buildup of reserves may raise difficulties at some stage.

First, on the question of timing, the notion that the Board could be responsible for delaying any urgently needed decision can hardly be borne out. The basic conclusion of the Board discussion on December 14 (EBM/87/169 and EBM/87/170) was clearly that the best decision can be made after the end of the current financial

year, when all relevant information is available. Specifically, two important issues will have been discussed by then: the access of members in arrears to the enhanced structural adjustment facility, and the decision on burden sharing. Any decision taken at this stage will prejudice the outcome of those very important future discussions; such an approach is hardly acceptable.

Second, regarding the steady buildup of reserves, I would like to stress a few points. At the beginning of FY 1988, there was no agreement to raise the income target from 7.5 percent to 10 percent. It is true that the rate of charge was set at a higher rate than would have been necessary to generate the agreed level of income. But to a large extent this compromise was devised in light of the uncertainties surrounding interest rate developments and does not reflect a clear and firm will to further strengthen the Fund's reserves.

In addition, it is to be recalled that no broad agreement exists on the question of provisioning. This is the main reason behind the reluctance of many Directors to accept additions to the Special Contingent Account, since this new account bears a distinct link to arrears.

As a final comment on reserve accumulation, I would suggest that we give some thought to introducing a ceiling on the overall amount of reserves. Such a ceiling could be defined as the ratio of reserves to total Fund credit outstanding, with a view to keeping it within reasonable limits.

Turning to some of the difficulties raised by the staff paper, I will begin with a reference to the decision on burden sharing. In this decision, dated July 25, 1986, and in the Managing Director's concluding remarks at the informal meeting held on July 17, 1986, it is said that any supplemental income in excess of the 7.5 percent target "will be recorded separately in the financial statements of the Fund," "will be refundable," and "will be placed in a special line of 'reserves.'" I suppose that Mr. Goos had this reference in mind when he asked the staff about the feasibility of establishing a special line of reserves which would be refundable. It is thus surprising that the staff paper does not contain any direct answer to his question, based on the aforementioned conclusions. If that means that the staff still considers that once the supplemental income has been included in the reserves it cannot be refunded, I would appreciate some clarification on the rationale for having a separate recording procedure and on the exact meaning of a "special line of reserves."

However, one may infer from the decisions on burden sharing that the supplemental income above the 7.5 percent target is refundable; the discussion at the informal meeting of July 17 supports this view, since the Managing Director explicitly

mentioned "the part of the net income above 5 percent that was refundable," and also referred to "setting up two subaccounts rather than to place only the refundable part in the special reserve." If this interpretation is correct, why would we place additional amounts of reserves in the Special Contingent Account when there is already a special line of reserves that can serve the same purpose more suitably? Actually, the burden sharing principles apply to this special line of reserves whereas that is not the case for the Special Contingent Account, as an ad hoc decision must be made before any further additions to that Account are made. Incidentally, regarding burden sharing itself, I would like to make it clear that my authorities are of the view that any further increase in the income target should be financed exclusively by creditor countries.

All these questions and ambiguities remain unanswered by the staff; we therefore do not wish to proceed with the new proposals before clarifying the complex rules that apply to the accumulation of reserves in the context of burden sharing. Waiting for the coming review of the decision on burden sharing thus appears to be the more sensible approach, if only to forestall any ill-founded or premature decisions.

The Treasurer, in response to a question by Mr. Nimatallah as to what would happen to excess income if the Board did not take a decision at the present meeting, indicated that the Board would have to make a decision to dispose of the net income recorded at the end of FY 1988. Any income in excess of the 7.5 percent of the income target could be used for either additions to the Special Contingent Account, transfers to reserves, a retroactive reduction in the rate of charge, or would be distributed to the membership at large.

The staff representative from the Legal Department pointed out that a 70 percent majority vote would be required to decide on a retroactive reduction in the rate of charge, while a simple majority was required for a placement to reserves in accordance with Article XII(6).

Mr. Nimatallah noted that if a decision were not taken at the current meeting, then the income in excess of the target could be lost to reserves, where it would be locked up by a simple majority vote, while amounts assigned to the Special Contingent Account were refundable.

He then made the following statement:

The problem of overdue obligations to the Fund is becoming more and more serious as the overdue amounts will be close to SDR 2 billion by the end of this fiscal year. The establishment of the Special Contingent Account is only a temporary measure until a final solution is found and adopted by the Board.

It is clear that this is an interim measure meant to satisfy the External Audit Committee, in keeping with the requirement of prudent financial management of the Fund. With the worsening of the problem of overdue payments, the question now is only how to augment the precautionary balances placed in this Account.

The latest development that offers some hope is the establishment of the enhanced structural adjustment facility. I realize that that facility has been established with the objective of helping all eligible countries adopt structural adjustment programs, and therefore of improving their economic prospects. However, I also see an opportunity for the Fund to find a final solution to the problem of overdue payments, as it helps the members with arrears to the Fund. Of course, this can take place with or without insistence on prior clearance of arrears. The potential problem is the difficulty in arranging for bridge financing, which therefore could delay certain countries from entering into arrangements under the enhanced structural adjustment facility, as well as postpone a solution to the problem of overdue payments.

Until the Board decides positively to suspend the condition of settling arrears for the enhanced structural adjustment facility only, it is important to augment the resources of the Special Contingent Account. As I have said previously, the Board should do that on a judgmental basis, in light of the worsening of the problem of overdue payments. The augmentation should take place now, before the end of the financial year, and should be, as the staff suggests, up to SDR 60 million, or approximately 5 percent of present total reserves.

As half of that amount was already decided upon by the Board, I have an open mind about how to finance the other half of SDR 30.2 million. I can agree with financing this amount through burden sharing, with the understanding that income in excess of the revised target amount of SDR 121 million would be used for a retroactive reduction of the rate of charge. I can also agree that the SDR 30.2 million would be generated through an adjustment of the rate of remuneration only, since I can go along with the Board if it decides that the amount already in the Account has been contributed by borrowing countries only.

On the question of the method of reducing amounts in the Account, either for refunding to members or to meet a loss judged by the Board, I can, like the staff, go along with alternative (b), namely, that "losses could be charged and reductions paid in proportion to the balance in the Account at the time of a loss or a reduction."

I hope that the creation and augmentation of the Special Contingent Account will turn out to be a useful interim solution,

with the funds in that Account being refunded, partly or fully, within the next three years. By then, countries with arrears that are eligible for the enhanced structural adjustment facility will have had a chance to receive Fund support under the facility, and, I hope, to settle their arrears in the process. The one country that I am worried about, which is not an eligible member, is Peru. Let us hope that Peru will find it in its best interest to settle its arrears as soon as possible.

It is important to note that, in the absence of a decision today on either alternative (a) or (b), it is possible that at the end of the financial year, when this matter will be taken up again in connection with the rate of charge for FY 1989, the excess income will be diverted in full to reserves. This would certainly be true if no consensus emerges by then.

Mr. Salehkhov made the following statement:

The persistent problem of overdue obligations to the Fund, which the Board is again to address on February 10, is indeed of particular concern to the membership at large. This chair has consistently adhered to and emphasized the cooperative nature of the Fund as well as the revolving character of its resources. It has also stressed the fact that the number of members in arrears has been limited to only few and that there are no indications as to their unwillingness to discharge their financial obligations; far from it, they have been obliged to stop payments because they have simply not been in a position to pay. Moreover, Fund policies have largely contributed to the emergence of such arrears. The tightening of conditionality, the reduction in access to Fund resources, the cessation of commercial flows, and the sharp reduction in official development assistance have all made the task of members in arrears extremely difficult. If these root causes of the problem are not adequately and realistically addressed, it is likely that these members will never be in a position to service their debts out of their meager resources, which are endangered by the unprecedentedly depressed commodity prices.

