

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/2

10:00 a.m., January 7, 1987

J. de Larosière, Chairman

Executive Directors

A. Abdallah

A. Donoso

M. Finaish

M. Massé

Y. A. Nimatallah

G. Ortiz

G. A. Posthumus

C. R. Rye

G. Salehkhoul

A. K. Sengupta

K. Yamazaki

Alternate Executive Directors

E. T. El Kogali

Jiang H.

M. K. Bush

L. Hubloue, Temporary

B. Goos

J. Reddy

J. Hospedales, Temporary

M. Foot

H. Fugmann

J.-C. Obame, Temporary

S. de Forges

O. Kabbaï

N. Kyriazidis

L. Van Houtven, Secretary

K. S. Friedman, Assistant

1. Overdue Financial Obligations - Six-Monthly Report;
Special Charges; and Sale and Use of Currencies of
Members in Arrears to the Fund Page 3
2. Mexico - Exchange System Page 49
3. Eastern Caribbean Central Bank (ECCB) -
Technical Assistance Page 49
4. Indonesia - Technical Assistance Page 49
5. Annual Report on Exchange Arrangements and Exchange
Restrictions, 1987 - Part One - Outline Page 50
6. Assistant to Executive Director Page 50
7. Salary of Deputy Managing Director Page 50
8. Approval of Minutes Page 50

Also Present

Asian Department: L. De Wulf. European Department: R. P. Hicks.
External Relations Department: H. O. Hartmann. Legal Department:
F. P. Gianviti, Director; W. E. Holder, R. H. Munzberg. Treasurer's
Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer;
D. Berthet, J. E. Blalock, D. H. Brown, J. C. Corr, J. A. Gons, D. Gupta,
B. E. Keuppens, A. Salehizadeh, G. Wittich. Western Hemisphere Department:
C. M. Loser. Internal Auditor: R. Noë, C. P. McCoy. Personal Assistant
to the Managing Director: R. M. G. Brown. Advisors to Executive
Directors: A. A. Agah, P. E. Archibong, E. Ayales, A. Bertuch-Samuels,
M. B. Chatah, L. P. Ebrill, S. M. Hassan, G. D. Hodgson, R. Morales,
A. Ouanes, P. Péterfalvy, I. Puro, A. Vasudevan. Assistants to Executive
Directors: M. Arif, O. S.-M. Bethel, J. de la Herrán, F. Di Mauro,
R. Fox, G. K. Hodges, Hon C.-W., O. Isleifsson, S. King, V. K. Malhotra,
T. Morita, C. Noriega, G. Schurr, G. Seyler, E. L. Walker.

1. OVERDUE FINANCIAL OBLIGATIONS - SIX-MONTHLY REPORT; SPECIAL CHARGES;
AND SALE AND USE OF CURRENCIES OF MEMBERS IN ARREARS TO THE FUND

The Executive Directors considered staff papers on the six-monthly review of overdue financial obligations (EBS/86/255, 11/20/86; Cor. 1, 12/31/86; Cor. 2, 1/5/87; and Sup. 1, 12/31/86), the review of the system of special charges on overdue financial obligations (EBS/86/283, 12/24/86), and the sale and use of currencies of members in arrears to the Fund (EBS/86/271, 12/2/86).

Mr. Nimatallah made the following statement:

Overdue financial obligations continue to accumulate. According to the most recent information, outstanding arrears are again in excess of SDR 1 billion. Table 1 in EBS/86/255, Supplement 1 shows that over the four years from end-1982 to end-1986, overdue financial obligations increased from about SDR 29 million to about SDR 1,032 million. What is even more disturbing is the information revealed in Table 3 in the same paper, which indicates that the percentage of late payments in relation to total obligations due rose from about 7 percent to 21 percent in the period end-1982 to end-1986. Over the same period, the number of members late as a percentage of members with obligations due jumped to almost 50 percent.

The staff's assessment of the situation on page 3 is that "the situation remains serious." I could not agree more. However, I would have liked the staff to have explained more fully why the situation remains serious. For example, it would have been pertinent to have detailed the factual financial impact of overdue obligations on the membership through increased charges and reduced remuneration. It would have been even more pertinent to have explained how this impact might become unbearable should the arrears situation worsen and provisioning be introduced. The potential financial impact on creditors could result in a deterioration in their support for a quota increase, and as charges become more prohibitive and conditionality more unbearable, borrowers might be discouraged from coming to the Fund.

The question to ask is why countries are becoming less adept at repaying the Fund. Something is not right. I remember that during previous reviews of the problem of overdue obligations some Executive Directors blamed the system while others tended to blame the Fund. In my view, the time for placing blame should be behind us.

I hope that the Executive Board will have the opportunity to go beyond a routine discussion of the six-monthly report on overdue payments. Irrespective of who is to blame, let us see what the Fund can do to secure timely repurchases, both current

and prospective. Of course, this is an objective that goes beyond the scope of today's six-monthly report. What I have in mind is a wider perspective that encompasses three phases: a phase involving prospective users of Fund resources; a phase involving countries that have already made purchases from the Fund but soon have to make repurchases; and a phase involving countries already in arrears, including countries that are at the predeclaration and postdeclaration of ineligibility stages.

Let me begin with the first stage, which could be characterized as potentially the least serious but which requires preventive measures to avoid the emergence of repayment problems. Is the Fund doing all it can to ensure that these potential users of Fund resources will be able to meet their obligations to the Fund on time? While I welcome the increased staff emphasis in medium-term scenarios on countries' ability to repay, three questions come to mind. Are the programs realistic enough in terms of adjustment measures and length of repurchase period? Is the Fund paying sufficient attention to the debt profile of countries, and in particular is enough emphasis being placed on avoiding unnecessary bunching? Is the Fund well equipped to monitor repurchase obligations, thereby being in a position to follow up diligently in cases of delays?

I believe that the Fund is becoming more realistic in the area of program design, as it is now paying increased attention to growth and is taking into account to an increasing extent the specific circumstances of individual borrowing countries. I encourage the Fund to continue to move in those directions. There is still a problem, at least for certain countries, with respect to the length of the repurchase period. However, I am glad that the structural adjustment facility is emerging to provide an important additional dimension to Fund arrangements in this area. I hope that the Fund can some day find ways in which to enlarge structural adjustment facility-type resources and increase structural adjustment facility-type programs, which seem to be helpful in adapting the repayment period to the need for structural adjustment.

In the area of bunching of external repayments, the Fund has started to pay more attention to the potential burden that this can be for members. I urge management and the staff to continue in this direction. On the matter of how the Fund follows up on members with repayment obligations before and after they are due, it is not clear to me whether the Treasurer's Department is equipped with a unit devoted only to securing the safe return of Fund resources. If there is no such unit, I urge management to give serious consideration to establishing one with clear terms of reference on how to alert members. That unit could work

closely with members and could use the offices of Executive Directors to help. A comment on present procedures in this respect by the Treasurer would be helpful.

For their part, members should cooperate with the Fund and avoid falling into arrears. Unfortunately, there is ample evidence that certain countries with sufficient foreign exchange earnings and reserves have repaid other creditors and international organizations and have neglected the Fund. Therefore, the Fund may need to insist in advance that countries give first priority of repayment to the Fund. Countries should also know in advance that they cannot accumulate large reserves and not repay the Fund. More generally, I urge management and staff to continuously make improvements in preventive measures.

I will now comment on situations involving countries that have already made purchases but will soon have to make repurchases. The staff indicates in its paper that, while in the past few years repurchases have averaged less than SDR 4 billion a year, they are now projected to reach on average about SDR 7 billion in both 1988 and 1989. This implies that the probability of countries becoming overdue might increase unless some measures are taken in advance. What makes these measures more necessary now is that, according to the staff, some of the members facing heavy repurchase schedules in 1988 and 1989 have very weak external prospects. Worse yet, some are facing systemic problems stemming from a steady deterioration in their terms of trade and the rising tide of protectionism.

In view of all these discouraging prospects, it is imperative that the Fund and the whole membership cooperate to prevent a possible serious deterioration in the capacity of countries to service their debt obligations. The Fund can do its part by paying more attention early enough, through close monitoring of developments and through the proposed follow-up unit in the Treasurer's Department. The membership can do its part by resisting vehemently the rising tide of protectionism. In addition, members facing repurchases should be particularly vigilant so as to avoid adjustment policy slippages. With the cooperation of all the parties concerned, the prospects of avoiding overdue payments in 1988 and 1989 should improve.

As to countries that are already in arrears, I endorse the staff's call for "corrective measures" to be taken by those countries. I agree that they should adopt adjustment policies under programs supported by the Fund. In addition, I share the staff's hope that friendly countries will step in to help those countries become current with the Fund. However, some countries are in arrears to the Fund because they are willing but unable to repay while some others are able to pay the Fund but are unwilling to do so. I have the feeling that the staff has

avoided saying anything about countries that are able but unwilling to pay the Fund. I did not see anything to suggest a specific course of action for dealing with those countries--for example, the question could be asked whether the Fund should treat these cases as uniformly as it does others in, say, providing technical assistance in particular and carrying out regular relations with the Fund, including Article IV consultations, in general.

The Fund should continue its practice of cooperating with countries in arrears that have good intentions, are willing to repay when they can, and are willing to adopt and implement comprehensive adjustment policies. However, for countries that are able but unwilling to repay, the Fund, while being cooperative, should insist on credibility and discipline. Is the Fund sufficiently cooperative and firm? I give the Fund full marks on cooperation. However, I would give the Fund less than full marks on firmness. It is important that, while maintaining a spirit of cooperation, the Fund maintain its credibility and integrity. The way to do so is through the adoption and implementation of delicately balanced overdue payments procedures that take into consideration not just the narrow aspects of the particular cases concerned, but also the role of procedures as preventive measures for future potential cases. Therefore, the assessment of procedures and measures, such as the declaration of ineligibility, publicity, and the imposition of special charges, should not be made only in terms of immediate results, especially whether or not they lead to acceleration of repayment by the members concerned. This view is too narrow. For the sake of discipline and credibility, and to send the right signal to other potentially difficult cases, the Fund should look again at its procedures with a view to strengthening them.

Let me take the declaration of ineligibility as an example. I agree that the Fund should reach a judgment on the declaration of ineligibility on a case-by-case basis. There have been occasions when it was helpful to delay such a declaration, and when it would have been futile to waste any more Executive Board time, as this would have compromised the Fund's credibility. This is especially true of cases involving countries that are obviously unwilling to repay the Fund.

Another weakness of present Fund procedures is the handling of postineligibility cases. In my view, the Fund's credibility is being impaired by the perception that is projected by the way in which the Fund handles these cases. At present, the post-ineligibility period lacks the serious action that is needed to make the declaration more effective. I am disappointed that the staff did not explore more avenues, despite my previous attempts to stimulate their thinking in this direction. Ineligibility should be combined with other reinforcing measures to keep the countries that have been declared ineligible from feeling that remaining in arrears is a "good deal" for them.

There has to be more collaboration between the Fund and the World Bank. It would be appropriate to consider asking the World Bank to take into account more fully the Fund's declaration of ineligibility of a member country. I understand that the practice is moving in that direction now, but it would ultimately be in the best interest of those countries, the Fund, the World Bank, and indeed the whole system to strengthen the collaboration between the Fund and the World Bank by making it more explicit and systematic, thereby sending a stronger signal. Meanwhile, the Legal Department should again explore the concept of suspension of membership for one year and any other measure to strengthen the Fund's image.

This brings me to the suggestion that a member in arrears to the Fund should not be allowed to effect an increase in its quota consequent upon a general quota increase until that member becomes current. Although I agree that such a suggestion is a step in the right direction, I am afraid that it does not go far enough, as it does not provide an incentive to speed up the settlement of overdue obligations. It is possible that a member in arrears can wait for several years before settling its obligations, since the quota increase will always be available and, in any event, such an increase is not needed while the member is in arrears, as the Fund will not enter into any arrangements with such a member. Therefore, in order to obtain a speedier settlement, a deadline--say, one or two years--should be included in the proposal, and after the deadline the right of a member to effect a quota increase would disappear.

