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INTERNATIONAL MONETARY FUND

Secretary's Journal of Executive Board
Informal Session 87/5

9:00 a.m., November 13, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	Jiang H.
C. H. Dallara	M. K. Bush
J. de Groote	J. Prader
A. Donoso	
M. Finaish	
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	J. Hospedales
	C. Enoch
M. Massé	D. McCormack
Mawakani Samba	C. V. Santos
Y. A. Nimatallah	I. A. Al-Assaf
G. Ortiz	L. Filardo
J. Ovi	M. Fogelholm
H. Ploix	D. Marcel
G. A. Posthumus	G. P. J. Hogeweg
	C.-Y. Lim
G. Salehkhou	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	M. Sugita
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
R. S. Franklin, Assistant
S. L. Yeager, Assistant

Also Present

IBRD: E. R. Grilli, Economic Advisory Staff. African Department: A. D. Ouattara, Counsellor and Director; G. E. Gondwe, Deputy Director; J. Artus. Asian Department: B. B. Aghevli, K. A. Al-Eyd. European Department: M. Russo, Director; P. B. de Fontenay, Deputy Director; E. O. C. Brehmer. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; S. J. Anjaria, S. B. Brown, H. Hino, M. Nowak. External Relations Department: H. O. Hartmann, I. S. McDonald. Fiscal Affairs Department: E. S. Kreis. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; A. O. Liuksila, R. H. Munzberg. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; G. Hacche, E. Hernández-Catá, F. Larsen, D. J. Mathieson. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; M. N. Bhuiyan, J. E. Blalock, D. H. Brown, P. B. Clark, J. C. Corr, D. Gupta, D. V. Pritchett, B. B. Zavoico. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; Y. Horiguchi. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, P. D. Péroz, G. Pineau, I. Puro, N. Toé, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: N. Adachi, A. R. Al-Abdullatif, H. S. Binay, R. Comotto, F. Di Mauro, . N. Engert, S. K. Fayyad, V. J. Fernández, S. Guribye, M. Hepp, G. K. Hodges, L. Hubloue, V. K. Malhotra, W. K. Parmena, S. Rebecchini, A. Rieffel, G. Schurr, C. C. A. van den Berg, E. L. Walker, R. Wenzel, Yang W., I. Zaidi.

1. EXCHANGE AND FINANCIAL MARKETS - RECENT DEVELOPMENTS

The Executive Directors, meeting in restricted informal session, considered the implications of recent developments in financial markets. They had before them staff papers containing charts on exchange market developments (EBD/87/291, 11/11/87; and Supplement 1, 6/9/88) and charts on recent exchange and financial market developments (EBD/87/294, 11/12/87).

The Economic Counsellor observed that the staff statement was divided into three main sections: the first contained exchange rate and stock market data; the second discussed the implications of the recent developments in the exchange and financial markets for economic institutions and for the stability of the monetary system; and the third covered the implications of those developments for the world economic outlook. Information in the third section should be viewed as extremely tentative. As a complete assessment of the developments themselves had not yet been made, it was naturally impossible to be precise about the implications.

The staff representative from the Treasurer's Department, updating developments since the staff statement had been issued, noted that relative to other currencies, the dollar had reached its low point on November 10 but had since recovered sharply, primarily in response to the release of recent data indicating that the U.S. trade deficit for September had declined to $14.1 billion, at the low end of the range that the market had been expecting. On an effective basis, the dollar had appreciated since November 10 by about 1.5 percent, with the deutsche mark moving from DM 1.65 to the dollar to DM 1.69 per dollar. At the same time, the yen had moved from ¥ 133 per dollar to ¥ 136 per dollar.

Movements in interest rates had been mixed, declining somewhat in U.S. markets but remaining unchanged in Germany and France and moving slightly higher in Japan and the United Kingdom, the staff representative said. Stock markets had moved up sharply around the world since November 10, with the Dow Jones industrial average rising some 4.5 percent on November 11 and 12 combined.

Mr. Kafka stated that he had no difficulty with the staff analysis, from which he had drawn the conclusion that a modest further decline would occur in the world growth rate, which was, however, already unsatisfactory. He presumed that because of the low elasticity of supply of primary products, the adverse effects of the decline in the growth rate of industrial countries would fall disproportionately on the developing countries, through their terms of trade. At the same time, the decline might have a modestly equilibrating impact on the balance of payments of the major industrial countries, with a stronger negative effect in the United States than elsewhere. What response should the world make to such developments? As he saw it, looser money all around was probably a reasonable answer, although less so in the United States than in the other major industrial countries.

Fiscal restraint would continue to be necessary in the United States, both relative to other countries and in absolute terms, Mr. Kafka considered. Such restraint would be needed to provide room for increased exports in order to improve the balance of payments. On the matter of inflation, while it was unclear whether the dollar rate would fall further, it did seem that the avoidance of recession was more important than the avoidance of a mild increase in inflation. And that recipe was not inconsistent with his remarks on monetary policy.

On the matter of policy coordination, Mr. Kafka remarked, Professor Feldstein had recently suggested that there was no need to worry about such coordination because interdependence was limited, and countries would do only what was in their own interest. While that might well be true, his own feeling was that it was in the interest of countries to behave in a coordinated fashion.

Mrs. Ploix said that she had been surprised by the rather limited action taken in certain markets when the dollar had declined below certain levels. Also, accepting that any depreciation should be supplemented by adjustment measures, she found the adoption of such measures quite limited in some countries.

On what should be done in response to the recent developments, Mrs. Ploix observed that demand was too strong in the United States and that a slowdown was therefore necessary. However, other countries must pick up the slack to ensure reasonable world growth. Of course, if the dollar depreciation was too great, it could endanger the potential for growth in other countries, particularly in Europe. Hence, if growth was a viable objective, the appropriate steps to be taken toward achievement of that objective were adjustment followed by adequate exchange rates.