In the meantime, and while recognizing these constraints, which are in my view in great part of our own making, the Board has to face the financial consequences of these policies. In this regard, this chair has consistently maintained that the Fund's system of setting charges and remuneration is obviously unfair to debtor countries. This system consists of setting an unrealistic income target based on overpessimistic assumptions that generally lead to an excess income, which, in turn, rather than being returned to its generators--the debtor members--is literally seized to reinforce the Fund's financial position.

At the same time, while the rate of remuneration is protected by a floor, the rate of charge has no ceiling and can easily be changed on the occasion of each midyear review of the Fund's financial position; those changes can only be upward. The burden-sharing decision, which in principle is supposed to mitigate this inequitable system, has in its agreed present form been rather fictitious, since creditors have had negligible participation in reserve accumulation.

We can continue endless technical arguments whether or not the debtors or creditors should bear the responsibility for the existence of arrears. It is our duty, however, to share the consequences of such a situation on a more equitable basis.

I therefore look forward to the review of the burden-sharing scheme. While my preference is for a system in which the burden is shared according to quotas--given the voting structure in the Fund--I can go along with a system according to which the burden is equally shared between debtors and creditors provided, however, that the entire contribution to reserves, as well as to the Special Contingent Account, is burden shared. While this would be consistent with the cooperative nature of the Fund, it would also allow us to avoid the tedious discussions that we have continued to hold on these issues whenever the subject has come up.

I believe that the staff proposals before us today constitute a step in the right direction and I can go along with alternative (b).

Mr. Grosche said that while he shared the deep concerns about the continuing rise in overdues to the Fund, and favored steps to better protect the financial position of the Fund, he did not feel that additions to the Special Contingent Account were an appropriate solution. The Account was associated with provisioning, which suggested acceptance of members' not paying the Fund--a suggestion that could seriously erode the Fund's preferred creditor status. Without the clear expectation that repurchases would be made fully and promptly and before other creditors were paid, the Fund could not justify its lending to countries that had lost their creditworthiness. It had to insist on timely repurchases. Making provisions for potential losses because of overdue obligations could create the impression that the Fund was preparing for reschedulings, a bad signal for creditors to the Fund that would be harmful to the cooperative character of the institution.

On the other hand, the possibility of members leaving the Fund or other financial risks occurring, including those stemming from overdue obligations, could not be ruled out, Mr. Grosche went on. The financial position of the Fund had to be protected from those and other adverse effects. Therefore, he continued to favor a further substantial strengthening of reserves.

The position of the external auditors was not clear to him, Mr. Grosche indicated. Did they really consider the addition of what up to then had been token amounts to the Special Contingent Account to be more protective of the Fund's financial position than the full use of its reserves? Both management and staff should continue trying to clarify to the External Audit Committee the special character of the Fund, which fully justified certain exemptions from the generally accepted accounting principles: the Fund was not a commercial bank; it did not pay taxes; it did not refinance on the markets; and it did still have gold holdings.

The only characteristic that gave contingency allowances a certain advantage over additions to reserves was that they could be recorded separately, refunded, and placed in a special line of reserves, Mr. Grosche said. It was indeed that reference that Mr. Goos had had in mind when he had asked the staff about the feasibility of establishing a special line of reserves during the previous discussion on the Special Contingent Account (EBM/87/169 and EBM/87/170, 12/14/87). He was disappointed that the staff had not taken up that suggestion in its paper despite the fact that the Chairman had concluded that discussion by saying that "the staff will prepare a paper for consideration at that time to explore in more detail some of the alternatives that were suggested today...Mr. Goos's proposal and other thoughts." In referring to a special line of reserves, the German chair had wanted to make a contribution to bridging the different views that still persisted in the Board on the very nature of the Special Contingent Account. It was important that any replacement--whatever it was called--not be related explicitly, or at least not exclusively, to the problem of overdue obligations. The objective of the new precautionary balances account would be to protect the Fund from general financial uncertainties. As long as the Special Contingent Account in its present form continued to be linked directly or exclusively to overdue obligations, his chair was not in a position to support any additional contributions. Perhaps the Board could return to the issue at the end of FY 1988 and discuss it in the context of a review of the burden-sharing arrangement and in light of the excess income that might emerge at the end of the financial year.

Mr. Prader made the following statement:

Unlike Mrs. Ploix, I did not interpret the basic conclusion of the discussion at EBM/87/169 and EBM/87/170 (12/14/87) as being that a decision should be postponed to the end of the current financial year. The staff's desire to see the Board reach a decision before the end of FY 1988 on additions to the Special Contingent Account is legitimate. Failure to do so would mean that an amount would eventually be paid to the Special Contingent Account in 1988 solely by countries that paid charges, as was already the case in 1987. I therefore find a real contradiction between Mrs. Ploix's proposal to postpone the decision and her declaration that "any further increase in the income target should be financed exclusively by creditor countries."

Although the financing of a Special Contingent Account for 1988 out of a conservatively set rate of charge might be perfectly acceptable in some institutions, the principle of an equitable distribution of the cost of Fund financing is far too important and valuable for a cooperative institution like ours to disregard, especially since doing so could have undesirable effects on the willingness of some Fund members to participate in future financing operations.

In recognition of this principle's importance, a number of Directors from creditor countries made proposals, at the previous meeting on this subject, in the direction of sharing the burden of additional precautionary balances. For the same reason, the Board should not waste the present opportunity by acting indecisively.

In light of the deliberations, our chair supports alternative (a) presented by the staff today. We think that it reflects the spirit of that meeting to the extent that it incorporates basic ideas suggested and discussed at that time. At that meeting, a compromise, albeit for most Directors a somewhat uneasy one, was in process of emerging and seemed almost at hand, although for some reason the magic barrier of a 70 percent majority could not be passed.

It is our view that no matter how strong the temptation, there is no real need now to rehash at any length all the fundamental arguments, pro and con, about the meaning of a Special Contingent Account for 1988. Alternative (a) before us now contains (with the exception of one idea advanced by a number of Directors, which I will discuss in a moment) the principal elements of a compromise. First, the criteria initiating the buildup of precautionary balances would be based on judgmental factors rather than on some direct and automatic link with the level of arrears to the Fund. This nonreserve account would thus meet the requirement of holding precautionary balances against increased uncertainties. Second, part of the additional precautionary balances would come from a reduction in reserves. Third, for those who do not really believe precautionary balances are necessary, a nonreserve account has the advantage that after dissolution of the account the resources can be returned to Fund members.

While stressing our belief that alternative (a) can and should be accepted, we must also point out that the staff paper fails to address one important concern of some Directors. The progress toward consensus achieved in December was largely attributable to concessions made by some Directors strongly opposed to the idea of additions to the Special Contingent Account in 1988. They seemed willing to accept a compromise along the lines suggested in the present alternative (a), but were deeply concerned about how an increase in precautionary balances would be presented to, and perceived by, the financial world. To avoid any confusion

with the notion of provisioning, which would imperil the special creditor status of the Fund, Mr. Goos suggested calling the additional precautionary balances a "special line of reserves." Also, the arguments put forward today by Mrs. Ploix in her statement support the view that it is possible to arrive at a solution along the lines of the "special line of reserves" scheme, meeting the concerns of both Mr. Goos and the Treasurer. However, none of the options submitted by the staff make any mention of this alternative approach. Perhaps the need to have the Special Contingent Account scheme implemented has so thoroughly occupied the staff's attention as to prevent the staff from giving due thought to this issue. We would welcome some clarification of the staff's position in this regard. In any event, in the spirit of consensus building, and because there is substance to this presentational concern of some Directors, I suggest that this idea be incorporated into the formulation of alternative (a).