Mr. Abdallah's suggestion that country officials should bring moral pressure to bear on countries in arrears is a good one. One can only add that the borrowing countries may be in a better position to persuade other countries about the burden of arrears, since it is mainly borrowing countries that are suffering from arrears, as a result of higher charges, greater conditionality, or a potential lack of new resources.

Special charges is another area where the Fund is not firm enough in projecting an image of discipline in handling present and potential cases of arrears. Penalty charges on overdue repurchases, if imposed selectively--for example, in cases characterized by an evident lack of cooperation--could have a positive impact. That approach is definitely legal. However, for the time being, I encourage the Fund to persist at least in recovering the costs that it incurs due to delays in the settlement of both charges and repurchases. Therefore, I endorse the proposed decisions in the staff paper. I support both the extension of special charges to include potential arrears associated with drawings under the structural adjustment facility and the proposal to use the basic, rather than the adjusted, rate of

charge as the relevant rate for comparison with the SDR rate. I see very little benefit to be gained from the sale and use of currencies of members in arrears to the Fund.

In conclusion, the six-monthly review of overdue obligations is becoming a matter of routine, as it has the limited objective of updating information. It has not been successful in coming up with workable solutions to the arrears problem. A more helpful approach to solve this problem would be to widen the scope of the review, with a view to devising measures and mechanisms that address the fundamentals of the problem. It should be remembered that the basic objective is to secure the timely return of resources--present and future. Therefore, I suggest that a staff paper be prepared with this broadened scope in mind. Such a paper could perhaps be discussed by the Executive Board soon after the Interim Committee meetings. In this paper the staff should take a fresh look at all dimensions of the issue, perhaps within the framework that I have described in this statement. This fresh look should leave no stone unturned. It might even consider the implications and legalities of rescheduling by the Fund. The present six-monthly review could then be circulated like the three-monthly update. Alternatively, the perspective of the present six-monthly review could at least be expanded to encompass the dimensions of the problem beyond those associated with countries that are at present in arrears to the Fund.

The seriousness of the overdue obligations problem is not clearly understood. It is true that the Fund has been able to introduce some welcome measures to strengthen its financial position and that the membership has shared in the burden of these measures. One can imagine the great difficulties that would arise if the Fund is some day faced with an arrears problem of such a magnitude that would force it seriously to consider provisioning. The Fund could then find itself in the dilemma of being in a no-win situation: the burden of provisioning on the membership would be intolerable, while the failure to introduce provisioning under such circumstances would be considered imprudent and could undermine the financial integrity of the institution. I hope that the Fund will not have to face such a prospect. The Fund is too important an institution to place at risk. Fortunately, we still have time to work together to preserve the strength and integrity of the Fund for the interests of its membership and the system.

Mr. Rye made the following statement:

Commenting first on the six-monthly report on overdue obligations I would note that, notwithstanding some favorable developments, one cannot escape the conclusion that, overall, the problem worsened again in the period under review. It is true

that the number of member countries with overdue obligations fell from 17 to 12 between March and December 1986 and that the number subject to complaints fell from 10 to 7 over the same period, and to 6 if Jamaica fulfills its promise to eliminate its arrears by next week. However, total arrears increased to a record level of more than SDR 1 billion at December 24 and became more concentrated and protracted. Since March, arrears of two years' duration have increased more than three times while arrears of one to two years' duration have doubled. It seems that we are getting down to the "hard core" cases. There can be little comfort in this when forthcoming obligations of these members amount to SDR 750-1,000 million in 1987 and in 1988. Nor, as the staff notes, can there be any assurance that the problem, or even most of it, can be restricted to these present cases, particularly since, over the coming few years, a number of members with weak external positions face heavy debt service schedules. In brief, it takes little imagination to see the potential for arrears to increase much more in each of the next two years than this "base" rate of SDR 750-1,000 million, as unfavorable as that is.

Another cause for concern is the increasing number of members that are late in settling their obligations to the Fund--almost half those required to make payments to the Fund in the year to September 1986. The proportion of members adopting a cavalier approach to the principle of prompt payment to the Fund seems to be creeping inexorably upward.

It is of course much easier to deplore these developments than to find solutions. It is difficult even to suggest improvements in our own procedures, although Mr. Nimatallah has made a radiant effort to do so. Some of his ideas, such as the possibility of penalty charges on countries that clearly are not cooperating with the Fund, should be further explored. Although it is a matter for consideration later, his suggestion for a deadline on the right to take up a quota increase also seems to be worth pursuing.

As Mr. Nimatallah stated, the Fund will need to ensure that future programs are "realistic in terms of adjustment measures and length of repurchase period." No doubt we all agree with this, as a general proposition. The difficulty will come, as it always does, in translating a fine general sentiment into particular hard decisions, including, I suggest, one or two that are likely to be in the pipeline in coming months.

In the final analysis, there must be adequate adjustment efforts by member countries facing arrears problems or heavy repurchase schedules. Members must also be encouraged to give priority to payments to the Fund. With members' cooperation, the Fund and creditors can continue on a case-by-case basis to

help ensure that members have sufficient time and an adequate flow of external finance to settle outstanding arrears and stabilize their medium-term external positions. In this connection, I would welcome any elaboration by the staff of the reference on page 8 of EBS/86/255 to a possible need to "strengthen and systematize" cooperation by donors and creditors.

I agree that the Fund should continue to cooperate fully with and to seek cooperation from, other international institutions, especially the World Bank, on arrears matters. But I would have some reservations about any suggestion that the Fund might initiate formal action to try to influence the policy decisions of other institutions toward their members.

I am not in favor of making a declaration of ineligibility a standard at the time of the first substantive complaint. While the current case-by-case approach may sometimes lead to unnecessary slippages in the Fund's response, it also provides the Executive Board with needed flexibility to react to differing circumstances of members. In addition, I have some sympathy with the staff view that the prospect of ineligibility may have a greater effect than the actual decision. As Mr. Nimatallah noted, our ineligibility procedures seem to lack any real teeth. This is a matter that should be given further careful thought, including the possibility of cutting off technical assistance to ineligible members as a further step in the sanctions process.

I agree with the staff that each decision on a suspension of a member's right to use SDRs should permit the member to use SDRs in the settlement of its financial obligations to the Fund.

I turn now to the question of the system of special charges. Thus far, special charges have not proven to be particularly effective in encouraging either the settlement of protracted arrears or prompter settlement of members' obligations. Of course, in the case of protracted arrears, positive results were always rather unlikely. As to the effectiveness of these charges in encouraging prompt settlement, I agree that it is still early to make such an assessment, although I would not be averse to further consideration of the possibility of penalty charges in appropriate cases.

I support the proposed decisions on pages 12 and 13 of EBS/86/283. I agree with the staff that it would be appropriate to use the unadjusted rate of charge in calculating special charges on overdue repurchases of ordinary resources and that the application of special charges on overdue charges should not be modified. Any other decision would disadvantage all the membership to the benefit of members in arrears. I also support the introduction of a system of special charges for overdue obligations under the structural adjustment facility similar to the system applying to overdue Trust Fund obligations.

I need comment only briefly on the question of the sale and use of currencies, as the staff paper establishes clearly that the prospects of anything worthwhile coming out of such an approach are remote. The most promising--or the least unpromising--idea is perhaps that of "testing" the bona fides of members in arrears, or that have been declared ineligible, through this mechanism. But it would be difficult to find the right balance between an amount that was too small to represent a real test and one that was so large as to fall under the general claim of the defaulting member that it was simply unable to pay in usable currencies. There would certainly be a need, as the staff notes, to avoid any suggestion that burdens that should be properly borne by the Fund membership as a whole might inadvertently be placed upon a particular purchasing member. In sum, I see no reason for further work on this issue. However, I would not object, if the majority of Executive Directors so wished, to a low-key exploration of the possibilities for the use of currencies of members in arrears either by purchasing countries--with the safeguards suggested by the staff on page 14 of EBS/86/271--or by outside organizations.

Mr. Reddy made the following statement:

I endorse the staff's conclusions in the six-monthly report on overdue financial obligations. The number of members in arrears has declined, although the outlook is not particularly promising because of the less favorable outlook for the world economy and the larger than usual obligations falling due in the coming period. Nevertheless, the broad range of measures that have already been introduced constitute a major effort to avoid the emergence of new arrears and to provide incentives for members that already have arrears to become current. I strongly endorse the preventive measures that have been taken and the measures to strengthen the Fund's financial position. In addition, I endorse the existing procedures for dealing with members with arrears and the staff's suggestion that the timing of the declaration of ineligibility should be decided on a case-by-case basis.

When the Executive Board first discussed the system of special charges on overdue financial obligations this chair had reservations about the effectiveness of such charges. Those reservations have been borne out by the experience with the charges between January and October 1986, which shows that only SDR 1 million out of total special charges of SDR 9 million were recovered. This chair still feels that imposing special charges on overdue members has the effect of compounding the very difficult circumstances of those countries. In addition, I agree with the staff's conclusion on page 11 that there is not enough evidence to conclude that the system of special charges has

influenced members' payments performance to any significant extent. Even though I still have reservations about the effectiveness of special charges, I can go along with the proposed decisions on pages 12 and 13 of EBS/86/283.

I understand the arguments for and against the use of currencies for members in arrears to the Fund set out in the staff paper. On balance, I am not convinced that the sale and use of currencies of members in arrears is a practical idea. There are at least five considerations that have led me to this conclusion. First, the countries in arrears are facing serious balance of payments problems and are accumulating arrears not only to the Fund but also to other creditors. It is highly unlikely that these members would be in a position to meet their exchange obligations if their currencies were used to finance purchases; indeed, the proposal would have the effect of further worsening the already difficult balance of payments position of the members with overdue obligations.

Second, as the staff notes on page 14, it would be inconsistent with the purposes of the Fund for the institution to place the purchasing member at risk of not being able to exchange its currency for a convertible currency or SDRs. The Fund must not encourage a member to take such a risk.

Third, from the viewpoint of members with arrears, there may be legal problems in implementing some of the proposals. For example, there are legal provisions in many countries requiring compulsory surrender of foreign exchange receipts from sales of goods and services to foreigners. There are also rules and regulations governing the currencies in which foreign exchange reserves may be invested. These considerations may make the exchange of currencies very difficult.

Fourth, the proposal is based on two heroic assumptions, namely, that members with arrears will have the means and be willing to exchange domestic currency for foreign exchange, and that some members would be willing to take the necessary risk by purchasing overdue members' currencies without any discount or would be willing to receive the overdue members' currency without seeking an exchange. These assumptions, which are spelled out in paragraph 5 on page 22, are not realistic.

My fifth point is a more fundamental one and is based on the following question: what exactly are we trying to achieve through the proposal on the sale and use of currencies of members in arrears to the Fund? It seems to me that the basic objective behind the ideas that are examined in the staff paper are to transfer overdue obligations of the Fund to member countries and other institutions that might be willing to accept them, for whatever reasons, in the hope that they would be able to recover

the Fund's debts, or that they would be willing to convert these debts into grants. In other words, we are trying to transfer a probable loss of the Fund to other parties. While I am not opposed to such an approach, unfair as it may be, I would submit that probable losses arising from overdue obligations can best be handled through equitable burden sharing in an international cooperative institution like the Fund rather than by individual members. For all the reasons that I have outlined, I do not favor the sale and use of currencies of members in arrears to the Fund.

As to whether or not the Fund has the legal authority to sell currencies of overdue members, I would emphasize the overriding principle in the Articles that the sale of currencies of members should be subject to the finding that the members' balance of payments and reserves are strong. Therefore, while I can go along with the staff view that legal authority exists for the Fund to sell currencies of members in arrears, I believe that the authority to sell currencies of members in arrears should be used with extreme caution and only in exceptional circumstances.