Economic policy cooperation was in her view an important element in the response, and it was clear that the markets shared her view, Mrs. Ploix continued. The reaction of the markets immediately following the Louvre Accord made it clear that cooperation was deemed appropriate. And it seemed that the markets were looking for cooperation on exchange and interest rates with supporting economic policies. As she saw it, cooperation in Europe was particularly important. With no risk of inflation, real interest rates must decline. In that respect, a good example of cooperation in Europe had been demonstrated recently in the steps that Germany had taken to reduce interest rates, steps which had helped to increase growth in France. Finally, with respect to countries in the dollar zone, one must ask whether it was appropriate that countries that pegged their currency to the dollar should benefit from overcompetitiveness just because the dollar was depreciating so sharply.

Mr. Grosche agreed that recent developments in the currency and financial markets were clearly disturbing, although care must be taken in assessing the implications for individual economies. Still under the shock of those developments, countries tended to be perhaps more pessimistic than they needed to be. The financial markets could have power over global economies only if such power were accorded them. Events could be controlled if appropriate policies were adopted; and, while fine tuning was not the answer, it was certainly possible to control inflation and prevent depression. The markets would take over only if countries were inactive and failed to instill confidence among people in a better outcome.

There was no doubt in his mind that the effort toward cooperation among the major industrial countries--with the assistance of the Fund--continued to be the right approach to creating an environment conducive to sustainable growth and to financial and exchange rate stability, Mr. Grosche remarked. Coordination efforts of the major industrial countries had certainly served the global economy well; however, recent developments in the markets demonstrated that those efforts were not sufficient yet. In their meetings over the past two years, the major industrial countries had reached a common view on the nature of the imbalances they faced, and they had concluded that fiscal measures must be the cornerstone of the policy aimed at reducing internal and external imbalances and at fostering exchange rate stability. The Louvre Accord had in the recent past been misinterpreted somewhat, in the sense that perhaps too much attention had been given to exchange rates and too heavy a burden had been placed on monetary policy, leaving fiscal policy somewhat neglected. What was needed in current circumstances was a rapid restoration of confidence and clear signals from policymakers that they were prepared to put the right set of policies in place. It was his hope--and expectation--that the current budget talks in the United States would result in a substantial cut in the deficit for FY 1988 and that those discussions would give the markets clear indications that further substantial cuts would follow in the years ahead.

His own authorities remained fully committed to the objective of achieving a more stable exchange rate system and of adopting and maintaining policies that underpinned such a system, Mr. Grosche said. Cooperation among the major industrial countries must be continued and improved, drawing lessons from recent experience. In that connection, he took some comfort in knowing that the Fund was involved in the process, and he sensed that the present meeting could contribute to a better understanding of the implications of the recent developments for the global economy.

He was perhaps more worried than Mr. Kafka about inflation in general, Mr. Grosche commented. Inflation was difficult to control and, given the liquidity that had been and was being created, he was concerned about inflation in the years ahead. He did share Mr. Kafka's views about cooperation and policy coordination and agreed with Mrs. Ploix that recent developments in the relations between Germany and France showed the positive effects of cooperation in the area of monetary policy in Europe.

Mr. Posthumus, remarking first on the stock market crash, indicated that it was important to recognize that on November 10, the Dow Jones index had still been 22 percent higher than its lowest level in 1986 and only 6 percent lower than the highest level in 1986. That comparison suggested that the effect of the perceived loss of wealth on consumption might be somewhat less than was feared by some. At the same time, if one assumed that the increase in wealth in the course in 1987 had led to an appreciable increase in consumption during that period, then the effects of the loss of wealth might be larger. In such circumstances, the staff estimates of the negative effects of the stock market crash--which he was happy to note were the lowest estimates that he had seen thus far--should be considered with the utmost care.

The decisions to maintain liquidity in the financial system and perhaps to prevent an immediate decrease in consumption and investment following the stock market crash had been well timed, Mr. Posthumus considered. However, in light of the current account deficit of the United States, a slowdown in the growth of expenditure in that country remained necessary. In the third quarter of 1987, real GNP growth in the United States on an annual basis had been 3.8 percent, which was more than 1 percentage point higher than the potential growth, according to the world economic outlook, and was probably near capacity limits. In addition, national expenditure had increased by 4.3 percent. Balance of payments adjustment, of course, had not been supported by those developments. The lower interest rate in the United States might not be sustainable for long, because there was some solid basis for inflationary expectations and the current account was not moving in the right direction. A substantial reduction in the fiscal deficit would, of course, contribute to a slowdown in expenditure and to a gradual shift from consumption to exports and investment.

The support of the dollar by central banks in Europe and Japan following the Louvre Accord had led to an increase in money growth and to some increase in interest rates, Mr. Posthumus observed. The latter development had been unfortunate because, considering the deficit in the United States and the surpluses in Germany and Japan, parallel developments in interest rates--of the sort that had been observed in the past few months--could not be helpful to stabilizing exchange rates. On the other hand, like Mrs. Ploix and Mr. Grosche, he could point to recent measures in the European Monetary System where a lowering of the rates in Germany and in the Netherlands and an increase of rates in France supported the exchange rate stabilization efforts and showed that interest rate policies should not be forgotten as an instrument for attaining exchange rate stabilization. He would strongly urge that exchange rate measures not be made unworkable by fear of recessionary effects or by too much political pressure to lower interest rates, although he agreed that interest rates could not be the main instruments in an exchange rate stabilization effort and that fiscal and social policies should also play an important role.