On the issue of the disposal of the amounts placed to the Account in 1987, we continue to favor the principle of redistributing the amounts presently held in the Account to the members that paid charges in 1987. We also hold the view that the distribution of any refund or reduction because of loss should be made in proportion to the amounts contributed.

Mr. Ovi said that he largely agreed with Mrs. Ploix. The only argument in favor of taking a decision at the current meeting instead of at the end of the financial year--the preferred option--was the valid concern that contributions be burden shared. His chair was firmly committed to the principle of burden sharing, but issues had been raised as to the exact meaning of that term, and the agreement on burden sharing would soon be reviewed. Further elaboration of Mr. Goos's suggestion at EBS/87/169 would also be welcome.

Accordingly, he had an open mind on the issue of the need for a further increase in reserves at the end of FY 1988, Mr. Ovi indicated. If a decision were to be taken at the current meeting, he would favor something along the lines of the staff's alternative (a), namely, that, in order to avoid a retroactive decision, it should be agreed to add 2.5 percent of reserves to the Account, on the understanding that no further increases would be discussed in the next financial year.

Mr. Reddy said that during the latest discussion on the midyear review of the Fund's income position, his chair had supported the idea of strengthening the Fund's precautionary balances, provided that the burden of such an option was shared equitably between the debtor and creditor countries. He therefore welcomed the staff's proposal to augment the Special Contingent Account. The staff had proposed two alternative modalities for increasing the net income target and adding to the Account. For the reasons given by the staff, his chair supported alternative (a). With regard to the issue of the order of reducing balances in the Account

when the need for it either was reduced or had disappeared, he supported the proposal that any refund be made in proportion to the amounts contributed up to that time.

Mr. Hospedales made the following statement:

This chair has always taken the position that the Fund's accepted technical framework, including the decision on principles of burden sharing adopted in July 1986, provides it with sufficient flexibility and judgment to take appropriate cautionary action to protect the Fund's integrity and financial position against the effect of overdue financial obligations to the Fund. Given our conviction that all members with overdue obligations will eventually liquidate their arrears, we continue to believe that it would be difficult to form a judgment based on the potential impairment of the Fund's assets by arrears.

For this reason, we have advocated on many occasions, and continue to do so now, that wide-ranging collaborative action among creditors, donors, multilateral institutions, and debtors themselves, is a necessary prerequisite for the resolution of this protracted and growing problem. We look forward, therefore, to the staff proposals on the use of the enhanced structural adjustment facility as a mechanism to resolve this issue.

Accordingly, the establishment of the Special Contingent Account and its funding arrangements still do not appeal to us as a method for solving the arrears problem, if only for the reason that such a mechanism serves to impose higher costs on the financing of existing obligations for a large number of members and not only aggravates their already difficult debt-servicing problems, but also impairs their capacity to maintain the momentum of adjustment efforts.

Nevertheless, we cannot ignore the fact that overdue financial obligations, while confined to a small number of countries, continue to rise and are projected to exceed SDR 2 billion by April 30. Given the Fund's character as an intergovernmental cooperative institution, the fact that our burden-sharing decision of July 1986 provides an adequate framework for tackling this issue, and, in particular, the fact that any decision to share the burden of the cost of financing overdue obligations must be taken before the end of this financial year, we could support a scheme along the following lines.

First, the Special Contingent Account would be dissolved. Second, SDR 30 million of refundable supplemental income would be generated under the provisions of the decision on burden sharing adopted in July 1986; we believe that this amount is appropriate on the basis of judgmental and burden-sharing considerations. Third, SDR 15 million would be transferred from the Special

Contingent Account to supplemental income, to represent the contribution of debtors to supplemental income. Fourth, the other half--SDR 15 million--would be generated through an adjustment of the rate of remuneration only, to parallel the placement to supplemental income of SDR 15 million by debtors. This will ensure that the remuneration coefficient for the final quarter of FY 1988 on the basis of the present SDR interest rate and other assumptions would not be reduced below 85 percent--the floor under the burden-sharing arrangement. Finally, the residual SDR 11.4 million in the Special Contingent Account and income in excess of the target amount at the end of FY 1988 would be used for a retroactive reduction in the rate of charge to 5.5 percent.

In our view, this modified proposal could resolve a number of pertinent issues pending our review of the burden-sharing decision on April 25, including the need for prudential action in the light of the concerns expressed to the Managing Director and to the Treasurer in the report of the 1987 Audit Committee, and the modalities for future additions to and distribution from the Special Contingent Account. It is very important, however, that the rate of charge on existing obligations to the Fund will be contained.

Mr. Enoch said that his position remained broadly as his chair had set it out at EBM/87/169. He continued to see a need for further strengthening the Fund's financial position in response to the arrears problem. While the enhanced structural adjustment facility might enable many countries to normalize their relations with the Fund, it would be premature to rely upon that possibility at the present stage.

He remained opposed to provisioning on both theoretical and practical grounds, Mr. Enoch declared. Theoretically, it was not clear that provisioning was appropriate in an institution such as the Fund. In practical terms, any realistic form of provisioning could easily prove to be prohibitively expensive. In addition, provisioning might well also not be financeable within the burden-sharing agreement and could add an excessive burden to those countries that had struggled to keep current in the Fund. In addition, it should not be forgotten that gold holdings represented an important underpinning for the Fund. In light of those points, the most appropriate course would be to carefully examine the adequacy of the Fund's reserves level at the start of each financial year, taking into account trends in and prospects for the level of arrears.

On the timing of the decision, his initial preference would be to postpone decisions on the Special Contingent Account until the beginning of FY 1989, Mr. Enoch said. Indeed, that was what he thought had been decided at the December meeting. The reasons for that preference were the same as indicated earlier by Mr. Ovi: the increase in arrears had been largely foreseeable at the time of the decision to establish a 7.5 percent reserve target for FY 1988; the burden-sharing agreement would soon be

reviewed; and any decision on the Special Contingent Account had implications on burden sharing in general. While he understood why the staff had argued for an early decision, it would be more sensible to take a decision on the appropriate reserve increase at the start of each financial year.

While that was his first preference, he would be willing to join a consensus for an immediate decision along the lines of alternative (a) in the staff paper, Mr. Enoch indicated. It would, however, be premature to decide at the current meeting how any surplus income for the year as a whole should be allocated. While, in current circumstances, the argument that any surplus income should be returned to the debtors in some form or another was valid, it did seem strange to allocate money that the Fund did not yet have. While there was a case for distributing the amount placed in the Account in FY 1987 to the debtors, if and when the arrears problem was resolved, it was difficult to know what circumstances would prevail when winding up the Account, and, therefore, it would be unwise for the Board to commit itself on that question. He could go along with the staff suggestion on how future charges against the Account should be assessed.

Mr. Yoshikuni said that his chair's basic position on the issue of additions to the Special Contingent Account had not changed since the previous Board discussion on the matter; detailed discussion should be postponed until the end of the current financial year. The staff paper currently before the Board suggested two alternative ways to expand the Special Contingent Account, without referring to other possibilities. However, since some Directors were reluctant to see an immediate increase in the Account, a comprehensive discussion should be held concerning the precautionary balance, including the validity of expanding the Account, and the possibility of establishing a special line of reserve; such basic issues should be settled before specific procedures were decided upon. Moreover, it would be preferable to determine the size of additions to the Account at the beginning of the following financial year, and not in the midst of the current financial year.

However, he recognized that the situation of overdue obligations to the Fund had worsened since the previous discussion, and the urgent need to strengthen the Fund's financial position was clear, Mr. Yoshikuni continued. Therefore, if most Directors found that action should be taken at the current meeting against the recent rapid increase in overdue obligations to the Fund, and if the majority of the Board wished to place an addition to the Account, his chair would not be opposed to alternative (a). However, even in that event, the way in which the expected excess income for FY 1988 of SDR 42 million could be used should be decided at the end of the financial year; it was too early to decide to use it for the retroactive reduction of the rate of charge for FY 1988. Alternative (b) was not acceptable because it led to a change in the decision on burden sharing, and such a change was too important to be discussed at the current meeting. He could go along with a decision to pay back the SDR 26.5 million that had already been placed to the Account to those members that had paid charges in FY 1987.