In the fourth paragraph on page 22 there is a suggestion that an overdue member's currency may be placed for sale under what the staff calls a "fail-safe" mechanism in cases involving a member that apparently is not collaborating with the Fund and is judged to have sufficient resources to pay. I am not enthusiastic about any such approach, which would not only be a highly unusual banking practice, but also require subjective judgments about whether a member "appears" to be willing to collaborate and whether a member has "sufficient" resources. Use of such a technique could also adversely affect the Fund's relationship with the member. In any event, the technique that is suggested in the fourth paragraph on page 22 would not produce positive results if the member is either unwilling or unable to pay.

The staff posed the question in paragraph 5(c) on page 23 whether the countries in my constituency would be prepared to purchase the currencies of members in arrears, which would be the acid test of the staff's proposal. While I have not received responses from all the members in my constituency, I can say that in general there is not much enthusiasm among them for purchasing the currencies of members in arrears. They would view these transactions as a form of bilateral aid. In addition, the mechanism could entail difficult legislative and administrative hurdles. For example, in many countries there are laws requiring the surrender of foreign exchange receipts and rules and regulations that prescribe the choice of reserve currencies. These laws would make it difficult for the countries concerned to hold the currencies of members that are in arrears to the Fund.

The use of currencies of members in arrears to finance administrative expenses of the Fund would be extremely limited and could cause undue inconvenience. Hence, I do not favor the use of currencies of overdue members to cover administrative expenses.

Mr. Jiang made the following statement:

Overdue financial obligations have been and will continue to be a matter of concern, especially as they seem to be on the rise and there is no indication that they will be eliminated in a short period. At the same time, however, I have noticed that several difficult and protracted cases of arrears have been resolved in recent months, even though overdue financial obligations continue to rise, although at a slower rate than previously. The increase in arrears has been due mainly to the increase in the amount of arrears of a limited number of countries with prolonged overdue obligations.

The staff paper shows that cooperation by donors and creditors played an important role in the settlement of several important cases, and that the efforts of the members in arrears to adopt correct adjustment programs facilitated the settlements. All these positive efforts should be encouraged, and I look forward to further cooperation with the international development institutions in these concerted efforts to eliminate the arrears problems.

However, as this chair has pointed out on previous occasions, the problem of arrears cannot be eliminated by relying on the imposition of penalty charges or by other sanctions, such as the suspension of certain rights of members or making a member's increase in quota conditional on the elimination of its arrears. There have been dozens of cases of arrears in recent years, and all the measures that have been suggested have nothing to do with the root cause of the problem we are facing. Therefore, we will need to find imaginative and creative ways in which to solve this problem.

For the present, the Fund must continue its efforts to assist members in formulating growth-oriented economic adjustment programs and in finding donor support so that these adjustment programs can be effective. The industrial countries should be called on to make an effort to coordinate their macroeconomic policies to aim at stronger and more sustainable growth and to roll back the growing protectionism. Only in this way can we hope for a better external environment in which the debtor members can make a firm improvement in their economies and solve the arrears problems.

I am not surprised that the system of special charges, about which we expressed serious reservations earlier, "has not influenced members' payment behavior to any significant extent," and that "the system has been only partly successful in recovering costs to the Fund." It is also evident that the special charges have increased the debt burden of the members with arrears to the Fund.

I wonder whether it is not too early to adopt a decision applying the system of special charges to the newly established structural adjustment facility. However, if the majority of Executive Directors endorses the proposed decision, I can go along with them.

Some of the mechanisms suggested by the staff for the sale and use of currencies of a member with arrears to the Fund do not seem to be particularly meaningful as techniques for reducing arrears, since the potential amounts are very small in absolute terms and compared with the outstanding arrears. Some of the mechanisms seem to involve some very restrictive preconditions, thus making them more or less impractical. However, if purchasing members give some indication that they wish to obtain the currency of a member in arrears in order to assist that member to become current, if they cooperate with the Fund in dealing with the overdue obligations, and if they state their intention not to seek exchange for a certain period, then the sale and use of currencies of members in arrears might provide a new channel for eliminating the arrears.

Mr. Ortiz made the following statement:

The situation regarding overdue obligations to the Fund remains very serious. I noted with concern the unfavorable developments during the past six months, such as the steep rise in the absolute and relative amounts of overdue obligations, as well as the potential amounts that could become overdue from members that are already in arrears. At the same time, it has become increasingly evident that the problem remains concentrated in a few countries. Among the few positive signs in the staff paper is the fact that problems of prolonged and significant arrears do not seem to be spreading widely across the membership. Nevertheless, given the large amount of repurchases falling due in FY 1987 and FY 1988 and the persistence of the factors that caused this problem, the possibility of a significant additional number of members falling into arrears cannot be ruled out.

In the light of these developments, I will make several general comments before turning to the specific issues raised by the staff.

The situation of overdue obligations is part of a larger problem--the debt problem. In this context, it would not seem to be realistic to expect the emergence of an overall solution to the problem of overdue obligations. The Fund's approach to the situation should be pragmatic, and the first priority should be to contain the problem, avoiding to the extent possible its widening. To this end, preventive actions and close collaboration between the Fund and official and private creditors and donors are crucial.

In keeping with such a pragmatic approach the Fund should use the various tools and actions available to it to contain the arrears problem and to deal with the most serious cases. This requires flexibility and the ability to tailor specific actions and procedures to individual cases, avoiding as much as possible the implementation of mechanical rules. Within this flexible approach the criteria of equality of treatment should be preserved, and given the cooperative nature of this institution, considerable persuasion and patience are called for. I agree with Mr. Nimatallah that a distinction should be made between countries that are able but unwilling to pay and countries that are plainly unable to pay. Serious consideration should be given to explicit rescheduling--not de facto rescheduling, as has sometimes been the practice--for countries that are clearly unable to pay the Fund.

As to the specific issues raised by the staff, I agree that, in the area of preventive measures, given the uncertainties surrounding the different elements that determine a country's capacity to service its debt to the Fund, the assessments prepared in connection with a member's request for Fund resources must provide an indication of potential risks. Nevertheless, the development of medium-term projections and the evaluation of financing gaps emerging from different scenarios are an important tool for assessing both the nature of the adjustment efforts that a country must undertake and the possible responsibilities that creditors and donors may be willing to assume. I agree with Mr. Nimatallah's comments on the need for more realism in the design of adjustment programs and on the issues of bunching of repurchases and the length of repurchase periods.

In the area of corrective measures, it seems clear that, in addition to the adjustment efforts of individual countries, collaborative efforts by creditors are essential. As the staff notes, some difficult cases have been resolved through such collaboration. As to cooperation with the World Bank and other multilateral institutions in these matters, I believe that requesting these institutions to refrain from granting new credits to countries in arrears to the Fund could be counterproductive, since the balance of payments positions of these countries could be further eroded. A more effective way in

which to prevent the emergence of overdue obligations is to avoid cross-conditionality and the unnecessary delays and deadlocks that often result from the entanglement of conditionality. In the case of countries with significant arrears--especially countries whose balance of payments position permits them to pay the arrears--persuasive efforts at the political level by friendly countries may be of significant help and should be encouraged.

As to the sale and use of currencies of member countries, in line with the flexible and pragmatic approach advocated earlier, several possible avenues of action should be explored, including the sale of the Fund's holdings of the currencies of members with overdue obligations. The staff paper on this subject suggests that the scope for this type of operation is limited and that the potential amounts involved may not be very significant. This is especially true of the possible use of currencies to cover the Fund's administrative expenses.

The staff's assessment in the final paragraph on page 21 that "if the member were willing to pay, it could be argued that in most cases this transfer might be more straightforwardly effected by other means, such as direct payment by the member with resources acquired through export or other current receipts or through aid donations or creditor financing," or put more succinctly, "if a member is truly willing to pay, it can merely proceed to pay," seems to beg the whole question. Presumably most members in arrears argue that, given their balance of payments position, they cannot pay, although they would be willing to do so once their external position improves. In fact, the possible sale of the currencies of members in arrears could be more useful if it is done on a voluntary basis as a means of helping member countries to discharge part of their obligations.

In principle, it would seem that if a member does not appear to be willing to collaborate with the Fund, it would not be very helpful for the institution to offer the member's currency for sale, especially if the sale includes a "fail-safe" mechanism. Not only would it be unlikely that other members would voluntarily purchase such currency, while the Fund would remain ultimately responsible for guaranteeing convertibility, but also it could lead to a further deterioration in the relationship between the Fund and the member country rather than serve as a "test" of cooperation. In sum, the scope for these operations is limited, and whether the currencies of members in arrears are used to finance purchases by other members or to effect exchanges for SDRs, such sales should be agreed both with the member in arrears and with the purchaser of the currency.

I support the three decisions proposed by the staff in the paper on special charges. I agree that the main purpose of the imposition of special charges on overdue obligations is to recover

the financial costs and losses incurred by the Fund on account of these arrears, and I agree with the staff that the SDR rate remains appropriate for measuring such costs. However, as this chair has stated on previous occasions, the system may have at best a limited impact on the member's payment performance and would have an adverse impact if it is perceived as yet another signal that the Fund is searching for methods with which to punish members rather than for a cooperative approach.

The procedures for dealing with overdue obligations have been limited thus far to considering the timing of steps in a predetermined process. We have mentioned in the past that the trend has been toward shortening the time between the substantive consideration of complaints and the final declaration of ineligibility, and that the results of that process are not very encouraging, although it is perhaps early to make such a judgment. I doubt whether much can be accomplished by adding obstacles to the already difficult position of the countries in arrears. Within the established framework, however, I continue to favor an approach that can be adapted to individual cases, taking into account the changes in relative weights of the factors that influence decisions on ineligibility as the circumstances dictate.

Mr. Yamazaki made the following statement:

Overdue financial obligations to the Fund clearly pose a serious problem for this unique financial institution, whose resources should be revolving in character. The problem is inconsistent with the cooperative nature of the Fund, as the costs of the arrears have to be shared by the whole membership.

In most cases, the arrears are associated with deep-rooted economic imbalances and inappropriate policy responses. Therefore, to solve the arrears problem the members concerned should, first and foremost, implement a comprehensive adjustment program. The Fund has stood ready to assist members in formulating needed adjustment policies and it will continue to do so. Without adjustment efforts by the members in arrears, collaborative support of creditors, donors, and the international financial community is difficult to obtain or might not lead to solutions to the arrears problems.

During the period covered by the present six-monthly report, total overdue obligations continued to increase, reaching SDR 911 million. At the same time, the number of members in arrears declined. The number of members that are subject to complaints has been reduced to two, and efforts are being made to clear the arrears of those members. However, the five ineligible members that account for the bulk of the arrears have made only small payments since each was declared ineligible to use

the Fund's resources. On balance, the overall arrears situation appears to have further deteriorated, although at a slower pace. As the obligations of these members falling due in the next few years amount to SDR 777 million, we will have to continue monitoring the situation closely.

I agree with the staff that at the present stage there is no need for any major modification in the general policies and procedures related to overdue obligations. I attach particular importance to the case-by-case approach that we have followed, paying due regard to the particular circumstances in individual cases against the background of decisions taken in earlier cases.

To strengthen the Fund's financial position in response to the overdue obligations problems, the net income target has been increased from 5 percent to 7.5 percent in the context of the burden-sharing agreement. However, the adequate level and target for the Fund's reserves should be kept under review in the light of the evolution of overdue obligations.

I have no difficulty in supporting the addition of the proposed phrase in decisions on complaints under Rule S-1.

I agree with the staff that the basic structure of the present system of special charges remains appropriate as a system that is designed to recover direct financial cost and losses to the Fund arising from members' overdue obligations to the Fund. The SDR interest rate is a reasonable basis for measuring direct financial costs.

As the staff argues in its paper, the direct financial costs to the Fund of overdue repurchases are in theory not recovered by the adjustments of the rates of charge and remuneration under the burden-sharing arrangement. Therefore, it is reasonable to conclude that during the period in which the burden sharing is in effect, the special charges on overdue repurchases should be calculated as the difference, if positive, between the SDR interest rate and the basic rate of charge determined at the beginning of the financial year.