The und[illegible]conomic situation might not have warranted the extent of the stock [illegible] crash, as many observers had said, but it had certainly been unsusta[illegible], Mr. Posthumus commented. Economists were like meteorologists: in [illegible]ting to forecast the weather, they might be able to see the approach of a break but could never know precisely when it would occur. In that context, however, discussions in the Fund--particularly the recent Article IV consultations with the United States and Germany only a few months previously--had clearly indicated which adjustments had been needed and how urgently they should have been adopted. That led him to conclude that the strengthening of the surveillance role of the Fund was necessary, not only because surveillance was useful in itself but also because it served as a basis for further international cooperation. The additional benefits of cooperation and coordination in the timing and extent of adjustment efforts were to be found in the acceleration of their positive effects.

It had become urgent that the process of depreciation of the dollar--which seemed out of control--be discontinued, because there were no longer any winners in such a process, Mr. Posthumus considered. And while a credible decrease in the U.S. budget deficit was necessary, it was no longer sufficient: other industrial countries must also implement adjustment measures. If, in addition, the markets could be convinced that the authorities of industrial countries were prepared to use and coordinate interest rate policies, then the cost of speculation would become prohibitive and stabilization of exchange rates would be possible. Finally, measures to roll back protectionism should be part of any new package, because macroeconomic policies could no longer overcome existing rigidities in the markets.

Mr. Kafka, noting his agreement with Mr. Posthumus on the direction of policy, said that he was concerned that if the markets were not easily convinced that the U.S. balance of payments would be improved by budgetary measures and that interest rate coordination could maintain the exchange rate relationship, the world would be faced with the danger that interest rates in the United States would have to be raised too high or that interest rates elsewhere would have to be lowered too far for comfort.

Mr. Yamazaki stated that like other Directors, he was concerned about the recent instability of world financial markets. Developments since late October clearly underscored the importance of maintaining and strengthening policy coordination among the industrial countries.

The Louvre Accord had had two important components in its contents: policy coordination and exchange rate stability, Mr. Yamazaki recalled. In line with the agreement on policy aspects, Japan had adopted a fiscal package amounting to ¥ 6 trillion, which was now being implemented and was having salutary effects on the expansion of domestic demand. At the same time, the other component of the Louvre Accord, namely, the prospect of exchange rate stability, provided considerable support for business confidence, which, in turn, led to substantial growth in planned private capital investment. Firming domestic demand further boosted business confidence as well as business profit, and, prior to the recent events, there were indications that a virtuous circle may have started.

That was perhaps one of the reasons why the decline in the Tokyo stock index was smaller than that in the United States or in Europe, Mr. Yamazaki considered. As far as the Japanese economy is concerned, the direct impact on consumption might not be as large as that in the United States, since the equity holding by consumers as a percentage of total assets was lower in Japan than in the United States. More worrying was the sharp appreciation of the yen, which, if continued, could seriously undermine the emerging business confidence, the source of the strength of fixed investment. His authorities therefore attached the highest importance to maintaining the Louvre Accord and to reaffirming the policy coordination in line with that Accord.

Finally, with respect to Japan's external account, despite the progress in adjustment in real terms, the current account in U.S. dollar terms had not shown an improvement until the spring of 1987. Since then, however, the current account surplus has begun to decline, even in dollar terms, on seasonally adjusted three-month averages of $8.3 billion in the first quarter, $7.0 billion in the second quarter and $6.6 billion in the third quarter.

Ms. Bush commented that recent developments in the financial markets were clearly a source of concern to her authorities, as they were obviously to others. The markets had sent a powerful message that policy reinforcements were necessary in order to enhance the prospects for reducing imbalances in an orderly fashion. The United States recognized the urgency of further action on the U.S. fiscal deficit in order to reinforce market confidence and to continue the process already under way. It was equally important that the United States and other major industrial countries recommit themselves to international economic policy coordination. Such coordination was all the more necessary in light of the highly integrated financial markets. In that connection, perhaps even the most sophisticated observers might have been surprised at the sensitive linkages in those markets.

Her authorities continued to support the objective of exchange rate stability, Ms. Bush remarked. However, recent developments had underscored that such stability depended fundamentally on sound underlying policies. Indeed, the full range of policy instruments must be brought into play if the objective of stability was to be achieved. It was to be hoped that other major industrial countries were reassessing their policies in considering ways in which they could strengthen the fundamentals. Finally, recent developments had highlighted the need for the Fund to intensify its efforts to encourage policy coordination among the industrial countries. As others had already suggested, the message that the market had sent with such force in October had been sent more quietly and analytically in earlier Board discussions on the world economic outlook.

Mr. Nimatallah stated that he had been reassured by the commitment of those who had spoken before him toward the strengthening of policy coordination, a process in which the Fund should play a role.

His reaction to the recent exchange and financial market developments was perhaps rather different from the reaction of some of his colleagues, in that he preferred to focus on some of the positive elements in the so-called crash, Mr. Nimatallah continued. He had found seven identifiable favorable points. First, inflationary expectations had subsided. Second, there appeared to be greater awareness that more credible action toward fiscal adjustment would be required in the United States. Third, falling interest rates might encourage consumers and investors worldwide to sustain demand. Fourth, Japan and Germany currently seemed more aware of the role they must play on the structural adjustment front. Fifth, the crash had offered the world economy an opportunity to test its resilience, and it was clear that the world economy was stronger than it had been at the time of the crash in 1929. In that connection, what central banks had done was commendable, particularly in the United States, and the reactions of governments generally had been reassuring. Sixth, the recent developments might lead to a somewhat higher rate of personal savings in the United States, and such a rise was in his view needed. Finally, it had become clear that coordination was an essential part of the resiliency of the global economy and should be continued, albeit on a more discreet basis.

On the appropriate response to the recent exchange and financial market developments, Mr. Nimatallah considered that it might be helpful if the Managing Director were to gather the main elements of the present discussion in a formal summing up or concluding remarks that could be passed on as soon as feasible to all those who might find those remarks useful. As he saw it, the Chairman should emphasize the importance of continuing policy coordination among the major industrial countries and should indicate to Germany and Japan that they should speed up structural adjustment within their economies. He was certain the German authorities were being honest in their expressions of concern about the dangers of fiscal expansion, particularly with respect to inflation. But their concern might be lessened if they were to reduce the number of structural rigidities in their economy, a move that would very quickly send positive signals to the markets. In the United States, action to reduce the fiscal deficit was badly needed. A credible fiscal process must be put in place, although it should be designed in a way that avoided global recession.