Mr. Sengupta made the following statement:

When the Board last discussed the matter of additions to the Special Contingent Account in December, this chair expressed some concerns that have not been touched upon in today's paper, which deals only with the financing aspect. We feel that additions to the Account should not have any semblance of provisioning, and that the Fund should adopt realistic approaches that would help solve the problem of the overdue obligations of a few countries. Recent initiatives such as the enhanced structural adjustment facility would be helpful and should in fact be put in place quickly. Proposals for the building up of precautionary balances should clearly spell out the "normal" level of reserves. It was in this context that I have referred to the discussions in the Board in 1985 when the net income target was increased from 3 percent to 5 percent owing to an increase in overdue financial obligations. Logically speaking, the Fund would have to return to the net income target of 3 percent, which was considered "normal" prior to the emergence of the overdues problem, following the adoption of other approaches such as setting up the enhanced structural adjustment facility or building up precautionary balances. This element should be considered in any consideration of additions to the Special Contingent Account as a part of the building up of precautionary balances.

The Acting Chairman's remarks at the end of EBM/87/170 gave the impression that such an exhaustive discussion could be considered at the end of the financial year. The staff advanced the date of discussion primarily because it fears that the overdue financial obligations to the Fund will exceed SDR 2 billion by the end of the financial year, and in view of the continuing increase in overdue obligations, it is necessary that further prudential actions be taken now. The staff also pointed out that if these prudential actions have to be burden shared, then the problem of a retroactive adjustment of the rate of remuneration arises, which is why some decision regarding arrears should be taken now. But we have held the view that overdue obligations are growing not because the concerned members lack the will to pay, but because they do not have the capacity to pay. Only a very small minority--eight countries, or 5-6 percent of the total membership--is unable to meet its overdue obligations. It would therefore be wrong to penalize the large majority of members by building up reserves or the Special Contingent Account by putting a charge on the net income. In addition, even if further "prudential actions" are taken at this juncture, the increase in overdue financial obligations cannot be stopped until resources are placed in the hands of the defaulters, enabling them to strengthen their economies so that they can discharge their liabilities. Fund policies also need to be geared to that end, including the earliest possible implementation of the enhanced structural adjustment facility.

In the past we have expressed opposition to the building up of additional reserves or the creation of the Special Contingent Account. The staff papers and discussions in the Board have not convinced us to change that view. As emphasized on several occasions, there is no need for a cooperative institution like the Fund to follow commercial practices to overcome payments uncertainties through the establishment of the Special Contingent Account.

The case for advancing the discussion and decision on additional prudential measures is related to the basic question of today's discussion--burden sharing. If the burden-sharing principle can be agreed to now and be put into effect at the end of FY 1988, the Board could wait until then to take a decision, provided it agrees that any surplus income at the end of the financial year--after taking any necessary prudential measures, such as building precautionary balances, in accordance with the principles of burden sharing--will be used for a retroactive adjustment of the rate of charge.

Extending his remarks, Mr. Sengupta said that he was trying to meet Mr. Grosche's concern, because the question of how to build precautionary balances was still open. However, if any measure was taken to build those precautionary balances, the process should be in accordance with the principle of burden sharing. If it was decided at the end of the financial year that it was not necessary to build precautionary balances, then a decision would have to be taken on how to dispose of the Fund's excess income for FY 1988. The problem was that because of the legal provision that only a 50 percent majority vote was required to place that amount to reserves, while a 70 percent majority vote was required for a retroactive reduction of the rate of charge, excess income tended to be placed into reserves. Such a practice was contrary to the principle of burden sharing in that it placed the whole burden of adjustment on the developing countries that were paying the rate of charge. Excess income should be used to adjust the rate of charge retroactively.

He could understand some Directors' unwillingness to discuss the modalities of building precautionary balances, since the issues involved were not very clear, Mr. Sengupta indicated. However, the Board should decide that if, at the end of FY 1988, additions were made to the precautionary balance, such additions would be burden shared, and that the remaining excess income would be returned to the developing countries by a retroactive adjustment of the rate of charge. If a decision were taken at the current meeting, his preference was alternative (b).

Mr. Ortiz said that the Fund should not necessarily add to its precautionary balances in response to the problem of overdue obligations. The Fund was a cooperative international organization and, as such, there was no reason for it to follow the accounting principles applied to banks and other commercial institutions. If the majority of the Board was



concerns--in particular, those of the German chair--that were expressed during the previous Board meeting on this subject. In this regard, as a first step in taking a decision on adding to this Account, the Board might consider clarifying the reasons for establishing the Account. That may, of course, involve a slight amendment to the decision establishing the Account, and I would welcome any views the staff may have. But we would certainly not object to an amendment to the decision that originally established the Account that acknowledges Mr. Goos's concerns, at least to a certain extent, by noting that the Account was established, and will be maintained and built upon, in light of a number of factors regarding the Fund's financial position, among them, but not exclusively, the arrears problem. This does seem to be in line with the direction of Mr. Grosche's thinking earlier today. Perhaps this could be taken care of in the summing up, but we would certainly be willing to consider, if necessary, a minor amendment to the decision if that would be helpful.

Regarding the continued funding of the Account, we could support the staff's first alternative, which would add the 2 1/2 percent of reserves that is currently burden shared to the Account. In addition, we support burden sharing of an additional 2 1/2 percent of reserves to be added to the Account. We would be willing to allow the SDR 26 million currently in the Account to be returned to debtors if and when the account is dissolved. However, we are somewhat reluctant at this stage to support the proposal by the staff to return any excess income at the end of the financial year to the debtors, not because a sound case cannot be made for that, but simply because the income is not yet entirely determined; its disposal would best be considered at the end of the financial year, when the Fund's financial position is more clear.

It is extremely important to take a decision on this issue today. While we can understand the reluctance of some Directors to take a decision before the end of the financial year, we do feel that it is incumbent upon the Board to act prudently in light of the financial circumstances, which unfortunately continue to deteriorate at least as far as arrears are concerned. We hope that our willingness to broaden the rationale and the basis for the Account will help some of our colleagues. In that connection, I would certainly also be prepared to see entered into the record or summing up a statement that today's decision is in no way intended to reflect a change in the current position of the Fund regarding rescheduling of the obligations of its members.

Mr. Nimatallah said that he supported Mr. Dallara's suggestion that the decision creating the Special Contingent Account be amended to state that the Account was precautionary against not only overdue payments, but also all possible difficulties that might arise, including the problem of arrears. The fact that a judgmental approach was included in the decision

on the Special Contingent Account, as opposed to a specific formula, was another characteristic that would help bring the Account closer to what Mr. Grosche had had in mind.

Mr. Ortiz commented that he welcomed Mr. Dallara's flexibility regarding Mr. Grosche's concerns, although he was disappointed that the same type of flexibility had not been shown regarding a number of other Directors' concerns. He reiterated that in principle his chair opposed the notion of adding to precautionary balances. However, in an effort to reach a consensus, he was willing to take a decision at the current meeting on the condition that a decision were also taken that any excess income be returned to those members that had paid charges in the current fiscal year, thereby clearly burden sharing the addition to the Special Contingent Account. In addition, any future additions to precautionary balances should be taken in the same manner, rather than allowing excess income to be assigned to reserves by a 50 percent majority at the end of the financial year.