The adjustments of the rates of charge and remuneration do not fully compensate for the costs to the Fund arising from overdue charges. As long as unpaid charges are not placed to deferred income and are therefore not covered by the adjustments, the Fund sustains the loss of earnings. Therefore, the introduction of the adjustments could not in itself justify a modification in the application of special charges on overdue charges. However, to the extent that such adjustments recover the financial costs to the Fund, it is logical to conclude that, if circumstances permit, the proceeds of payments of overdue charges should be used to mitigate the financial consequences for those members that had borne the cost of the adjustments.

I agree with the staff that the considerations that led to the adoption of special charges on overdue Trust Fund obligations should apply to overdue obligations under the structural adjustment facility in a similar fashion.

I support the proposed decisions on pages 12 and 13 of EBS/86/283.

The interesting staff paper on the sale and use of currencies of members in arrears to the Fund shows that the Fund has the legal authority, with certain important limitations, to sell and use its holdings of the currencies of members in arrears, with the exception of sales of these currencies in the market before withdrawal of such members. However, the staff paper also shows that, because of technical difficulties and practical considerations, it would not appear to be advisable to pursue further the idea of using the currencies of members in arrears in the absence of a keen and overwhelming interest of the Executive Board in this matter.

The obligations of an issuing member to exchange the currency purchased for a freely usable currency under Article V, Section 3(e) would make operations under a system for using currencies to finance purchases by other members virtually impractical. As to the possibility of sales of currencies to other members or prescribed holders in exchange for SDRs, my authorities have strong reservations. Since SDRs are held as part of international reserves, the purchase of currencies in arrears in exchange for SDRs would cause administrative difficulties for the purchasing members. My authorities doubt whether the operation would be consistent with the reserve character of the SDR and whether the uneven distribution of holdings of SDRs among members might in practice limit the operation. It is important to recognize that the parties concerned have a more straightforward option of helping the members in arrears to the Fund through balance of payments assistance.

Using local currencies to finance administrative expenses of the Fund would not appear to be an effective option, since the operational costs and complexities could be expected to outweigh the benefit of the reduction in arrears.

Mr. Foot made the following statement:

Previous speakers have adequately summarized the rather alarming picture of overdue obligations. I strongly agree with Mr. Nimatallah that the Fund must look very closely at a member's ability to repay the Fund before agreeing to programs. These assessments should be frank and full. The Executive Board may still make what would turn out to be the wrong decision, but it

is the Executive Board's job to make such decisions and the staff's job to set out the facts fully and frankly. I also agree with Mr. Nimatallah on the need for all the parties concerned to help to prevent arrears from arising and, when they do occur, to attempt to eliminate them. This was done with increasing success during 1986 and is one reason why the number of cases of arrears has not risen significantly. My office has been involved in the cases of Sierra Leone, The Gambia, and Tanzania, and other offices have been involved in other cases. In this respect, the process is working very well indeed.

In some cases involving frailer economies, there have been fairly substantial payments of charges or repurchases have been made only after a number of months when the same members made little or no payments. The Paris Club normally encourages a debtor to pay regular monthly amounts into an account in recognition of the likely burden that the payment effort can constitute over a year. In other words, the Paris Club encourages countries to put money aside on a regular basis. I wonder whether such an arrangement might be helpful for the countries concerned and as a means of sending an early warning signal to the Fund of new arrears problems.

The Fund should not press other financial institutions to change their policies toward countries with arrears to the Fund. However, individual shareholders of those institutions can and should consider the arrears; the United Kingdom does consider arrears in playing its shareholder role in other institutions.

I am still not certain that the Executive Board's procedures for dealing with cases of arrears ensure the most effective use of the Board's resources. However, the time has not yet come to reconsider those procedures. We may have to look at this matter again at some stage in the future.

As Mr. Nimatallah suggested, the six-monthly reviews should be an opportune occasion for more than a ritual review of overdue obligations. I particularly endorse Mr. Nimatallah's suggestion to have more detailed analysis of the appropriateness of granting quota increases to members in arrears. I am less convinced that it is worth exploring further penalty charges for members that are able to pay the Fund but are unwilling to do so. I would not wish to rule out the introduction of that option at some future date. If more work is needed on these areas, it would be best to do it sooner, rather than to wait until the arrears problems worsen.

Like Mr. Ortiz, I found the staff papers on special charges and the sale and use of currencies difficult to read. The paper on special charges shows that SDR 1.1 million was paid by November 30, 1986 that would not otherwise have been paid. It

is too early to judge what effect the imposition of special charges is having on the behavior of frequent late payers. Four of the members that have incurred special charges in the first quarter of operation of those charges have not incurred such charges since then. Most of the countries that have continued to incur special charges have chronic balance of payments problems, and it was never expected that special charges would have a significant impact on those countries.

I accept the proposed decisions on pages 12-13. I am only somewhat enthusiastic about the staff's proposal on page 12 that receipts of special charges on deferred charges be used to mitigate the financial consequences for members of these adjustments by reducing charges and increasing remuneration. My enthusiasm for this proposal is limited only because I do not believe that the sums in question warrant any significant additional administrative activity and complexity in the way in which charges and rebates are organized; the proposal apparently involves another system of reimbursements separate from the one that is envisaged for the distribution of receipts from late payment of deferred charges. There are already enough administrative mechanisms, and we should avoid creating additional ones. The whole subject of special charges should be kept under review, perhaps on a yearly basis. Accordingly, we could return to the subject again in one year.

This chair has consistently expressed reservations about the idea of selling and using the currencies of members in arrears. The additional details provided in the staff paper confirm these reservations. As the staff notes, few of the possibilities that are open to us would improve the balance of payments of the members in arrears, and all of them would require a measure of cooperation by the members concerned, either explicitly, because a member's consent would be required, or implicitly, because action by the relevant central bank would be needed. In sum, the routes that are explored by the staff seem to offer little hope of material benefit. Some would involve administrative inconvenience and cost to the Fund and all of them would run the major danger that if the member in arrears did not cooperate, broad issues relating to fundamental aspects of the Fund's finances would be thrown into urgent and stark relief because of the further doubt that would be shed on the value of the Fund's holdings of the currencies concerned. The case for and against provisioning needs to be considered in detail at an appropriate time and not as a hurried and unintended--but nevertheless possible--consequence of an attempt to make modest reductions in the Fund's arrears. Of course, we would not wish to stand in the way of voluntary transactions involving the intermediation of the Fund between members in good standing with the Fund and members that are not in good standing in cases in which the

former wished to obtain--and hold--the latter's currency from the Fund. My authorities do not see themselves taking part in such transactions.

I do not favor further efforts by the Fund to develop other possibilities or to enter into discussions with other institutions in the area of the sale and use of the currencies of members in arrears. This includes additional efforts to increase the proportion of the Fund's administrative expenses that are to be met out of local currency.

Mr. Salehkhoulou made the following statement:

Although in the period end-March to end-September 1986 the amount of overdue financial obligations to the Fund has continued to rise, the total number of members with arrears was reduced to 11 and 12 as of September and December, respectively. According to Tables 1 and 2 in EBS/86/255, this is the lowest number of overdue financial obligations to the Fund since the end of 1981, and the overall problem has tended to become more heavily concentrated in a small number of members that have already been declared ineligible and which together represent 78 percent of the arrears. During the same period, 18 complaints were issued, 10 of which were subsequently withdrawn as the members concerned became current in the Fund, thereby leaving only 8 complaints outstanding, for a net reduction of 2 in 1986. At the same time, 4 of the 5 ineligible members have managed to make some payments to the Fund following their respective declarations of ineligibility.

These facts indicate that, first, the problem of large and prolonged overdue financial obligations to the Fund is due mainly to the rising amounts of such obligations that are confined to only a handful of members. Second, whether or not new arrears to the Fund by other members occur, the amounts overdue of the present few members would continue to rise sharply should the difficulties facing them remain. This is especially true as their respective forthcoming purchases, special charges, surcharges, and other punitive actions by the Fund would only compound their arrears problems. Third, as I have always maintained, experience has clearly shown that the introduction of punitive measures has neither helped the Fund to alleviate the problem nor encouraged the members that were not in a position to do so to discharge their overdue obligations to the Fund. Furthermore, the membership at large, including those with arrears to the Fund, have responsibly demonstrated that they are indeed conscientious about meeting their obligations despite the serious hardship facing most of them.

Therefore, the question remains as to the real cause of the delay in settling overdue obligations. While I agree with the staff that members' arrears to the Fund vary widely in relation to their differing economic circumstances, the prospects for settling these and other financial obligations depends in almost all cases upon factors that are largely beyond the control of these members. For example, I fully agree with the staff that "the slowing of growth in the industrial countries, continued weakness of commodity prices, and the slow expansion of world trade, exacerbated by protectionist measures, [have] served to create a rather subdued international economic environment during the period reviewed." Furthermore, although little economic analysis has been presented as to why the rise of overdue obligations has been slower or why there are less cases of arrears to the Fund, the staff has indicated that the decline in oil prices "has had a direct positive influence on many members' external positions and consequently on their ability to meet obligations to the Fund." Whether or not the staff's assumption has firmly and quantitatively been established, the point that I wish to stress is that, apart from certain countries' domestic weaknesses, the main causes of most members' arrears to the Fund are exogenous in nature.

That is to say, many member countries, particularly those with arrears to the Fund, have experienced tremendous hardship and have made great efforts to strengthen their external positions while giving priority to timely repurchases and to the settlement of their obligations to the Fund. Given the magnitude of the exogenous factors, in many cases such efforts have not produced sufficient resources even when accompanied by prolonged technical assistance and advice from the Fund.

I was surprised to read about the implementation of general guidelines for preventive measures on page 6 of EBS/86/255; there has been no discussion of such guidelines or the necessary approval of them by the Executive Board. I do not believe that previous references to this issue by a few Executive Directors ever resulted in a broad consensus in the Executive Board in favor of the far-reaching and unilateral measures that the staff is contemplating. It goes without saying that the nature of the proposed measures touches upon important policy issues, such as conditionality, and raises serious questions of principle concerning the Fund's relations with its members. Therefore, before they are implemented, these guidelines should be appropriately presented to the Executive Board. Such assessments and measures should not be aimed only at domestic policies of the members concerned; they should also place more emphasis on all the pertinent exogenous factors and the general international economic environment that greatly influence a member's short-term as well as medium-term prospects. In this connection, the use of automatic contingency clauses that are to be triggered by the occurrence

of adverse exogenous factors would be appropriate and would go a long way toward avoiding the asymmetry brought about by the type of measures that the staff has advocated. Should we persist in following such a narrow financial approach, I am afraid that the institution would lose its cooperative character.

By the same token, while the Fund's efforts to provide assistance through various channels to strengthen a member's external position to enable it to meet its financial obligations should continue, the problem of overdue financial obligations must be considered in the larger context of the global debt problem, which as we all recognize is far from being solved, despite numerous strategies and initiatives. In this respect, while cooperation by donors and creditors in securing the settlement of arrears to the Fund in several important cases is welcome, I wish to reiterate that falling commodity prices, rising protectionism, declining official development assistance, a virtual lack of access to commercial resources, curtailment of potential and actual access to the Fund and other multilateral resources, and the tightening of conditionality in recent years appear to be major obstacles to strategies to deal meaningfully with debt payments, including those to the Fund. The international financial community would be well advised to seriously face these problems instead of resorting to ineffective measures of the type suggested by the staff and which by the staff's own recognition have not contributed significantly to the containment of the problem let alone to its solution.

As a final comment on the general guidelines, I wish to recall that in several of the summings up by the Chairman on previous Executive Board discussions on overdue obligations special care was taken to emphasize the necessity of "consultation" and "cooperation" with member countries in trying to help them to overcome their problems. It is regrettable that the staff paper does not reflect this spirit in any way. Instead, it suggests a self-righteous approach and goes far beyond the intent of the Executive Board.

As to policies affecting the Fund's financial position, I oppose the suggestion to find "possible techniques to provide that an individual member's quota increase would not become effective until the member had eliminated its overdue obligations to the Fund," something that in my view is clearly extreme.