What had happened thus far to the dollar might well be in the right direction, Mr. Nimatallah continued, although he would suggest that the dollar had fallen far enough, at least at the present stage. What must be done now was for the relevant countries to accept relationships between the dollar and other currencies at a lower level and to recommit themselves to maintaining stability in those relationships at the lower level. If action by the relevant countries was not effective, the fall in the dollar might be even greater than the staff had suggested. In the circumstances, it was to be hoped that governments would take great care in responding fully to the measure of the problem and not to take it lightly, since matters could get worse.

Mr. Kyriazidis noted that he had approached the discussion with one serious question, namely, whether the monetary expansion witnessed since the October developments was sustainable and, if so, for how long, particularly in the United States. He had found Mr. Grosche's remarks on the possible dangers of rekindling inflation to be important, and he believed that Directors should take seriously the warning behind them. He had also found particularly interesting Mr. Grosche's remarks on the importance of guiding the markets through policies rather than allowing the markets to determine those policies. Recent cooperative measures in the area of monetary policy were certainly most welcome, although he wondered whether those tended to disprove or support Professor Feldstein's ideas. There remained considerable room for improvement on the coordination of fiscal policy and, while the prospect of fiscal adjustment in the United States was certainly most welcome, there remained uncertainty about the extent and desirability of fiscal adjustment in other countries; and that uncertainty had important implications for the sustainability of monetary policy coordination. Despite the staff's welcome efforts to provide data on the recent exchange and financial market developments, the information available was not sufficient to carry the analysis very deeply. In that respect, he hoped that the staff would be able to update the simulations of the world economic outlook on the basis of developments since September 1987. The rough estimates that had been provided of the effects of the shock were interesting but not sufficient. In particular, he would be interested in seeing a full simulation on the basis of the models used by the staff, with emphasis on the effects on world trade.

Mr. Ovi recalled that at the spring meeting of the Interim Committee, and later in the July Board discussion on indicators (EBM/87/106, 7/22/87 and EBM/87/107, 7/23/87), his chair had raised the idea that a kind of exchange rate trigger should be introduced as an indicator. The idea was that if the exchange rate of one of the major currencies moved substantially, that movement should trigger multilateral discussions among major countries. Of course, the important point was that such an exchange rate change materially affected the setting of economic policy in a number of countries; and, in a multilateral context, one should establish whether such a change in exchange rates required a change of emphasis in economic policies. He had found little support for the idea when it had been introduced. However, the time had arrived when it was important that multilateral discussions take place on the most appropriate response to the current problems. He had little doubt that bilateral contacts were being made; but, to foster multilateral discussions aimed at ensuring that the interests of the membership at large were taken into account, he would urge the Managing Director to participate actively in the ongoing deliberations.

Mr. Enoch considered that the staff's statement contained useful statistical information and analysis. However, a day-by-day snapshot of events in the exchange and stock markets might be somewhat misleading, in that the picture excluded the role of the authorities of member countries, who had responded quickly and significantly in the area of domestic interest rates and had presumably taken steps on the external side as well. In the United Kingdom, for example, reserves had increased by more than $6 billion in the month since the October crash. Analysis which was limited to describing exchange rate movements on particular days and did not take into account the role of the authorities was not complete.

On the implications of the exchange and financial market developments, Mr. Enoch noted that his views were partly, although by no means entirely, parochial, in the sense that the stock market fall had occurred approximately one year after the wide-ranging reforms in the London markets known as the big bang. At that time, individuals had expressed some concern about the deregulation in the markets, and in some quarters the fall itself had been seen as indicative of weaknesses underlying those reforms. He had two comments to make in that regard. First, the autonomous role of the markets was perhaps fairly limited. As others had noted, the correction that had occurred could be attributed to economic and political factors. The markets had risen rapidly over the past five years, trebling in real terms on both the London and New York stock exchanges and certainly rising far faster than the growth of company profitability. In the circumstances, there had been a gap between the return on equities and the return on bonds, and some correction had been needed. Moreover, it was possible to identify proximate economic causes. In that sense, the autonomous role of the markets might not have been as large as some had suggested. Second, people had argued that the relative strength of institutions in different financial markets was related to the extent of the fall. In that respect, they had suggested that the fall in Japan might indicate that Japanese institutions were stronger than those in the United Kingdom, for example, where a particularly sharp fall had been experienced. In his view, one way to assess the markets was to note that the dramatic correction that had occurred had not required the closing of the London market. The market makers had always been prepared to make markets, and there had been no free fall or threat of free fall even during those periods of rapid movements in prices. In that sense, the recent fall in the stock market might be taken as a vindication of the structure of the markets, although individual elements would require a closer look.

On the prospects for the world economy, Mr. Enoch agreed with the staff that the effects of the October developments were not clear, in part because the markets remained quite volatile. In the past 24 hours, the Tokyo market had experienced its third largest increase in history, and there would likely continue to be large movements in both directions, at least in part because of the sensitivity of the markets to the policy responses by the authorities. Like others, he welcomed the recent efforts to establish with some urgency a policy response; and in that connection, it was clear that the outcome of negotiations aimed at reducing the U.S. fiscal deficit would help to determine the overall impact of the movements in the market. In general, it would be difficult to disentangle the cause and effect relationships in the market movements. Already, lower interest rates were evident than might otherwise have been seen; and the fiscal deficit had been reduced somewhat. At some stage, presumably, developments would stabilize sufficiently to enable a proper reassessment of prospects for the world economy. The staff's estimates provided for the current discussion were only a first guess; and, while they seemed to be reasonable, he was not certain at the present stage it would be appropriate to call for a major world economic outlook exercise, since so many critical assumptions might be rapidly overturned.