Mr. Sengupta stated that a retroactive adjustment of the rate of charge, in order to return any surplus income to the debtors, was essential to the spirit of burden sharing. His second point was that if the Special Contingent Account were broadened to include all uncertainties, as opposed to overdue obligations alone, then the point at which the need for the Account was over would have to be specified.

Mr. Nimatallah said that he did not expect the Fund to be dealing with many problems of uncertainty at the same time; the Special Contingent Account was currently available for the problem of arrears, and could be adjusted on a judgmental basis. The advantage of defining the Account more generally was that even if it held no funds, it could be left in existence in preparation for other problems, at which time precautionary balances could be once again built up and reduced on a judgmental basis.

Mr. Kyriazidis said that his chair did not consider the addition to the Special Contingent Account an issue of great urgency; an appropriate decision could well be taken at the end of the current financial year. However, he could go along with the staff's proposal, if there were a wide consensus in the Board, and provided that the following conditions were met. First, any allocation to the Account would have to come from the SDR 90.6 million of target income for the present financial year. Second, the circumstances under which contributing countries would receive a refund would have to be clearly specified, and the refund would have to be made in proportion to the amounts contributed. Third, resources in the Special Contingent Account had to be considered on the same footing as reserves. That implied that in calculating further increases in reserves in the following financial years the sum of total reserves and Special Contingent Account resources would be used as a base.

In view of those conditions, he could accept only the first part of the staff proposal--to add to the Account the SDR 30.2 million already provided by debtor and creditor members as part of the present income

target of SDR 90.6 million agreed for FY 1988, Mr. Kyriazidis stated. As for the second part of the staff proposal--on how to generate an additional amount of SDR 30.2 million--both alternatives were unacceptable, because they did not allocate the additional amount from the current income target. It was inappropriate at the present juncture to request from creditor countries additional contributions--which would be frozen into the Fund's reserves--in view of the significant efforts that were already under way to help countries in arrears both directly and through enhancement of the structural adjustment facility.

Mr. McCormack made the following statement:

When this subject was discussed by the Board last December, this chair was part of the emerging consensus in favor of adding to the Special Contingent Account. In doing so, it was recognized that the Account represented a compromise between conflicting positions, namely, between those who favored a fully fledged provisioning regime and those, like ourselves, who believed that provisioning ran counter to the cooperative nature of the Fund. We recognized that, as for many such compromises, few, if any, would be entirely pleased with the result. However, we believed, and continue to do so, that the Special Contingent Account represents an appropriate response to the problem of arrears, that it could be operated flexibly, and, most important, that it could be reversed if, and when, as we all hope, the problem of arrears abates. We emphasized that, in making additions to the Account, judgment and discretion should be exercised, rather than linking such additions mechanistically to the outstanding level of arrears. I think this general position would not be inconsistent with Mr. Dallara's suggestion concerning amendment of the decision establishing the Account. Also, we agreed that financing should be on the basis of burden sharing. These considerations lead us to support alternative (a), as set out in the paper before us today. They also point to the desirability of taking a decision now rather than waiting until the end of FY 1988. Such a delay would, in effect, preclude the operation of burden sharing in this case.

There are two specific points on which our judgment is requested. First, in relation to the amounts contributed in FY 1987, we can agree that these "be deemed to have been derived from charges." However, we believe that this is a somewhat arbitrary decision, and does not in fact constitute a precise determination of ownership, but rather is adopted for essentially pragmatic reasons. Parenthetically, one might note that precisely because this is a somewhat arbitrary assumption, it does not provide an adequate underpinning for alternative (b) as presented by the staff--another factor which reinforces our support for alternative (a). With respect to the formula to be employed in regard to refunds from, or reduction of, the Account because of a loss, we are inclined to support the proportional formula suggested by the staff.

Mr. Donoso considered that the creation of a Special Contingent Account to face the impact of overdue payments, which could hypothetically become definitive losses for the Fund, was inappropriate. Whenever specific cases of overdue payments had been discussed, the Board had stressed the notion that indebtedness to the Fund was a different and more serious problem than arrears to other creditors. By creating the Special Contingent Account, and accumulating precautionary balances, the Fund was indicating its preparedness to accept losses or reschedulings, while achieving no concrete improvement in the arrears problem.

If the majority of the Board favored an addition to the Account, he would prefer alternative (b) as presented by the staff, which would result in the same amounts being assigned to reserves and the Special Contingent Account as would alternative (a), Mr. Donoso indicated. The only difference would be that under alternative (b) debtors and creditors contributed according to the principle of burden sharing, while under alternative (a) the Fund would retain financing provided by debtors in excess of that provided by creditors until the arrears were over. After many discussions, it was clear that income in excess of targeted amounts reflected an excessive contribution by debtors. He welcomed the fact that that notion was implicit in both staff alternatives. Otherwise, burden sharing would have no practical meaning, since any misestimations in the staff projections would increase arbitrarily the contribution of debtor members. However, it was regrettable that the staff did not yet consider that point an integral part of the burden sharing approach.

He understood that under alternative (b), as under alternative (a), it would be formally agreed that income in excess of the revised target amount of SDR 121 million would be used for retroactive reduction in the rate of charge at the end of FY 1988, Mr. Donoso concluded.

Mr. Mawakani said that he was concerned that the growing overdue financial obligations could undermine the financial position of the Fund. However, it would be premature to propose a solution at the current meeting without sufficient information on all the relevant facts for the current financial year. Moreover, it did not appear that the question of additions to the Special Contingent Account was a matter of urgency, and furthermore, the issue of provisioning had not yet been resolved.

Although the level of financial obligations had risen, only a few countries were responsible for those growing arrears, Mr. Mawakani pointed out. The solution to protracted arrears should include assistance in the context of growth-oriented adjustment programs. In addition, the financial situation of many low-income countries was precarious, and any increase in charges would therefore be a heavy burden on their already deteriorating fiscal and reserve positions.

His chair's first preference was to add to the Special Contingent Account at the beginning of FY 1989 in the context of the discussion on burden sharing and review of the Fund's income position, Mr. Mawakani concluded.

Mr. Munthali made the following statement:

In considering any prudential action to place additional amounts to the Special Contingent Account, the Board should not lose sight of the fact that this proposal is intended basically to safeguard the Fund's income position in the face of the impairment that could result from the incidence of overdue financial obligations. However, the paper before the Board this morning gives the uneasy impression that such prudential action of setting aside precautionary balances is an end in itself; this should not be the case. The underlying motive for such action should be to ensure the robustness of the Fund's income when faced with the inherent uncertainties associated with arrears. Accordingly, the Board is perfectly justified in making a judgment on contributions to the Account based upon, among other factors, trends in the Fund's income position. However, a postponement of the decision to create such precautionary balances until the end of the financial year, in keeping with the concerns expressed by the External Audit Committee, does not mean that the Board is being unresponsive. On the contrary, the Board would be exercising caution by avoiding hasty action, so that all relevant factors are taken into account. Furthermore, this chair has held the view that the Special Contingent Account was created mainly to conform with prudent accounting practices, since it does not provide a real safeguard for the Fund's income.

The staff has also argued that postponing action on additions to the Account until the end of the current financial year could make it technically difficult for the Board to achieve the principle of burden sharing, since retroactive changes in the rate of remuneration are not possible. Mr. Rye has referred to this advantage by stating that the additional contribution could be burden shared. However, given the current projections of the overall income position and since the rate of charge is already generating SDR 12 million above the revised target income, perhaps an adjustment should be made only in the rate of remuneration by the proposed 35 basis points. Further action on the rate of charge could then be postponed until the final outcome is established at the end of the financial year.

Otherwise, a delay of another 15 weeks in taking the decision to add to the Account should not be considered as being unresponsive to the need for precautionary action, given the favorable overall financial performance and the level of reserves to date. The Board could, and indeed should, go further by considering more focused action toward those countries that have been facing the problem of protracted arrears. The search for more durable solutions specifically centered on those few countries would be a more meaningful approach to the problem at hand.