In discussing procedural issues the staff notes that "in no case so far has a member's payments performance improved following a declaration of ineligibility." I wish to reiterate that this chair would not support the introduction of any procedural and/or substantive measures to punish the member countries with arrears to the Fund unless a member's recalcitrance is established beyond any doubt. Similarly, I oppose pursuing the idea of seeking the

collaboration of the World Bank and other multilateral institutions in imposing collective punitive measures not only for the reasons outlined by the staff, but also because it would be in contradiction to our declared willingness to help members in difficulties through the Fund's much heralded catalytic role. This collaboration proposal would compound the problems facing the members concerned, make their respective relations with all the international institutions concerned confrontational in nature, further aggravate their external situation, and consequently reduce their ability to repay creditors, including the Fund. Experience over the previous several years has clearly shown that in dealing with members in arrears the Fund has gained much more through cooperation than through confrontation and punitive measures.

I am not surprised by the staff's observation that the system of special charges "has been only partly successful in recovering costs to the Fund." The system imposed an extra burden on some members that were already facing considerable financial problems. I also noted the staff's conclusion that it does not believe that there is sufficient evidence to conclude that the system has influenced members' payments performance to any significant extent. Hence, as I continue to believe that the special charges would only make members' difficulties worse and to reiterate this chair's opposition to the introduction of any such system, I wish to register my opposition to the proposed decisions on pages 12 and 13 of EBS/86/283.

As to the sale and use of currencies of members in arrears to the Fund, I see very limited practical use of such a course of action apart from possible use to cover expenditures by a purchaser in the issuing country, which would be limited in size and would therefore not contribute significantly to reducing the scope of arrears to the Fund. I do not foresee any straightforward economic or financial incentive for third party purchases. I wonder whether the staff has given any thought to potential adverse monetary or financial consequences for the issuing country should the third country have any political or other motives in making such an acquisition. In any event, should there be any extensive desire by Executive Directors to apply such a scheme, I feel strongly that it will have to be on the basis of further papers that delineate precisely the type and nature of the envisaged operations. Furthermore, although legally the sale of currencies by the Fund under some of these operations is not subject to agreement by the issuing member, I feel that for political reasons and in order to preserve the cooperative nature of the Fund, such agreement should nevertheless be sought and obtained before the operations are undertaken.

In concluding, I wish to reiterate my consistent position that as long as the root causes of the arrears problem are not addressed, the Fund will continue to face difficult cases of arrears. In the circumstances, however, as this chair has suggested on previous occasions, for all practical purposes we should be realistic and seriously consider the possible activation of Article V, Section 7(g) and Section 8(e). I look forward to the circulation of the staff paper on the legal and technical aspects relating to the postponement of repurchase obligations and the payment of charges in domestic currency.

Mr. Fugmann made the following statement:

I continue to be concerned about the implications of the arrears problem for the Fund as a cooperative monetary institution. Both aspects--cooperative and monetary--are equally important.

I welcome the staff's increased emphasis on early measures to prevent the emergence of arrears. The assessments of member countries' capacity to repay the Fund that have been worked out in this connection are welcome. They should of course be applied with discretion, as large uncertainties are often involved.

But the value of such assessments depends upon the conclusions drawn from them--for example, in those instances in which the capacity to repay the Fund in the medium term is found to be lacking with a high degree of certainty. There have been cases in which such assessments have not played the role that one would have hoped, and the firmness that Mr. Nimatallah advocated should be exercised at this early stage in order to be of the greatest help to member countries.

I agree with the importance of the assumptions about future access to official financing and that assessments in certain cases could result in more explicit discussion of possible shortcomings in members' programs and of the potential implications for future financing requirements. I support monitoring by the Fund of a member country as long as the country concerned has outstanding financial obligations to the Fund and before the possible emergence of arrears. In addition, monitoring would contribute to a consolidation of the adjustment made by the country under a Fund-supported program. I would appreciate having a more detailed description of the modalities of such monitoring.

In the area of corrective actions, I agree that it is important to have adequately functioning cooperation among donors, the Fund, and debtors to deal flexibly with practical problems relating to the arrears, as has been done in some cases. However, such

cooperation should be conducted primarily on a case-by-case basis, although it would be useful to hear more about the staff's views on how to systematize this cooperation.

Urging by a friendly country to make payments to the Fund should be considered only in the most serious cases. Direct contacts between the Fund and its member countries are preferable to indirect contacts through third parties.

The need for close cooperation between the Fund and the World Bank is particularly important when arrears emerge. The two institutions should support each other's policies; a declaration of ineligibility by one institution should be an important factor in the consideration of lending by the other. However, I am not inclined toward establishing a formal link between measures by the Fund vis-à-vis countries in arrears and measures of other institutions. The Fund's room for maneuver and independence vis-à-vis other institutions would be reduced if such a formal link was introduced, as there would obviously be a risk that the institutions would make similar demands on the Fund. Perhaps, in certain cases, the Fund should appeal to other institutions to take measures vis-à-vis the countries in question. This is particularly important in serious cases.

The question has been raised whether a declaration of ineligibility should take place at an earlier or later stage in the evolution of each arrears case. I would underscore the staff's approach concerning the application of the case-by-case approach. A stricter treatment--in other words, a declaration of ineligibility at an early stage--is warranted when a country has clearly shown that it is unwilling to eliminate its arrears and to discuss its economic situation with the Fund. Within certain limits, greater understanding--through a declaration of ineligibility at a later stage--should be shown in cases in which countries have made efforts to cooperate with the Fund and other creditors in an attempt to solve the arrears problem.

Consideration could be given to delaying the entry into force of a member's quota increase until the member has eliminated its arrears to the Fund. I look forward to the results of the study that the staff is conducting on this issue.

I agree with the staff suggestion concerning the form of decisions on the suspension of a member's right to use SDRs.

The system of special charges should primarily cover the Fund's forgone interest income due to the arrears but should also provide an incentive for the timely settlement of obligations. As the staff noted, the latter purpose has hardly been obtained--and, therefore, the first objective has also been missed--as only

a small share of levied special charges has been paid. One of the reasons for this is the relationship between interest rates: it pays members to neglect to repurchase the Fund's ordinary resources. In addition to enabling the borrowing member to keep its liquidity, arrears involve lower costs than new credits from the Fund, which, moreover, are associated with conditionality. This conclusion is valid when the level of charges on ordinary resources is higher than the SDR rate.

It is particularly unreasonable that the more negligent that certain borrowing countries are, the greater is the risk that the level of charges for all borrowers will exceed the SDR interest rate--because of increases stemming from deferred income--a situation in which no further special charges are levied on overdue repurchases. Therefore, I strongly support the staff proposal to change the basis on which special charges are calculated so that special charges will be levied at a rate equal to the difference, if positive, between the SDR rate of interest and the basic rate of charge on ordinary resources determined at the beginning of the financial year--before any adjustment in respect of deferred income during the relevant period.

Despite this modification, when charges on ordinary resources exceed the SDR interest rate there will be no incentive to make timely repurchases. Therefore, the possibility of applying surcharges should be studied--for example, for countries that have been in arrears for a long time. This should not involve any kind of profit for the Fund, but rather a redistribution of the interest burden between timely and untimely payers. The idea is that the untimely payers should shoulder a larger share of the costs that the Fund incurs because of their arrears while the burden carried by borrowers in good standing should be reduced--as seen in relation to the level prevailing in the absence of surcharges--through a reduction in the rate of charge on ordinary resources.

I support the proposal concerning special charges in relation to the structural adjustment facility.

It is of great importance to search actively for different methods for clearing arrears to the Fund. Therefore, the staff paper on the sale and use of currencies of members in arrears to the Fund is welcome. However, in practice, this particular method apparently will be of little use.

Sales to finance purchases or in exchange for SDRs should be made only in association with the provision of a fail-safe mechanism to protect the member making the purchase. Given all the conditions that need to be met in individual cases, these methods can hardly be applied to any large extent. However, at best, the

method of exchange for SDRs can have a certain, although limited, effect. The development banks, including the World Bank, are among the group of other holders which pay significant amounts in local currencies in certain countries.

The Fund's own expenses in member countries are small, and paying these in local currencies would imply an unreasonable amount of additional work in relation to the amount of savings. As the staff suggests, perhaps certain individual large payments could be made in local currency.

As the staff notes, sales of currencies provide advantages concerning the balance of payments for the issuing member only in exceptional cases. One could therefore hardly expect any support from these countries for these measures.

Despite the legal and practical difficulties involved in sales of currencies, efforts to try these possibilities after identifying the prerequisites for such sales could be made if the majority of the Executive Board so wishes. Meanwhile, given the continued uncertainties prevailing, the Nordic countries do not wish to state a position on their possible acceptance of currencies in specific situations.

It is unsatisfactory that a member in arrears is in a sense subject to less pressure after a declaration of ineligibility than before. Selling currency, even small amounts, could be tried in individual cases as a test of the member's ability and willingness to pay the Fund. This practice could be useful for the Fund, at least indirectly. Such tests should of course be complemented by other measures when a country has reached this phase in its relations with the Fund. It goes without saying that all such measures must be conducted in such a way that they do not provide an incentive for other member countries to build up arrears to the Fund.

The argument presented by the staff in the footnote on page 7 that a failure by a member country to comply with its obligations to exchange its currency against a freely usable currency would violate an obligation under the Articles and could, among other things, give rise to the member concerned being excluded from participation in quota increases is interesting. No automaticity should be applied here; failure to exchange currency should be seen as one indicator that combined with other negative signals could lead to some kind of penalty.

On a suitable occasion in the future, the Executive Board should again review the treatment of ineligible members.

Mr. Goos made the following statement:

I share the concerns expressed by the staff and the previous speakers about the continued increase in overdue obligations to the Fund. The prospect that the total amount of overdue obligations is likely to increase even further is clearly alarming.

The potentially grave consequences of arrears to the Fund for the membership and the institution have been clearly described by previous speakers. I would underscore the point that was made by the staff that the existence of large amounts of arrears--let alone any further increase in those amounts--could adversely affect the attitudes of potential lenders to the Fund and the outcome of the coming quota review.

Nevertheless, the analysis in the six-monthly report reveals that there are some positive aspects in the development of the arrears problem, which suggests that the existing procedures for dealing with that problem, although far from perfect, are effective to a considerable extent. Accordingly, I agree with the staff that for the time being there is no need for a general modification of the procedures. However, this should not prevent us from strengthening them wherever their effectiveness could be improved. Any undue indulgence of overdue members would certainly be inconsistent with the seriousness of the problem and could even encourage a further proliferation of arrears.

As to the specific issues that are raised in the six-monthly report, I welcome the staff's intention, in the context of preventive measures, to place greater emphasis on members' capacity to repay the Fund and to monitor this capacity as long as members have obligations outstanding to the Fund. A thorough examination in this connection, preferably enhanced by basing it on alternative scenarios, should remain the essential starting point in considering requests for Fund financing. In addition, I encourage the staff to make more extensive use, where appropriate, of specific specific arrangements that would secure the availability of sufficient foreign exchange by members when their repayment obligations fall due. Another important preventive device is the Fund's technical assistance to members that have only weak administrative capabilities.

In the area of corrective actions, it is of central importance for both management and the Executive Board to insist with firmness and unanimity on the prompt settlement of overdue obligations. At the same time, the Fund should continue, wherever appropriate in close cooperation with the World Bank, to offer its advice and support in finding appropriate solutions to the problem by providing technical assistance and its good offices in facilitating negotiations with bank creditors and the Paris Club. On the other hand, once our internal procedures for dealing with

arrears have been exhausted in particular cases--especially cases involving members that are able to pay the Fund but are unwilling to do so--the Fund should not unduly delay the declaration of ineligibility. As to the specific timing of such declarations, I agree with the staff that the existing case-by-case approach should be maintained. For the time being, we should also maintain the existing informal cooperation between the Fund and the World Bank in the area of overdue obligations without establishing links between the declaration of ineligibility and the lending decisions of the World Bank. However, I would welcome an explicit clarification by the World Bank to the effect that borrowing requests by countries that are overdue to the Fund would be scrutinized with particular care as long as the arrears have not been settled.