Like other speakers, he continued to regard the cooperative approach as an essential part of economic policy formulation, Mr. Enoch commented. Stability in the external markets had existed for much of the year, partly as a result of the Louvre Accord and the feeling in the markets that the authorities in different countries were talking to one another and cooperating. One of the factors in the fall in various markets had been the appearance that some of the cooperation had been breaking down. In that sense, it was reassuring that all his colleagues had re-emphasized their support for the cooperative framework as set out in the Louvre Accord.

Mr. Ortiz said that he had been struck by Directors' calls for policy coordination that would ensure control of the markets while, at the same time, Mr. Grosche, for example, continued to suggest that fine tuning was inappropriate. He himself saw little difference between fine tuning and the type of recent policy reactions to events in the exchange and financial markets. Did his colleagues believe that intervention was again important and that policy coordination and cooperation--in the area of monetary, fiscal, and exchange rate policies--was something that the monetary/financial authorities could manage in reacting quickly to events? Or did they believe that one could simply plan for the medium term and allow the markets to arrange everything else? He sensed a dichotomy between the general dislike for the concept of fine tuning and the events that were currently being witnessed. In that connection, Mr. Kyriazidis's reference to the sustainability of monetary expansion and the dangers of rekindling inflation was a key point. Prior to the so-called crash, the world had seemed generally in agreement that the fundamental determinants of inflation in the major countries were such that there was little risk of a rekindling of inflation. Those fundamental determinants had not changed over the past few weeks; hence, the only way inflation could pick up was through the mechanism of inflationary expectations. In that sense, the key to ensuring that monetary expansion resulted in a permanent lowering of interest rates without inflation--and thus led to a milder decline in economic activity--was to ensure that inflationary expectations were kept low. And the only way to achieve that goal was to take policy actions directed toward calming the markets and restoring confidence. In that respect, fiscal action by the United States was particularly important. The contractionary effects of the size of the cuts in the U.S. fiscal deficit had been widely debated, but it was clear at the moment that any short-run contractionary impact that such cuts might have would be more than offset by the beneficial effects of improved confidence in the markets. That confidence could translate into a higher permanent demand for liquidity, such that the current liquidity could be absorbed without rekindling inflation. As he saw it, that would be the only acceptable outcome for 1988. It would be disastrous if that scenario failed to materialize and the world was thrown into declining economic activity with higher interest rates that fueled inflation. The first to lose in such a scenario would be the developing and indebted countries. Finally, if there was one positive element to the recent crash, it might be the trade-off between a mild reduction in economic activity and substantially lower real interest rates. If that trade-off were real, one could expect that the atmosphere for debt negotiations and the debt situation would not worsen considerably in 1988.

Mr. Mawakani indicated that he could agree with previous speakers on the necessity of policy coordination by the major industrial countries. The recent exchange rate developments and statements by policymakers in different forums had raised legitimate questions about the status of the Louvre Accord. Some had even argued that the Louvre Accord was a key cause of the crash of the financial markets. He would appreciate hearing whatever information was available on the status of the Louvre Accord and the views of others about its relationship, if any, to the recent developments.

Mr. Massé observed that much had been said about policy cooperation and coordination among the major industrial countries and about whether it had taken the right form or had been sufficient. He tended to take an optimistic view of the recent crash in saying that, especially for midsized countries like Canada--which did not always have the influence that they might wish to have on some of the major players--there was a sense of being protected much more by the rules of the game of cooperation, since such countries could not dictate those rules. However, what such countries were unable to do, the market had recently done for them. It was clear that cooperation had been necessary but that the pace and extent of cooperation had not been sufficient. The market had inflicted its punishment for that failure and had in a way imposed on the major countries the kind of pressure that the midsized countries had not by themselves been able to exert.

He continued to believe in cooperation and in the notion that the Louvre Accord, or something like it, remained necessary, Mr. Massé said. The crash emphasized that the analysis which formed the basis of agreements like the Louvre Accord must be of high quality; otherwise, the markets would reach the conclusions that such agreements were only a sham. And the quality of that analysis depended upon the International Monetary Fund in an important way.

On prospects for the world economy in 1988, Mr. Massé noted that his own analysis was rather similar to that of the staff. The immediate effects of the decrease of share values--the so-called wealth effect--was likely to be small. The only effect that he was concerned about was the effect on expectations; if the stock market crash had created among people expectations that their return on investments would be smaller, they would tend to invest less. And if consumers were worried, they would spend less and thus create the recession which all feared. If that analysis were correct, one was led to conclude that expectations would be affected by an increase in confidence created by the countries that took the most important decisions. In sum, the real need was the adoption of confidence-building measures. If the relevant countries did not take the various measures that the market expected, then no words describing a new agreement would be sufficient. With the adoption of measures perceived by the markets as confidence building, the stock market crash would have very few long-term adverse effects; indeed, historians might see the effects as quite positive in helping to re-establish world economic order.

Mr. Posthumus observed in response to Mr. Massé's remarks that it was a sad commentary indeed on international cooperation if it took a stock market crash to underline the importance of the role of institutions like the International Monetary Fund in fostering international cooperation.

Mr. Kyriazidis, recalling Mr. Grosche's warning about the possibility of rekindling inflation, commented that the perception of such dangers had a number of implications for policy actions--particularly monetary policy actions--that could be expected in the near future. In taking note of that warning, however, he had not in his own intervention attempted to assess the extent to which those fears were well founded.