On the two specific proposals elaborated by the staff, alternative (b) could be acceptable if it was agreeable to creditors. The reduction in the rate of remuneration need not be as much as 70 basis points if the SDR 12 million currently being generated by the prevailing rate of charge could be deemed as a contribution by the debtors. Perhaps an adjustment could be made to reduce the rate of remuneration by, say, 35 basis points. If the rate of charge is then left at its present level, this proposition would be considered a compromise toward the view of the French authorities; I was greatly persuaded by Mrs. Ploix's powerful line of argument.

The staff has recommended the first alternative but I have some difficulty in accepting it for several reasons. First, the effect of raising the rate of charge and reducing the rate of remuneration by 35 basis points for the remainder of the current financial year generates income well in excess of the amount proposed to be placed in precautionary balances. As we indicated on December 15, 1987 we would prefer to keep these balances to a minimum. Furthermore, the anticipated reduction in the rate of charge in FY 1988 to 5.56 percent is only illusory at this stage, since consideration has to be given to the overall projections for the year as a whole. Its level will undoubtedly depend on how all the relevant factors that determine the income position interact over the financial year. I therefore believe that making the proposed adjustment to the rate of charge at this stage could cause some difficulties for many countries. Most countries have already put in place plans to discharge their obligations based on information they have already received from the Treasurer's Department--all the more reason to delay a decision on additions to the Account until the end of the current financial year. If postponement has majority support, we would expect that such action be balanced by a more active approach by the Fund in finding more durable solutions for those few countries that have been experiencing protracted arrears. Indeed, there is a light at the end of the tunnel with the establishment of the enhanced structural adjustment facility.

Mr. Dai said that during the previous discussion on additions to the Special Contingent Account, his chair had had serious doubts about the role and functioning of the Account. The practice of repeatedly adding to the Special Contingent Account was, in substance, provisioning under a different name, which he was not in favor of, and there had not been a broad consensus in the Board on the question of provisioning. He had always stressed that the Fund was an international cooperative institution; its financial strength and creditworthiness rested on the cooperation and support of all member governments, as well as on the use of appropriate policies when dealing with the problems of debtor countries, rather than on the Fund's following of generally accepted accounting principles, including provisioning.

It was generally agreed that a default by a sovereign government with respect to the Fund was highly unlikely, Mr. Dai observed. If the Fund's financial position were weakened, it could be restored through a quota increase, by borrowing from member countries, or by other effective means, such as through the recent enhancement of the structural adjustment facility, which had received wide support from member countries. If all member governments worked together in a cooperative spirit and gave their wholehearted support to the Fund, the Fund would neither lose its creditworthiness--in fact, the Fund never went to the capital market--nor go into bankruptcy.

Bearing in mind those considerations, Mr. Dai said he agreed with Mrs. Ploix that the Board should not be in a hurry to make any additions to the Special Contingent Account at the current meeting, and that it should seriously consider the proposal to set a ceiling on the overall amount of reserves.

Mr. Hogeweg made the following statement:

I welcome the initiative to place this subject on the Executive Board agenda again, prior to the end of the financial year. As we have made clear in previous discussions on the subject, we favor strengthening the Fund's financial position in view of the mounting arrears problem. We have advocated provisioning in the context of the Fund, using some fixed rule to determine the amounts involved as the arrears situation develops, and we favored financing of these amounts by way of burden sharing. The Special Contingent Account, as it was created at the end of the last financial year, could, to a certain extent, fulfill a similar function.

At the previous meeting on the subject in December 1987, we were pleased to witness growing support for additional prudential steps by the Fund. We noted that a majority of Directors was in favor of a judgmental determination of additions to the Special Contingent Account rather than applying a preset formula. We would still stress that the size of the arrears problem should be a factor of paramount importance when making such a judgment. Like Mr. Dallara, I would also be willing to be flexible in the wording of the decision establishing the Account, recognizing that other problems may come into play as well, if that would help the Board to take a decision.

I agree with the staff that it is better to take a decision now than to wait until the end of the financial year. That would allow the rate of remuneration for the last quarter of the financial year to be adjusted and, more as a matter of principle, we should avoid creating the impression that the eventual difference between actual Fund net income and the target amount would determine the amount of the addition to the Special Contingent Account.

Both alternatives presented by the staff would add 5 percent of the level of reserves at the beginning of the current financial year to the Special Contingent Account. Both use the burden-shared 2 1/2 percent already decided upon, which would be diverted from reserves to the Special Contingent Account. I, like the staff, prefer the first alternative for raising the additional 2 1/2 percent. It does not necessitate an immediate change in the decision on burden sharing since the resulting remuneration coefficient would not have to fall below 85 percent. Of course, there is no reason why the coefficient would not be allowed to fall to the 80 percent limit later on, if that is deemed necessary. Furthermore, alternative (a) leaves unchanged the conclusion reached earlier that the amounts placed to the Special Contingent Account in FY 1987 can be deemed to have been derived from charges.

I note that the staff proposal calls for an increase in the rate of charge now, even though, given the current projections, that might not be necessary. I think that an increase is justified now, however, because it would make additions to the Special Contingent Fund and its financing clearly independent of the outcome for net income in the rest of the financial year.

Finally, I can go along with the staff preference for using the Special Contingent Account, with respect to both refunds and reductions because of losses, in proportion to the amounts contributed until that time.

I sincerely hope that a sufficient majority will emerge on this occasion.

Mr. Othman said that his position on further additions to the Special Contingent Account in FY 1988 remained essentially the same as at the December 1987 meeting. He could go along with alternative (b) as proposed by the staff. On the charging of losses to, and refunding of amounts out of, the Special Contingent Account, he continued to be in favor of proportionate attribution.

Mrs. Ploix asked first, what majority was required to decide retroactively to reduce the rate of remuneration and, second, why the staff had not proposed such a decision to the Board in order to make the functioning of burden sharing more flexible and smoother. Also, would it have to be decided at the time of each addition to the Special Contingent Account whether that amount would be burden shared or not? She could support Mr. Sengupta's proposal, and it should be decided at the current meeting to refund any excess income to the debtors.

Mr. Kabbaj said that he agreed with Mrs. Ploix that any excess income should be paid back to the debtors, regardless of the solution agreed at the current meeting.

Mr. Dallara asked whether Mrs. Ploix and Mr. Kabbaj could support the proposal of Mr. Sengupta in the context of an overall decision to increase the Special Contingent Account at the current meeting.

Mr. Kabbaj said that all amounts set aside for dealing with arrears should be burden shared, whether they were assigned to general reserves or to the Special Contingent Account. The present system was heavily biased against the debtors.

The Treasurer remarked that the Special Contingent Account could indeed receive burden-shared funds. For example, alternative (a) suggested in the staff paper involved burden sharing: the proposed addition to the Special Contingent Account of 2.5 percent of the level of reserves at the beginning of FY 1988 would be generated in accordance with the decision on principles of burden sharing.

Mrs. Ploix said that she understood that a decision could be taken to burden share additions to the Special Contingent Account. However, could a decision be taken to have all additions to the Account burden shared?