I am not in a position to offer specific proposals regarding the cooperation by donors and creditors and possible ways in which to strengthen the effectiveness of their financial assistance to members in arrears that undertake convincing adjustment efforts. However, I can assure you of my authorities' continued willingness to cooperate in efforts to find appropriate solutions. In this context, I would like to mention a more general concern that arises from recent program failures: it is of paramount importance that the Fund's efforts to assist members in arrears should take place on a solid economic foundation that offers the prospect for realistic and durable solutions to the existing balance of payments problems. In particular, we should resist the temptation to seek quick-fix bridging finance arrangements that aim primarily to restore the creditworthiness of members in arrears with the Fund so that Fund resources can be made available to repay the bridging finance while there is no assurance that the balance of payments will return to a viable position in the medium term. Such arrangements would be shortsighted and, in the final analysis, counterproductive to a durable solution of the arrears problem.

Before commenting on the other papers I wish to address some of the points that were made by Mr. Nimatallah. Although I do not share his rather harsh criticism of the usefulness of the six-monthly report, I agree that future reports could benefit from the inclusion of additional information on the potential financial impact on debtors, creditors, and the Fund of a possible further deterioration in the arrears situation. Such information could highlight the particular urgency of the problem and its potentially disastrous dimensions for the Fund. Furthermore, I support Mr. Nimatallah's proposal to consider, in the forthcoming paper on the possibility of withholding quota increases from ineligible members, the idea that the right of those members to effect a quota increase would disappear after a certain period of continued noncompliance with their obligations to the Fund.

My authorities are concerned about the very short circulation period for the technically rather difficult paper on special charges. However, they fully agree with the analysis and recommendations in the paper, and I support the proposed decisions. While it might be difficult to assess the extent to which special charges have actually influenced members' payments behavior, I am encouraged by the fact that 17 of 25 members that were subject to such charges from February to October 1986 have settled those obligations and in most cases have reduced their overdue obligations or even eliminated them as they applied to normal charges and repurchases. This payments performance seems to indicate that the system of special charges is operating in the right direction. The lack of responsiveness of the members with protracted arrears is of course a cause for the greatest concern. Therefore, it might be useful at a later stage to impose much higher special charges or definite penalty charges in a selective manner, as was proposed by Mr. Nimatallah and supported by some others.

As to the disposition of payments resulting from special charges, the necessary decisions should be taken in the light of the overall income position of the Fund. Such payments could perhaps be used in the first instance to mitigate the financial consequences for members resulting from burden sharing, provided, however, that this would not involve the introduction of a new complicated redistribution system. In this connection, I fully share Mr. Foot's concern about the increasing complexity of the system. If there is no easy way in which to dispose of these receipts, they should be added to reserves without crediting such additions to the reserve growth target.

I have little to add to the staff's assessment of the potential benefits and drawbacks of the various options discussed in its paper on the sale and use of currencies. I particularly share the staff's skepticism about the effectiveness of most of the options or techniques in making a significant contribution to solving the arrears problems. A major shortcoming of the various techniques is the fact that their application would presuppose the cooperation of members in arrears. Such cooperation can hardly be taken for granted, as the occurrence of arrears reflects an unwillingness or inability to cooperate in solving a member's payments problems. Moreover, in the final analysis the techniques would merely substitute a reduction in the Fund's currency holdings for the direct or indirect provision of foreign exchange to members in arrears that could use such foreign exchange receipts in a much more straightforward manner in direct settlement of their obligations to the Fund. Nevertheless, I would not rule out the possibility that these techniques could provide a useful tool in certain cases. Accordingly, the Fund should be prepared to engage in such transactions and operations on a case-by-case basis. Of course, this should be done with due consideration to

the costs arising for the Fund, a consideration that in all likelihood would argue against the buildup of a new administrative capacity solely for the purpose of exploring the potential of these techniques.

As to the question posed in paragraph 5(a) on page 22, the Fund should be prepared to finance purchases with the currencies of overdue members under both of the options mentioned in that paragraph. In this context, I would caution, however, against using the operational budget to test the willingness of members in arrears to cooperate with the Fund. Even with the provision of a fail-safe mechanism, the confidence of members in the functioning of the operational budget might be undermined by such tests.

As to paragraph 5(b), the possibility of sales to other members or prescribed holders in exchange for SDRs merits further consideration. However, the efforts in this regard should focus on multilateral development banks, including the World Bank, as a general widening of the catalogue of authorized operations with other holders would not appear to be advisable for the reasons mentioned on page 12 of the staff paper. In this connection, it would be interesting to have some indication from the staff of the potential for purchases of such currencies by the World Bank against SDRs. As to possible participation in such operations by my authorities, there are legal and practical limitations that affect in particular Germany's development assistance. Moreover, the Bundesbank, as the holder of Germany's SDRs, does not finance such operations; therefore, its potential role--if any--would be limited to that of an intermediary between the Fund and other parties.

As to the proposal in paragraph 5(c), I would encourage the staff to explore with other holders, including the World Bank, their interest in acquiring the currencies concerned.

Finally, the staff should make an effort to increase the financing of its own administrative expenses out of its currency holdings of members with arrears, although I agree that such an effort should be confined mainly to large individual outlays that could be made in local currency.

Mr. Zecchini made the following statement:

My general impression from the six-monthly report is that the problem of arrears is not a static one but is instead undergoing significant changes. Although some of the changes seem to be favorable, the overall outcome does not justify any optimism about a rapid solution to the arrears problem. A positive development is the reduction in the number of countries in arrears. This development is positive not only because it shows that the

problem is not widespread, but also because it is the result of a new climate of cooperation between debtor countries on the one hand, and the Fund, creditors, and donors on the other.

However, several other developments are a cause for continuing concern. First, the arrears have reached an all-time peak value. Second, the average amount per country is rising rapidly. Third, the problem has become more deep-seated, as it is increasingly concentrated in a core group of countries that are in a structural sense insolvent for several reasons. In fact, most of these countries lack official foreign reserves even on a gross basis. Moreover, their economic policies are far from being appropriate, and they lack sufficient goodwill to cooperate with the Fund. The lack of willingness to cooperate with the Fund is particularly evident in the case of Peru.

Even if the problem of arrears were to remain confined to the core group of eight countries that are mentioned in the table on page 5 of EBS/86/255, the situation would remain serious, since more than SDR 2 billion in new maturities will become due in the next two fiscal years. In these circumstances, the strategy followed thus far is still valid but its effectiveness can be enhanced to some extent by introducing a few additional measures. Before commenting on these measures, I wish to stress that there is no alternative strategy that can yield more rapid results than the one that has been followed so far. I doubt that a more lenient approach, involving extensive debt rescheduling, would prompt debtors to introduce appropriate policies designed to restore solvency. The Fund has always been ready to cooperate with debtors in facilitating the implementation of adjustment measures, but this opportunity has not been seized upon by several countries with persistent arrears.

As to the Fund's strategy, more emphasis should be placed on preventive action. This has to include an explicit assessment of the member's capacity to repay before allowing the use of Fund resources under any facility. However, even more important is the enhancement of Fund surveillance over policies well in advance of the emergence of imbalances as well as after a program with the Fund has been completed. It is advisable for the Fund to address policy recommendations at an early stage of economic difficulties and for a member's request for a program to be considered in the light of the attitude that the member has shown toward these recommendations. The design of the program itself should reflect such an assessment and should incorporate safeguard measures concerning foreign exchange budgeting and management.

In the area of corrective measures, I firmly believe that the cooperation between the debtor, the Fund, other creditors, and donors, should always be sought, as this has proved to be the most effective means of dealing with arrears problems. This requires,

first, that a member be ready to adopt adequate economic and financial policies. To this end, a concerted representation by the membership could be advisable in specific cases; it could serve the purpose of emphasizing that the debtor should give the highest priority to its obligations to the Fund. Similarly, cooperation between the Fund and international development institutions like the World Bank might help to harness enough support to induce the debtor to adopt a more cooperative attitude. Although the Fund should not go as far as trying to establish de facto a cross-default rule, in particular circumstances the staff would establish appropriate contact with other institutions in order to safeguard the Fund's creditor position.

Urgent consideration should be given by the Fund to ways in which to freeze any quota increase for countries in arrears. It would be inconsistent to increase the voting power of a member that is violating the Articles and, as a consequence, the rights of other members.

As to the current procedures for handling overdue obligations, recent experience suggests the need to re-emphasize that the time periods between taking decisions and conducting reviews should not be interpreted as grace periods and should be applied flexibly in line with the attitude of the member toward cooperating with the Fund in solving the member's arrears problem. Any comparison of the treatment of various members in arrears should be based mainly on this consideration.

The Fund's experience with the system of special charges is too limited to enable us to draw any firm conclusions on the usefulness of the system. A large number of members have settled their special charges, and this could be taken to mean that the charges have contributed to prompter settlement, especially in the cases in which administrative difficulties or other relatively minor factors might have caused late payments. Of course, to better understand the impact of special charges we should have more information on the choices made by individual members in allocating a given amount of resources in settling obligations. The payment of charges on time tends to minimize the overall cost of the given amount of arrears. This particular information is also relevant in better assessing cases of large and protracted arrears, like that of Peru.

Leaving aside the particular case of Peru, it seems that levying special charges is not a proper incentive to accelerate the solution of deep-seated arrears problems. Nevertheless, it would be inappropriate to claim that special charges can only serve the purpose of allowing the Fund to recover the losses it incurs as a result of delayed settlements. Special charges are useful in both recovering an income loss and in inducing a timely settlement of obligations. As a consequence, I see no overriding

argument in favor of using the SDR rate as the limit on the level of special charges; the rate of charge, if higher than the SDR rate, could be equally appropriate. In fact, this is the direction in which the staff is moving in proposing to apply a special charge on overdue repurchases that is higher than the SDR interest rate. I understand that the staff is referring to a particular device, namely, the difference between the basic rate of charge and the SDR interest rate, and that this may differ from the positive gap between the rate of charge and the SDR interest rate.

However, I have several reservations about the rationale behind the staff's analysis and proposal. First, I do not agree with the statement on page 7 of EBS/86/283 that "when charges are not paid on time, the Fund fails to receive an asset on which it would otherwise earn interest." This statement confuses flow notions with stock notions. Charges are flows; they serve only the purpose of covering remuneration and administrative expenses. When charges are not paid, there is only a loss of a flow of income, which can last generally up to six months. After this period, the loss is fully made up by the adjustment of the rate of charge, which provides the Fund with all the resources to which it is entitled. In such cases, it is appropriate to permit special charges to rise as far as the level of the rate of charge, even if the latter exceeds the SDR interest rate. Special charges received by the Fund should be used first to finance a refund to the members that made up for the initial loss and, second, to strengthen the reserve base of the Fund in the face of the growing volume of arrears. If charges are paid on time and there is a failure to make repurchases of ordinary resources, this does not give rise to a loss of income, since charges continue to accrue; instead, it causes a loss of liquidity. This liquidity loss is not covered by additional borrowing at a higher cost than the SDR interest rate, since the borrowing terms and the financing mix for the use of Fund resources are predetermined at a level that are close to the SDR interest rate. Therefore, the staff proposal concerning the basic rate of charge does not appear to be justified. Nevertheless, I can endorse the proposal in order to add to the special charges a greater element of incentive for timely settlement of obligations to the Fund.

I accept the staff proposal to apply to overdue obligations under the structural adjustment facility special charges that are identical to those applied to arrears on Trust Fund obligations. I see no reason to use an approach for the structural adjustment facility that is different from the one that is used for the Trust Fund.