Mr. Donoso made the following statement:

> The Fund staff indicated before the crash that the United States had an unsustainable current account deficit. It was not possible then to think that enough foreign financing would be indefinitely available to maintain the situation. I think the symptoms of a reduced availability of financing were there, with the markets pushing to depreciate the dollar, monetary authorities offsetting those pressures, and interest rates going up.
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> The depreciation of the dollar, which started in 1985, had ceased and, as I mentioned on the occasion of the Article IV consultation with the United States, the recovery in prices of commodities had slowed down and we had even experienced reductions in prices of commodities during some months in the year.
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> The world economy was moving toward a recession, and coordination might have even helped to prolong the situation of imbalances in the major economies. Of course, everyone was saying that the United States had to reduce its fiscal imbalance, action which would improve the external accounts. However, at the same time, those pushing for a reduction in the fiscal imbalances in the United States were strongly against further exchange rate adjustments and could have sustained both positions at the same time based on the assumption that fiscal discipline in the United States would render exchange rate adjustments unnecessary, something which I think is at least doubtful.
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> I have the impression that if the world economy was moving in the wrong direction, risking a recession and risking structural damage through the impact of persistent misalignments on protectionism in the major economies and through misallocation of resources induced by relative prices out of line, then it was (and is) better to reorient policies earlier rather than later.
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> And in this sense I see some positive signs after the crash: a renewed preoccupation with, and a serious effort to reduce, the U.S. fiscal deficit; and a renewed independence of monetary policies in the major economies as, at least temporarily, the

exchange rate objectives have lost priority. I take these as healthy signs that all the authorities involved want to move in a direction which the markets might perceive as sustainable.

I hope that cooperation, to define and make explicit mutually consistent policy guidelines, can be re-established soon to smooth the movement toward the new market-oriented objectives. A sense of confusion and uncertainty exists at present, which is damaging. It seems to me that cooperation can be renewed only after each of the parties involved is in a position to assure others that it is giving up those elements in its policies which do not fit in a sustainable, market-supported strategy, be those fiscal deficits or protection through exchange rates. Basic policies have to be spelled out soon so that economic agents receive some orientation.

This whole episode, negative insofar as it has generated pessimism, irrational reactions, and confusion--which are bound to have bad consequences--has one positive element if it does induce new changes in those policies which would have brought much more serious difficulties to the world economy.

While new, clear, quantifiable policy orientations emerge, we should try to anticipate what they might contain. This adjustment in policies might involve developments requiring some specific actions on our part. I want to be optimistic and attach importance to a rather favorable scenario, even though I see some dangers to which we should pay attention. I would attach some probability to a scenario in which some fiscal adjustment in the United States occurs, which in the context of more accommodating monetary policies brings in some depreciation of the U.S. dollar. If in net terms the fiscal sectors in the major economies are reducing expenditures, one could expect lower real interest rates in the world, which, it is hoped, will induce private sector activity to offset the fiscal retrenchment. There might be some reduction in the overall level of activity in the short term; but lower real interest rates and a lower dollar could offset the effects of the reduced levels of activity on the prices of the goods exported by developing countries.

If real interest rates are lower and real prices of commodities strengthen, the indebted developing countries could be better off in an economic sense. However, insofar as this occurs in a somehow more inflationary environment, nominal interest rates could be higher. Inflation in commodities and in traded goods in general, ceteris paribus, improves the trade account of a country which has a trade surplus. However, if that inflation is reflected in higher nominal interest rates, it also has a negative effect on the current account balance in countries which are net international debtors.

Three percentage points of additional inflation could increase by 3 percent the trade surplus. If entirely captured by interest rates, the same inflation could raise interest rates by more than 30 percent, if considered on the basis of present rates. The generalized situation of the indebted countries is one of a current account in deficit, or at best in balance.

The stronger impact of inflation on interest rates, in comparison with its effect on the trade surplus, should, given this starting current account position, strongly erode that position for indebted countries, a most worrisome possibility. If countries were to adjust to offset the current account deterioration, they would have to reduce their indebtedness faster in real terms, and that is not possible. To maintain the originally envisaged path of debt reduction in real terms, these countries will need more financing. I am afraid that even in the most favorable of the possible evolutions of the world economy in the medium term, we could face a serious problem in the indebted countries in the short term.

It is thus the time to establish and put in place a facility to compensate for higher interest rates. I share the view of those Directors who feel that some inflation might be unavoidable to accommodate necessary changes in relative prices without excessive costs; but if this is going to be the case, we should take this point into account in our reviews of Fund policies.

Mr. Ortiz observed that despite the depreciation of the dollar against the deutsche mark and the yen, the impact on inflation in the United States had been minor. Among the explanations for that development was the notion that the prices of tradable goods had not been passed on to consumers, as exporters had reduced profit margins in an effort to hang on to market shares. To the extent that there had already been some structural accommodation to the new exchange rates in Japan and Germany, it was not clear to him why a further modest depreciation in the dollar of the sort that had occurred in the past few weeks would be expected to produce any more inflation than had been produced over the past 18-24 months.

Mr. Grosche considered that Mr. Ortiz was correct in his explanation of why the sharp fall in the dollar against the deutsche mark and the yen had not been translated into higher prices in the United States. However, it must be recognized that the import penetration of, say, German goods into the United States was small indeed. As fa as the U.S. deficit in the trade account was concerned, for example, trade with Germany accounted for only a small part--some 6-8 percent--in 1987; indeed, for Europe as a whole, the share in the U.S. trade deficit was only about 15 percent. Hence, the correction that was taking place in the exchange rate against European currencies and the yen did not by itself very much affect the problems the United States was facing in its trade deficit. Put another way, the prices of European goods did not greatly affect developments in the average price level in the United States.

Mr. Sengupta replied that, however valid Mr. Grosche's remarks, Mr. Ortiz's explanation of why prices had not risen in the United States despite the sharp fall in the nominal effective exchange rate remained unrefuted.