The staff representative from the Legal Department remarked that three mechanisms had been mentioned in the Board: first, the special line of reserves; second, supplemental income, as mentioned in Mrs. Ploix's statement and which was part of the burden-sharing decision; and third, the Special Contingent Account that had been established on June 17, 1987. The term "special line of reserves" had been used in the Chairman's summing up of the informal meeting in July 1986. The term had been set in quotation marks as having to be defined in a legal decision subsequent to that meeting. The definition had been accomplished in the burden-sharing decision, which provided that the supplemental income agreed upon in FY 1988 would be burden shared in accordance with the principles outlined in that burden-sharing decision; that that amount would be recorded separately; and that it would be refunded according to the mechanism described in the burden-sharing decision. Funds assigned to the Account were not reserves in the sense of Article XII, Section 6, but rather supplemental income that was recorded separately and was refundable to those that had contributed to it. Reserves, on the other hand, were not refundable and if it were decided to distribute them, the distribution would have to be made to all members in proportion to their quotas. Another distinction was that general reserves protected against general risks, while the funds raised in accordance with the burden-sharing decision existed for the purposes outlined in Section 1 of that decision.

With respect to the Special Contingent Account, the staff representative from the Legal Department said, it had been decided by the Executive Directors that the Account was set up in view of the existing overdue obligations, that the Account would be called a "Special Contingent Account," that amounts placed to that Account would be recorded separately, and that when it was decided by the Board that the amount placed to the Account should be refunded, that amount should be distributed to creditors

and debtors. It had yet to be decided how that distribution would be made, and how the criteria for the dissolution of the Account would be more precisely defined.

Mr. Nimatallah remarked that he saw no difficulty with adding to the decision the requirement that all subsequent additions to the Special Contingent Account be made on the basis of burden sharing. The SDR 26.5 million already in the Account should be distributed to the debtors; it was simply an accident that that contribution to the Account had not been made on the basis of burden sharing.

The staff representative from the Legal Department explained that burden sharing had been possible at the end of FY 1987 because the remuneration coefficient for part of that year had been below 100 percent. However, the remuneration coefficient had been at 100 percent throughout FY 1988. If an additional amount were placed to the Special Contingent Account at the end of a fiscal year out of that year's income without corresponding adjustments from the outset, and that amount was later refunded to the creditors, effectively, the remuneration coefficient would be retroactively increased. However, according to the Articles, the remuneration coefficient could not be more than 100 percent. Therefore, it had to be decided before the end of the financial year to reduce the remuneration coefficient in order to allow room for subsequent upward adjustment.

Mr. Nimatallah observed that if additions to the Account were to be made according to the principles of burden sharing, such addition would therefore have to be made before the end of the financial year. When the refund was made at some time in the future, it would be linked to the financial year in which the rate of remuneration had been adjusted, rather than the year in which the refund was being made.

Mr. Grosche asked whether it was not possible to refund amounts in the Account to creditors if the remuneration coefficient at the time of the Account's dissolution were 100 percent.

The staff representative from the Legal Department explained that the funds would have been placed in the Account through a reduction in the rate of remuneration to 85 percent under the burden-sharing decision, or 80 percent under the Articles. The subsequent refund of the amount in the account would, in effect, raise the rate of remuneration for the year in which the funds had been set aside to 100 percent.

Mr. Sengupta said that he wondered why decisions on the rate of remuneration had to be made in advance. He presumed that if the decision to add to the Account were postponed until the end of the financial year, the rates of charge and remuneration would be adjusted at that time. Was that not possible from a legal standpoint?

The staff representative from the Legal Department responded that there was no provision in the Articles for a retroactive reduction of the rate of remuneration.

In response to a question by Mr. Donoso, the staff representative from the Legal Department said that there was no provision for a retroactive increase of the rate of charge; that rate could be reduced retroactively, but not increased.

Mr. Dallara asked whether it was possible to amend the initial decision establishing the Special Contingent Account in order to take account of Mr. Grosche's concern that the Account be related to more than the arrears problem alone, and if not, whether it was possible to make clear in the decision taken at the current meeting that any amounts would be added to the Account in light of a variety of factors, including the problem of arrears. He would be prepared to support a decision that future additions to the Account be burden shared. With respect to disposition of any excess income for the current financial year, while he could understand some Directors' interest in retroactively reducing the rate of charge, that action seemed premature. Would those Directors accept either of the following possibilities: first, that a certain minimum amount of that excess income be returned retroactively, or second, that it be decided that all excess income either be returned retroactively or redeemed? It did not seem that a definitive decision on that issue was necessary immediately, although he could support either of those options if that helped form a consensus for alternative (a).

The Treasurer noted that when the decision had been taken to increase the income target from 5 percent of reserves to 7.5 percent of reserves, it had been anticipated that arrears would probably increase. However, it had been hoped that the majority of members in arrears at that time would become current. Therefore, the actual development of arrears over the past two years had not been fully anticipated when the decision had been taken, and for that reason the staff had proposed, and was again proposing in the current staff paper, that steps be taken toward adding to the Special Contingent Account.

The staff representative from the Legal Department, in response to Mr. Dallara's question on whether it was possible to change the language in the Special Contingent Account decision referring to existing overdue obligations, explained that several aspects would need to be considered. First, the decision adopted on June 17, 1987 stated that the Account was established in view of existing overdue obligations, but left the more precise definition of criteria for its dissolution open for a further decision by the Executive Board. The judgment as to when the need for the Account disappeared, however, was related to the purposes for its establishment. Second, a Special Contingent Account could be formed, for which the criteria would be somewhat broader, but which would leave the 1987 discount untouched. Finally, the language in the original decision had been used to describe the Account in the financial statements and had been explained to the external auditors as the rationale for establishing the Account.

The Treasurer, in response to a question by Mr. Dallara, said that the External Audit Committee might well be concerned if the language

defining the original Special Contingent Account were changed. When the Fund's accounts were being closed for FY 1987, the decision to establish a Special Contingent Account was taken before net income was established, and then a decision was taken on disposition of the net income. The rationale for establishing the Special Contingent Account was incorporated into Note 6 of the Fund's financial statements, repeating the language of the decision setting up the Account. As far as the allocation for FY 1988 was concerned, a broader rationale was possible.

Mr. Sengupta pointed out that the Special Contingent Account had been established as a response to the problem of arrears, and, accordingly, when that problem was perceived to have ended, or to have been reduced, additions to the Account would stop and the amounts in the Account could be refunded. If other factors were added as a further rationale for the Account's existence, it would be difficult to distinguish between the Account and general reserves. It would not be clear when the need for the Account had ended.

It had to be decided at the current meeting to return any excess income to the debtors, Mr. Sengupta noted. Based on the principle of burden sharing, the 100 percent rate of remuneration would be reduced, and the rate of charge raised. If it were not decided that excess income should be returned to debtors, then debtors would end up paying more than their fair share. If that were the case, his chair could not agree to either staff alternative.

Mr. Dallara said that the question of excess income was a separate issue from the burden-sharing exercise. If the burden-sharing decision were not in place, and the Fund had a traditional reserve target, then the disposition of any excess income required a decision by the Board. He certainly did not intend for the debtors to accept a disproportionately large share of the burden-sharing responsibility.

Mr. Nimatallah commented that the Special Contingent Account decision could be amended to say that subsequent financing of the Account would be burden shared, thus easing later redistribution. The question of broadening the rationale for the Account could then be postponed until the staff had further investigated the matter. On disposition of excess income for FY 1988, he suggested that the following wording be added to the decision: "that amounts in excess of net income could be used to reduce retroactively the rate of charge, provided that they are equal to or smaller than the amount contributed by the debtor countries to the Special Contingent Account in advance." No net gain would then be made by the debtor countries.

Mr. Ortiz said that the decision on additions to the Account should not be tied to the question of disposition of excess income. As Mr. Sengupta had explained that since the rate of remuneration was already at 100 percent, any excess income resulted from an excessive rate of charge, and, therefore, debtors should be reimbursed the excess income.

Any amount to be placed to the Special Contingent Account would be burden shared. A decision to do anything other than return excess income to the debtors would be unfair.