As to the sale of currencies of members in arrears, there is legal authority for the three cases that are mentioned on page 21 of EBS/86/271. On balance, I believe that the Fund, without

resorting to rigid rules, should adopt a pragmatic approach in using these currencies, both to increase liquidity and to test the member's willingness to cooperate with the Fund in clearing its arrears. In this connection, the Fund could offer these currencies to purchasing members in exchange for SDRs in principle only with the consent of the country in arrears. Such consent would, however, not be necessary if the purchasing member intends to enter into a triangular operation with an institution that is not a prescribed SDR holder, provided that the SDR holder is informed of the exchange constraints that it might face in using the currencies in question. Nor is consent necessary if the purchasing member intends to hold the currencies as a means of helping the debtor to become current in the Fund. However, it would be preferable for this latter form of assistance to be linked to an adjustment program, whether or not the program is supported by the Fund.

I recognize that the use of these currencies in financing local currency expenses of the Fund is rather limited, but it is worth exploring. In addition, the Fund should explore the possibility of directly selling these currencies at a realistic representative rate to outside institutions that are interested in using the currencies.

The previously mentioned forms of currency mobilization represent an actual or potential drain on debtors' foreign exchange receipts. However, this drain should not be seen as a cause for concern by the Fund in cases involving countries that have gross exchange inflows that are sufficient to allow repayment of Fund obligations. In this connection, it would be useful to know more about the potential willingness of members in arrears to cooperate with the Fund in the forms of currency mobilization that I mentioned.

Mr. Massé made the following statement:

I have only a few comments to make, given the valuable remarks by previous speakers, particularly Mr. Nimatallah.

The six-monthly report shows that the problem of arrears obviously remains difficult; there was an increase in total overdue obligations of SDR 250 million during the period covered by the report. Although overdue obligations have become concentrated in a smaller number of countries in the period concerned, the seriousness of the situation and the risk that arrears will emerge in other cases cannot be underestimated.

I agree with the staff that there is no need for general modifications of our procedures at this time. Continuation of the case-by-case approach seems to be justified, since it permits

us to weigh all the relevant factors in each particular case and to make judgments accordingly. I also agree with the staff that cooperation by donors and creditors has been valuable in securing the settlement of overdue obligations, and that diplomatic efforts and concerted representation can be valuable tools in encouraging countries to fulfill their obligations to the Fund. However, we need to recognize that donors, creditors, and other friendly countries can have the most influence in cases in which there are well-established political or economic linkages with a particular country. Concerted representation will therefore be most effective if it is based on existing relations, and we should encourage countries having the most leverage in a given case to use that leverage to the fullest extent possible.

It seems somewhat premature at this stage to judge the effectiveness of the system of special charges in either encouraging timely payments by members or in assisting the recovery by the Fund of costs resulting from overdue obligations. As the staff notes, the available evidence does not support the view that special charges have positively influenced the payment behavior of members to any significant extent. However, the system has been in operation for less than a year, and it is probably too early to reach any definitive judgment. I continue to agree with the staff that the SDR interest rate should be maintained as a standard for assessing costs and losses of income to the Fund because of overdue obligations.

As to the proposed decisions, I agree with the staff that a system of special charges for overdue obligations under the structural adjustment facility should be introduced and should be identical to the one that is applied to overdue Trust Fund obligations. In addition, it is reasonable that any special charges that are received should be used to mitigate the position of members that have experienced an increase in charges or a reduction in remuneration as a result of the present burden-sharing arrangement.

I have some reservations about the proposal that for FY 1987 and FY 1988 the calculation of special charges should be based on the basic rate of charge. I wonder whether a change of this nature needs to be made so early in the operation of the scheme. Although the rationale behind the proposal is clear, any benefit that might accrue to the Fund seems to be largely theoretical: countries that are already in arrears under the existing system of special charges may well not be in a position to meet any increase in those charges that might result from the proposed change. Therefore, it might be more realistic to watch the evolution of the present system further before making adjustments. However, I would not oppose the proposed decision if there were a majority in favor of it.

It seems clear that the Fund has the legal authority to sell its holdings of a member's currency, to exchange those holdings for SDRs, or to use currency holdings for administrative expenditures. Hence, legality is not the issue. Rather, the question is one of practicality and the net benefits to be derived from any use or sale of such currencies.

I see little scope in which to use Fund holdings of currencies to offset our administrative expenditures. Use of these currencies would require what appears to be a significant change in our operational practices with respect to administrative expenditures, with very small potential financial benefits. Furthermore, the use of currencies to cover administrative costs might actually encourage countries in arrears to the Fund to add further restrictions on nonresident use of currencies, thereby making the whole effort counterproductive.

Selling the holdings of a member's currency to other members in exchange for their currencies would only be fully possible and practical if the country in arrears to the Fund were to guarantee to exchange currencies. I would not wish to completely rule out this possible option, since circumstances may arise in particular cases in which an indirect method of reducing Fund holdings of a given currency might be useful. For example, a currency could be added to the operational budget if it were felt desirable to test a country's resolve to cooperate with the Fund. The sale of currencies to other members might also be an indirect method of making repurchases if some specific political constraint on direct repurchases were to arise. The circumstances under which an exchange of currency with another member would be useful might be limited, but we should perhaps keep this option open.

I am less sanguine than the staff about the scope for sales of currencies in exchange for SDRs. For example, exchanges for aid purposes would only be useful to cover local cost financing, which is often excluded from aid programs. Other financial institutions that are holders of SDRs also may have a limited capacity for using such currencies. Therefore, on the whole the exchange of currencies for SDRs in the manner described by the staff would involve a large effort for what might be a very small amount of actual financial gain. My Canadian authorities have indicated that they are not eager to use such practices and would prefer to provide financial assistance to countries in arrears to the Fund directly, if they so choose. I am also not sure how far other financial institutions would be willing to participate in such a scheme. Therefore, perhaps the appropriate next step for the staff to take would be to consult other institutions that are holders of SDRs to determine the extent to which they might be able to participate in such a scheme. If that response is broadly negative, then we would be reluctant to see the staff proceed further. In sum, the scope for action is quite limited and may not deserve much further effort by the staff.

Mr. Finaish made the following statement:

Although the total volume of overdue obligations has continued to rise since the previous six-monthly review, the recent drop in the number of members in arrears and the heavier concentration of the problem on the few cases of protracted arrears can to some extent be considered as positive developments. This has resulted in a slower rate of increase in total arrears relative to the preceding period. Furthermore, the concentration of the problem among fewer members should in principle make the problem easier to deal with, to the extent that the efforts of the Fund and the membership to help countries in arrears to become current can be more focused and therefore, I hope, more effective. Of course, these positive elements are probably only silver linings in what continues to be a very serious problem that is unfortunately unlikely to go away very soon.

I have no problems of principle with the preventive measures that are being implemented. Indeed, the staff is under an obligation to assess countries' ability to service their debt and to monitor the situation both during and after the period of a Fund arrangement. What is important, however, is for the Fund to avoid adopting a narrow approach in making such assessments, which would be inconsistent with the special role of the Fund as a creditor, including its crucial catalytic role. The fact that Fund decisions on requests for financial assistance can have a decisive impact on financial flows from other sources to the members concerned should be taken fully into account. It would be ironic if the Fund were to adopt the same attitude as certain banks that the Fund has been urging to provide additional financing to certain countries that have debt servicing difficulties but are willing to implement corrective policies. In some cases, shying away from providing additional financial assistance would be the best recipe for the emergence of arrears. This is as true for the Fund as it is for commercial banks.

One aspect of preventive actions that continues to warrant emphasis is assisting members in their cash flow management. This is particularly true for cases in which the financial program adopted by the country leaves little room for maneuver, thereby making an adequate cash flow system crucial to the avoidance of debt servicing problems.

The present policy with respect to corrective actions is generally appropriate. The fact that this policy has been only partially successful in enabling countries in arrears to become current is a reflection of the difficult nature of the problem more than of the inadequacy of the correct measures. The area where more effort is perhaps needed is the strengthening of coordination between the members concerned, the Fund, and other creditors. This coordination should focus on making aid flows

to countries in arrears that are willing to adopt a corrective policy program more predictable, more synchronized, and in the form that is most needed. It is also important that in putting together the elements of a solution to the overdue obligations in particular cases, attention should not be confined to the immediate future, since in a number of cases we have seen a re-emergence of arrears shortly after a country became current.

As to the desirability of establishing a formal link between actions by the Fund vis-à-vis members in arrears and actions by other agencies, I share the staff's concern and the concerns expressed by other speakers, particularly with respect to the reciprocity problem. Informal discussions with other institutions, on the other hand, may prove useful, provided that a clear distinction is made between members in arrears that adopt a trying to deal with their arrears problems and members that are clearly uncooperative attitude. It is crucial to keep in mind the fact that the objective is to eliminate the arrears and not to make things more difficult for the members concerned.

I continue to believe that the declaration of ineligibility should be made only after a thorough examination of all the relevant considerations. Even then, it should be kept in mind that frequent use of this measure would reduce its significance as the ultimate or penultimate action that can be taken by the Fund vis-à-vis members in arrears.

As to the form of decisions on the suspension of a member's right to use SDRs, I support the staff's suggested amendment for future proposed decisions.

The outcome thus far with respect to special charges seems to support the view that I and others expressed in the past namely, that special charges would not by themselves have a significant impact on the overdue payments situation. Indeed, I would have been surprised if the evidence had shown a perceptible change in the arrears picture as a result of this incremental cost of being in arrears to the Fund. For most, if not all, members in arrears to the Fund, the problem is hardly one of marginal choices that can be influenced by adding to the cost of arrears at the margin. However, this does not necessarily mean that special charges cannot and do not perform a useful, albeit a limited, function. I agree that it would be fair for the direct financial cost to the Fund resulting from overdue obligations to be borne by members in arrears. The fact that only about one tenth of special charges has actually been received by the Fund is to be expected. It is difficult to see why members in arrears would rush to pay special charges when they are still unable to settle other obligations. However, this in itself should not be taken as evidence of the failure of the special

charges, since we continue to operate on the premise that all obligations, including special charges, will eventually be settled.

I support the proposal that for the period of operation of the burden-sharing mechanism the calculation of special charges on overdue repurchases should be based on the rate of charge prior to the adjustment associated with burden sharing. This would correct the present anomaly where *ceteris paribus* special charges are negatively correlated with deferred charges. As a footnote, I would add that somewhat similar reasoning would argue for using the basic rate of charge in the calculation of payments under the supplementary financing facility subsidy account; we will be discussing that issue separately in the near future. As to the receipts of special charges on deferred charges subject to burden sharing, I agree that they should be used to mitigate the burden on creditors and debtors. It would be consistent to divide the mitigation equally between the two groups, given the accepted principle of equal sharing of the burden between creditors and debtors. In this connection, I agree with Mr. Foot's remarks on the need to avoid further complexity in the system.

I support the proposed decision on special charges on overdue obligations under the structural adjustment facility. The staff's views in this area seem to be consistent with the spirit and the intent of the Executive Board's decision on the system of special charges.

I will now comment on the paper on the sale of currencies of members in arrears to the Fund. Although the Fund, according to the staff paper, has the legal authority to use the currencies of members in arrears in the currency budgets to finance purchases of other members, it is highly questionable whether this represents a viable way to reduce the overall overdue obligations. If a member in arrears is willing and able to pay the Fund, it is doubtful, to say the least, that it would prefer such a roundabout operation to a straightforward payment to the Fund. As is clearly recognized by the staff, such a mechanism would put the purchasing member at risk and complicate the Fund's basic functions. Even if procedures were put in place to safeguard the purchasing member's interest, we are most likely to end up with a more complex system that contributes very little, if anything, to the objective of reducing the arrears.

While the staff seems to be basically in agreement with this assessment, the paper nevertheless suggests that such a mechanism may be "valuable as a further formal technique that could be considered as a means of judging a member's willingness to cooperate with the Fund following a declaration of ineligibility." I fail to see the value of such a test, especially since the Fund does

not and should not stop its direct communications with members in arrears, including those that have been declared ineligible. If the Fund wishes to "test" a country's readiness to settle its overdue obligations, it can do so directly by asking the member concerned to pay the Fund. Of course, this is being done at present through communications by management and staff in addition to Executive Board decisions that follow every review of overdue obligations of individual members.