The suggestion that the market played the same role in exerting pressure on industrial countries that the International Monetary Fund did in its relations with the developing countries was an interesting one, Mr. Sengupta continued. However, there was a problem with that comparison. The market could only give signals; unless those signals were properly interpreted, the messages could be quite different. For example, Mr. Enoch had put forward a common argument that whatever had happened in the stock markets had been nothing more than a correction to the appropriate level. If that were the signal sent by the markets, Mr. Massé's problem of confidence was resolved. The market had properly determined that activity had been booming beyond expectations and that a cutback had been necessary. However, suppose a large country with a powerful impact on the market did not behave in the way some market readers expected it to behave. In those circumstances, the theory tended to break down. In general, therefore, there were two important points to remember: first, the signals must be properly read; and, second, the leverage must be sufficient to ensure that the participants in the market acted in the way that the collective judgment considered that they should behave.

It remained uncertain whether the developments of recent weeks had been due to expectations about the stock market or confidence in the market or whether the market had reacted to policies adopted or not adopted by members, Mr. Sengupta said. While the answers to those questions might not be precise, one should not be deterred from attempting to work out a policy framework aimed at responding to or resolving the current situation. There must be some notion of the appropriate state of affairs or the right alignment of exchange rates or fiscal policies or of the policies that would most efficiently assure a stable rate of growth. Everyone around the table seemed keen on the idea of policy cooperation and coordination; but policy coordination might well give dangerous results if there were no agreement on the approximately appropriate values of the different variables. Under the Louvre Accord, the major countries had agreed on a particular relationship among exchange rates and then had chosen to intervene in the market in enormous amounts to support those relationships. One could propose that the original agreement on relationships had been in error and that the relationships had been corrected by the market. If that hypothesis was correct, the original policy coordination and the mistaken understanding of the value of the variables could be substantially responsible for the current situation. It was for that reason that he repeated the view that it was important to have some idea about desirable exchange rate alignments and, as he saw it, it was the function of the International Monetary Fund to provide guidance on those alignments. He could think of no other organization that would be able to examine the issues objectively and determine the appropriate policies needed to achieve the desirable alignment of exchange rates. That was not to say that the Fund should go public with its views; indeed, the Fund could act as a secretariat to the group of major industrial countries seeking policy coordination and could keep its views secret.

Mr. Dallara said that he tended to agree with those who had suggested that the Fund should not prematurely attempt to conduct a world economic outlook exercise. It was important to observe developments in the markets in the coming weeks; moreover, the conduct of such an exercise would make little sense until additional policy efforts were in place to assess the outlook. He also tended to agree with Mr. Ortiz's comments on the contractionary effects of the U.S. fiscal deficit. The type of modeling done in the Fund and elsewhere made it difficult to take into account the potentially adverse effects of market shocks such as those that had just been suffered. Yet, in some ways, it had been implicit in much of the analysis that a continuation of the U.S. fiscal deficit would not be expansionary; and that very fact was difficult to take into account in models, even if its validity were well known.

He had heard many references to Fund surveillance in the course of the present discussion as well as a repetition of the widely held view that there must be strengthened coordination, particularly among the major industrial countries, Mr. Dallara commented. He shared that view and believed that thought must be given in the months ahead on ways in which the surveillance mechanisms should be strengthened. On a related matter, he had begun of late to question the wisdom of treating all Fund discussions in a confidential manner. The effects on the market of publishing, say, an abbreviated summing up of Board discussions of key Article IV consultations might be less than the accumulated effect of data that showed up piece by piece in the public domain from different sources.

He could sympathize with many of the points raised by Mr. Sengupta, particularly on the effort to assign some value to different variables in creating scenarios, Mr. Dallara continued. It was not clear how practical it would be for the Fund to attempt to determine with precision the appropriate level for any one variable, although the Fund should intensify its efforts in producing medium-term scenarios to articulate with some degree of explicitness the elements that would lead to desirable medium-term outcomes. Data provided for, say, the recent U.S. and German consultations and the world economic outlook went well beyond the information recently provided in the markets; and, in that connection, consideration might be given to whether particular attention should be paid to a limited number of variables. It was no secret that under the Louvre Accord a "spectrum" of exchange rates had been brought to the attention of the relevant authorities. It was worth considering whether similar "spectrums" for one or two other variables might be useful, not only for Fund discussions but also as part of the work the management and staff were doing in support of the efforts toward G-7 coordination in the surveillance exercise.

Finally, in response to a point raised earlier by Mrs. Ploix, it was clear that the pressure on the dollar exchange rate to move against major currencies in Europe and Japan reflected, to a degree, the lack of movement of the dollar exchange rate against certain other currencies, Mr. Dallara observed. It was important that all countries reassess their contribution to global adjustment; in that connection, he could not help but note that during the period of growing global imbalances, the Korean won had, rather astonishingly, continued to depreciate during the second half of 1987 on a real effective basis. Such depreciation was a source of concern to his authorities--and he presumed to the Board--in light of the guidance offered Korea by the Board only a few months earlier.

Mr. Lim observed that the real effective exchange rate of the Korean won had appreciated by 6.5 percent between April and August 1987. From August through October, the nominal exchange rate had appreciated against the U.S. dollar by 0.8 percent. As of November 10, it had appreciated 1.05 percent against the U.S. dollar. However, as the Korean exchange rate was based upon a basket reflecting trade weights of Korea's major trading partners, the nominal effective exchange rate had been depreciated somewhat more than 1 percent in the period, although that depreciation had taken place against the background of a substantial one-time wage increase of some 25 percent during the recent nationwide labor dispute, which was an important factor in the external competitiveness of the Korean economy.

Mr. de Groote remarked that the exchange between Mr. Dallara and Mr. Lim gave the misleading impression that the manipulation of the exchange rate could solve matters. In fact, what was under discussion was basic imbalances as reflected in exchange rates. Some people seemed to feel that if one temporary measure or another could be taken to restore confidence in the markets, matters would improve. That was not the point. The markets had recognized the existence of excessive absorption in the United States. The discrepancy between the very low yields on the stock market and high interest rates on bonds was an expression of the fact that there was a climate of confidence and expansion in the United States stimulated by the budget deficit, a deficit which was financed by external resources. In the circumstances, when the discrepancy was corrected by an adjustment in the stock exchange, the market was doing nothing more than reflecting the basic imbalance in the absorption of the economy. In that respect, it was illusory and dangerous to believe that very short-term measures directed at patching up confidence and creating an atmosphere of euphoria for a brief period could resolve the underlying problems.