Mr. Sengupta pointed out that, as explained in footnote 2 on page 3 of the staff paper, the rate of charge would not be increased on the basis of currently projected income. Debtors were taking a risk that the projection was accurate. However, a decision had to be taken to assure debtors that excess income would be returned to them.

Mr. Kabbaj said that he supported the staff's proposal and agreed with Mr. Sengupta that the Board could not accept part of the proposal and reject another part of it. Debtors should have an assurance that if the increase in charges led to excess income, that amount would not be put to reserves or to the Account, but would be returned to the debtors.

Mr. Dallara said that while he understood that none of the excess income should be returned to the creditors, that did not preclude either deeming the amount or placing it into reserves. However, he could go along with the proposal of Mr. Sengupta and Mr. Ortiz, if they could make an effort to take Mr. Grosche's concerns into account. Broadening the basis for the Special Contingent Account would not really create a problem for the closing of the Account--a problem that was rather remote at that stage in any case.

Mr. Sengupta commented that if Mr. Dallara would support the staff proposal, his chair could agree to discuss further modalities of the Special Contingent Account at a later date, after another staff paper had been prepared.

Mrs. Ploix noted that when the Account had been created, no one had foreseen the tripling of the structural adjustment facility and the fact that the risks associated with arrears would be carried by the creditor countries and not by the Fund. Those points had to be taken into account when assessing the effect of arrears on the Fund. The Board had to be careful not to add to reserves if changed conditions no longer indicated a need for such addition.

Mr. Grosche said that he appreciated Directors' attempts to meet his concerns. The Special Contingent Account had been established in view of existing overdue obligations and, therefore, was clearly close to provisioning--an inappropriate practice for an institution such as the Fund. The decision establishing the Special Contingent Account needed to be amended substantially to make it clear that the Account would accumulate supplemental income necessary to take care of general increased risks; any direct link between the Account and the arrears problem had to be avoided.

The difference between the general reserves and the supplemental income he was describing would be the manner in which the funds were accumulated; the supplemental income would be burden shared and could be repaid to those members that had contributed it, Mr. Grosche explained. Although

it should remain a matter of judgment for the Board, the Acting Chairman could indicate in the summing up several risk factors to be taken into account when deciding on accumulations of amounts in the Account. The same sort of judgment would be needed for the repayment of those funds.

The Acting Chairman said that a consensus seemed to be emerging. Apparently Mr. Grosche wished to make a distinction between the rationale for establishing the Account and the criteria for eventually closing that Account. For example, one could use a general judgmental approach for additions to the Account, but one could also have a more definitive basis on which to dissolve the Account, such as the elimination of arrears. Certainly, the basis for making repayments from the Account had to be more clearly defined than the basis for making additions. While he was reluctant to reintroduce the notion of arrears into the formula for the dissolution of the Account, it might be possible to do so in a summing up, rather than through a legal provision. Also, it might be possible to establish different voting requirements for additions to and decreases of the Account, although that was perhaps legally too difficult.

Mrs. Ploix asked whether Mr. Grosche's concern, as well as his wish to simplify the issue, could be met by returning to the idea of supplemental income. Such income had a wide definition, but was also burden shared.

The staff representative from the Legal Department noted that the decision on burden sharing contained a reference to supplemental income in Section I(1). In particular, Section V(4) mentioned the modalities for the distribution of supplemental income. There was a reference to outstanding overdue charges and repurchases, but a judgmental approach was also alluded to in the words "at such earlier time as the Fund may decide."

Mr. Nimatallah said that he continued to feel that refunds could be made on a judgmental basis, according to the relevant problem at that time. The Account could then be in place for any problem that might arise. The scope of the Account would be widened, but additions to and reductions in the Account would be made judgmentally, as a particular problem worsened or improved.

Mr. Kyriazidis asked what sort of problems, other than arrears, would not be covered by the general reserves.

Mr. Grosche said that he could not predict those problems. Currently, the arrears problem was clearly the most pressing one, calling for additions to reserves. However, the Board currently was not willing to increase the income target above 5 percent without burden sharing. Moreover, a clear majority wanted funds that were burden shared to be refunded, and because refunds could not be made from general reserves, a special line of reserves had to be created. He could go along with such an account, provided it was not linked exclusively to arrears. It would be for the Board to decide whether to add to or dissolve the account. The only problem with such an account would be the tendency, given the

discrepancy in required voting power, to add to reserves--which required a 50 percent majority--rather than refunding the amounts in the Account--which required a 70 percent majority vote.

Mr. Ortiz suggested that the Board's decision be separated, so that Directors could decide on an addition to the Special Contingent Account through either alternative (a) or alternative (b). Perhaps the summing up could mention a time at which the basis for establishing the Account could be discussed.

Mr. Nimatallah said that he favored a formula by which the scope of the Account was widened but each problem was judged on its own when a decision was taken to augment or reduce the Account. Then it could be decided that any excess income should be used to retroactively reduce the rate of charge.

Mr. Ortiz commented that Directors seemed to agree that whatever form the Account took, additions to the Account should be burden shared.

Mr. Sengupta noted that the decision to be taken at the current meeting was whether to adopt alternative (a), alternative (b), or neither. The question of the basis for the Account could be reflected in the Acting Chairman's summing up. However, that issue could be discussed after the staff had prepared a paper on that specific question.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/10 (1/25/88) and EBM/88/11 (1/29/88).

2. HONDURAS - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1

1. The complaint of the Acting Managing Director dated January 21, 1988 in EBS/88/9 (1/21/88) on Honduras is noted. It shall be placed on the agenda of the Executive Board for February 22, 1988.

2. The Fund urges Honduras to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule K-1 particularly affects Honduras. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8779-(88/11), adopted
January 28, 1988

3. BANGLADESH - TECHNICAL ASSISTANCE

In response to a request from the Bangladeshi authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/88/19 (1/20/88).

Adopted January 25, 1988

4. PEOPLE'S REPUBLIC OF CHINA - TECHNICAL ASSISTANCE

In response to a request from the Chinese authorities and the World Bank for technical assistance in surveying the country's tax system, the Executive Board approves the proposal set forth in EBD/88/23 (1/22/88).

Adopted January 27, 1988

5. EL SALVADOR - TECHNICAL ASSISTANCE

In response to a request from the Salvadoran authorities for technical assistance in reviewing the country's tax system, the Executive Board approves the proposal set forth in EBD/88/34 (1/25/88).

Adopted January 28, 1988

6. EQUATORIAL GUINEA - TECHNICAL ASSISTANCE

In response to a request from the authorities of Equatorial Guinea for technical assistance in reviewing the direct tax system, the Executive Board approves the proposal set forth in EBD/88/18 (1/20/88).

Adopted January 25, 1988

7. GUINEA-BISSAU - TECHNICAL ASSISTANCE

In response to a request from the authorities of Guinea-Bissau for technical assistance in reviewing the country's import tax system and duty assessment procedures, the Executive Board approves the proposal set forth in EBD/88/35 (1/25/88).

Adopted January 28, 1988

8. OUTPLACEMENT ASSISTANCE FOR STAFF

The program of outplacement assistance and the proposed home leave provisions during terminal leave outlined in Section II of EBAP/87/277 are approved. (EBAP/87/277, 12/18/87; Sup. 1, 12/30/87; and Sup. 2, 1/20/88)

Adopted January 25, 1988

9. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 87/105 are approved. (EBD/88/20, 1/21/88)

Adopted January 27, 1988

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/18 (1/22/88), EBAP/88/24 (1/26/88), and EBAP/88/25 (1/27/88), by an Advisor to Executive Director as set forth in EBAP/88/18 (1/22/88), and by Assistants to Executive Directors as set forth in EBAP/88/19 (1/22/88) and EBAP/88/22 (1/25/88) is approved.

APPROVED: October 6, 1988

JOSEPH W. LANG, JR.
Acting Secretary