If the Executive Board were to endorse the use of currencies of members in arrears to finance purchases, such use should be confined to the circumstances outlined in paragraph 5(a) of the summary section of the staff paper. If the member in arrears is willing to provide an assurance that that transaction will be fulfilled, it is difficult to imagine why that member would not be willing to settle its obligations directly. Similarly, it is difficult to imagine a situation in which the purchasing member, which by definition is in need, would want to abdicate its right to exchange that currency for one that is more generally usable and acceptable.

I agree with the staff that currency sales in exchange for SDRs may, in theory, offer a potentially wider range of demand for currencies of members in arrears. However, as the staff notes, such sales would require the concurrence of the member whose currency is being sold. Whether that member would be willing to engage in such a transaction is likely to depend on whether the transaction would be at the expense of foreign exchange receipts from the members or institution that are buying the currency in question. This is likely to be the case if the currency sales are used by the buying members for trade, aid, and diplomatic purposes, or by buying institutions to finance the local costs of development projects. On the other hand, the possibility that some members of the Fund would be willing to acquire and hold the currencies concerned as a means of assisting the members in arrears could be useful, particularly in cases in which institutional or legal considerations make direct assistance more difficult. Such a procedure is obviously possible now under the Articles and does not require any Executive Board action. The staff could ascertain the feasibility of such transactions in individual cases if there were indications that other members were willing to assist the member in arrears in this manner and when the other necessary elements to solve a particular arrears problem are also present. However, Executive Directors' comments thus far on this possibility do not seem to be very favorable.

The staff paper clearly indicates the limitations on and the problems associated with the possibility of increasing the use of currencies for Fund administrative expenses. Nevertheless, to the extent that it is judged to be practical and economical in cases involving significant outlays, it can of course be attempted.

Mr. Nimatallah recalled that his original proposal to introduce a system of special charges had been designed to impose penalty charges, partly as an incentive to members in arrears to pay the Fund. The system that was finally approved was designed merely to enable the Fund to recover the costs to it of arrears. Hence, the question that had been raised, whether the present system of special charges provided an incentive to pay the Fund, was irrelevant.

Mr. de Forges made the following statement:

After the very rapid increase in arrears in 1985 and the first half of 1986, it appears that developments have more or less stabilized. However, this stabilization is likely to be only temporary and has taken place at a very high level of arrears that is clearly difficult to sustain and is a source of deep concern to my authorities. Furthermore, the Fund faces a sharp increase in payment delays: during the 12 months ending September 30, 1986, 47 percent of the members having obligations to the Fund had been or were in arrears and 21 percent of the payments due to the Fund were not made on their due dates. I agree with Mr. Nimatallah that this is a disturbing trend that emphasizes the need for the Fund to assist member countries along the lines suggested by the staff in order to prevent the emergence of arrears. In that connection, the assessment of a country's capacity to remain current in the Fund is of the greatest importance. Improvements in this process should center on improving the reliability of the medium-term scenarios. Unfortunately, such improvements depend mainly on more accurate predictions of the general world economic outlook and financial developments rather than on a closer examination of developments in individual countries.

I agree that there should be increased cooperation by all the parties concerned, particularly donors and creditors, in the effort to tackle the difficulties facing member countries and to secure settlements. Nevertheless, I remain convinced that the case-by-case approach is the only efficient one available, and I would not favor establishing any formal link between actions by the Fund vis-à-vis members in arrears and actions by other agencies, for the reasons that are given on page 9 of EBS/86/255. However, this does not mean that relevant information should not be exchanged regularly.

I agree with the staff that the experience thus far is not sufficient to enable us to draw any firm conclusions on the influence of the new system of special charges on members' payments behavior. In addition, I support the two proposed decisions, which seem to be consistent with the current policy on the Fund's income.

The staff paper on the sale and use of currencies of members in arrears illustrates the increasing intricacy of issues related to arrears. After reading the staff paper it is my impression that the potential gains from using such indirect procedures are not fully commensurate with the administrative resources that would be needed to handle them. While I have an open mind on the three basic options that are examined in the staff paper, I have several reservations. It seems difficult to use a formula that is not likely to involve any significant amount of arrears. The use of currencies for settling administrative expenses incurred by the Fund would involve operational costs that would be disproportionate to the results. Similarly, sales of currencies through the operational budget do not appear to be a workable solution, since that approach would leave unsolved the problem of the availability of freely-usable currencies for the purchaser. The major advantage of the third option--transactions by agreement in SDRs--is its flexibility, as the Fund would arrange direct bilateral transactions inside or even outside the membership on a case-by-case basis. Nevertheless, it is obvious that such transactions should be made only on a voluntary basis, and my authorities are not enthusiastic about participating in such transactions.

I would be very reluctant to adopt any procedure that increases pressure on the Fund's debtors. The outstanding valuation claims by the Fund are at an historic minimum compared with the amount of Fund credit. Hence, it seems difficult to take advantage of such signs of good will, even if their practical influence is minimal, by exerting additional pressure on members through the use of these currencies. In my opinion, the relevant procedures should not be compulsory in any way.

Mr. Donoso made the following statement:

I interpret the staff papers as showing that the staff is in favor of being pragmatic and cautious in dealing with the problem of arrears, and that the staff opposes any extreme measures to deal with the problem. I fully agree with that approach.

A starting point for this discussion is the recognition of the seriousness of the arrears situation. In the six months from March to September 1986, the total amount of arrears to the Fund increased from SDR 666 million to SDR 911 million. Protracted arrears have almost doubled, and arrears of more than two years' duration more than doubled. In addition, arrears have increased in relation to total Fund activity.

A second important characteristic of the arrears situation is that the magnitude of the arrears problem is due to a considerable extent to the persistent problems facing the international

economy. In the year to September 1986, 58 members were late in settling their obligations to the Fund; these countries represented 47 percent of the membership, an increase from 43 percent in 1985 and 37 percent in 1984. The fact that total arrears remain heavily concentrated in a relatively small number of countries--nine members subject to complaints at the end of September accounted for virtually all the arrears to the Fund at that time--should not lead us to overlook the fact that there have been many more countries that have been late in settling their obligations to the Fund. The Fund's membership, and as a consequence the Fund itself, is going through a most difficult period. The number of arrears is one more manifestation of the problems facing many member countries owing to slow growth in the industrial countries, the continued weakness of commodity prices, the slow expansion of world trade, and the protectionist pressures in an overall context of heavy external debt in the countries concerned.

In these circumstances, we must be careful in deciding how to face the arrears situation. We should not rely on mechanisms that would run the risk of increasing the number of members in arrears. In this connection, I would like to comment on the staff analysis on concerted representation by the membership in the staff's discussion on corrective actions to reduce and eliminate arrears in EBS/86/255. One of the reasons given by the staff for members to join the Fund in persuading other members to settle their overdue obligations and in assisting them to do so is the impact of the arrears on the membership as a whole. It is mentioned that the arrears have resulted in a higher rate than would otherwise have been necessary. It is possible that the impact of the arrears could lead to the introduction of provisioning against loan losses.

Instead of stressing the cost of arrears for other members that fulfill their obligations to the Fund, we should analyze carefully the appropriateness of letting arrears be reflected in the rate of charge. After all, in the year to September 1986, 58 members--representing 47 percent of the membership--were late in settling their obligations to the Fund. I wish to stress the potential danger of the approach that we have been following; that approach should be carefully examined. Moreover, it is important to avoid engaging lightly in any action in addition to a declaration of ineligibility in order to encourage a country to settle its arrears. In particular, a country should not engage in formal actions to influence the policies of other institutions against a member country in arrears to the Fund. The impact on a member's creditworthiness of a declaration of ineligibility is in itself a serious effect. I do not see how curtailment of financing by all institutions would make it easier for a country to fulfill its obligations to the Fund. In addition, the possible further actions would cause permanent

damage to the Fund's relations with the member country concerned. This should be avoided if the Fund is to continue playing a role in solving the problems facing the countries that have been hit especially hard by world economic conditions and that have insufficient tools available to them to solve the problems. The Fund has played a positive role in managing the debt problem, and the crisis would have been much more serious without the Fund's participation. However, the problem still exists, and many countries are in serious financial disarray. I do not know whether new tools will become available to deal with the most serious cases of members that are unable to meet their external obligations. During this period of uncertainty, we should not damage the ability of the Fund to cooperate with members that are making additional efforts to solve their problems.

I will now comment on the specific issues raised in the staff paper. As to procedures, and specifically the timing of the declaration of ineligibility, I share the staff's view on the value of the case-by-case approach that has been applied thus far. In the area of specific actions by the Fund, emphasis should be placed on efforts to prevent problems from arising by identifying at an early stage the sources of potential difficulties in individual countries and by helping the members concerned to introduce adjustment measures or adopt arrangements that will ensure the availability of resources to cover obligations falling due to the Fund. In the area of corrective action in particular, it is clearly important for the staff to help members in arrears to formulate adjustment programs and to obtain financing from various sources to normalize their financial situation.

Representations by individual countries could play a positive role. Members can stress the fact that the Fund made its loans to countries when those countries faced great difficulties and, therefore, the Fund is entitled to be given the highest priority by a member that is trying to meet its external obligations. In addition, donors and creditors should be more aware of the need for their cooperation to solve arrears problems by facilitating the putting in place of necessary arrangements.

The sale and use of currencies of members in arrears can sometimes provide a valuable means by which to make it easier for a country to eliminate its debt to the Fund. However, I would not favor any of these operations if the member that issues the currency has not given its consent. Selling a member's currency without the member's agreement would be a source of conflict and would be inappropriate in an institution like the Fund. I strongly oppose the idea of testing a member's willingness to cooperate with the Fund after a declaration of ineligibility by offering that member's currency in financing purchases without its consent even with the provision of a fail-safe mechanism to protect the purchasing member.

I accept the staff's proposal concerning the form of decisions on the suspension of a member's right to use SDRs. I also agree with the proposal to base the calculation of special charges on overdue repurchases on the rate of charge determined at the beginning of the financial year. In addition, the receipts of special charges should be used to mitigate the consequences for members of the adjustments in the rate of charge and the rate of remuneration. I support the introduction of special charges on overdue obligations under the structural adjustment facility on the same terms that are being applied on overdue Trust Fund obligations.

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/87/1 (1/5/87) and EBM/87/2 (1/7/87).

2. MEXICO - EXCHANGE SYSTEM

The approval for the retention of Mexico's restrictive multiple currency practice under Decision No. 8386-(86/149), adopted September 8, 1986, is extended until March 31, 1987, or the completion of the first review under the stand-by arrangement for Mexico (EBS/86/161, Sup. 6), whichever is the earlier. (EBS/86/285, 12/31/86)

Decision No. 8494-(87/2), adopted
January 6, 1987

3. EASTERN CARIBBEAN CENTRAL BANK (ECCB) - TECHNICAL ASSISTANCE

In response to a request from the Governor of the Eastern Caribbean Central Bank for technical assistance in the field of banking legislation, the Executive Board approves the proposal set forth in EBD/86/337 (12/30/86).

Adopted January 6, 1987

4. INDONESIA - TECHNICAL ASSISTANCE

In response to a request from the Indonesian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/86/338 (12/30/86).

Adopted January 6, 1987

5. ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS, 1987 - PART ONE - OUTLINE

The Executive Board approves the proposed outline of Part One of the Annual Report on Exchange Arrangements and Exchange Restrictions, 1987, as set forth in EBD/86/333 (12/22/86).

Adopted January 5, 1987

6. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/86/327 (12/30/86).

Adopted January 5, 1987

7. SALARY OF DEPUTY MANAGING DIRECTOR

The proposal regarding the salary of the Deputy Managing Director as set forth in EBAP/86/323 (12/23/86) and Supplement 1 (12/30/86) is approved.

Adopted January 6, 1987

8. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/64 and 86/65 are approved. (EBD/86/335, 12/29/86)

Adopted January 6, 1987

APPROVED: August 7, 1987

LEO VAN HOUTVEN
Secretary