In fact, Mr. de Groote continued, it was perhaps not appropriate to look at the problem from a purely market perspective. It was preferable to take a basic macroeconomic point of view and draw from it the conclusion that one should not be overoptimistic if no measures were announced that clearly extended their effects over several years. Countries must continue to adjust; and if adjustment did not take place in time, the postponement would lead to the need for adoption of more difficult and costly measures.

On the matter of policy cooperation and coordination, Mr. de Groote said that he remained convinced that agreements like the Louvre Accord could not serve to identify even minor tensions on the exchange market so long as the public did not know the structure of the exchange rates being defended. In one of his statements at the time of the 1987 Annual Meetings, the Chancellor of the Exchequer had suggested that it might be wise in future to announce the exchange rate relationships that would be defended in order to prevent speculation and the superimposition on the market of relationships that were not desired by the partners in the agreement. That view was close to the one put forward by Mr. Sengupta, namely, that consideration should be given to the need for establishing and announcing some exchange rate zones or targets. In that connection, he tended to agree with those who felt that the Fund was perhaps a better forum for the establishment of such targets than was the directorate of the Group of Seven. After all, the directorate was based on informal understandings that were quite vulnerable, because people were uncertain whether countries would defend particular exchange rate relationships through the adoption of appropriate underlying policies. If exchange rate zones or targets were announced through the Fund, there was more chance that appropriate policies supporting those targets would follow.

The Economic Counsellor noted that many Directors had focused on the issue of confidence. In some respects, confidence was a form of capital that took a heavy investment of time and resources to build but which could quite quickly depreciate. The problem was how to build and then maintain confidence. One of the difficulties in forecasting the implications of recent developments was that making an assessment as to the extent and permanence of the shock was intrinsically difficult. The same held true as to the influence of confidence factors on investment and savings decisions. Some capital flight had been witnessed, and the shock might have implications for the access to capital markets by developing countries; those were risks that hinged seriously on the issue of confidence.

It was noteworthy that there remained a distinction between confidence in the economic and financial system and uncertainties about economic behavior, the Economic Counsellor continued. Especially in respect to the response on the monetary policy front, measures had been taken aimed at restoring and maintaining confidence in the system at large; yet, there remained a number of uncertainties about how the system would cope with the various dangers.

Various challenges remained, the Economic Counsellor remarked, and concerned the type and timing of policy measures as well as the question of who should undertake them. On the matter of timing, both long-term and short-term issues arose, especially in the context of monetary policy. For example, in the short term, efforts might be made to provide liquidity to ensure confidence in the financial system; however, the challenge in the long run was to make certain that the financial consequences of those measures did not create problems. On the relationship of timing to the type of instruments chosen, it was clear that reliance should not be placed on monetary policy alone and that fiscal policy measures were necessary. Of course, the intrinsic problem with fiscal policy was the time involved in making it effective. The decision-making process itself was slow, as was implementation; even the effects of fiscal policy, once implemented, were not immediately evident. The time involved might well divert attention away from fiscal policy and toward the use of other instruments. However, as he saw it, the more time necessary to make a policy effective, the greater the urgency to begin the process quickly.

The recent events in the exchange and financial markets had introduced a new reality that must be dealt with, the Economic Counsellor considered. Only one month earlier, no one would have believed that the market would fall 500 points; yet it had, and the lesson had been learned that such volatilities in financial markets were part of the new reality. The implication was that the world must also change its perception of what sort of policy stance was needed, because what might have been viewed as appropriate only one month previously could no longer be characterized as such. Finally, despite the emphasis some had placed on the positive elements of the crash, it must be clear to all that the crash had not been good news, except perhaps in the sense that the events demanded a greater awareness of the need for timely fiscal correction.

The Chairman made the following concluding remarks:

> The high quality of our discussion today is a clear demonstration of the fact that the Executive Board of the International Monetary Fund is a good forum for what might be called cooperative surveillance of world economic developments.
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> It is clear that the events of the past month have heightened the sense of urgency expressed in the Interim Committee communiqué regarding the need to address the imbalances of the world economy. The fall in confidence has led to sharp falls in equity markets with some clear risk of wealth effects. We are in a situation in which it is obvious that markets perceive a need for firm policy action. The recent developments in those markets were an unexpected and undesirable, but real, ratification of the conclusions of our discussions on the most recent world economic outlook.
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> Monetary authorities have rightly provided liquidity to avoid the aggravation of disturbances in the financial markets, and the decline of interest rates that has occurred could help to stabilize demand. However, a level of interest rates consistent with sustained growth requires support from other policies, notably fiscal policy, since at some stage the monetary authorities will need to reabsorb the liquidity that has been made available recently. In this connection, there is no dispute that the United States needs to act to deal effectively with its fiscal deficit, provided decisive and multiyear action is taken toward this end. A case can also be made for some further actions to ensure adequate growth in both Europe and Japan.

Fiscal and structural adjustment measures in the major countries, together with the exchange rate movements that have already occurred and supporting actions on the part of the smaller European countries and the newly industrialized economies will go a considerable way toward dealing with the financial imbalances that continue to cause uncertainties. All these actions must be mutually reinforcing, and adjustment must be universal.

Clearly, the imbalances will not be eliminated overnight. In the short run, it is certainly possible that there will be further volatility in financial markets and possibly some downturn in world activity. In this connection, I would emphasize two points raised by several Directors. The first is the need to maintain the credibility of medium-term policy objectives and to focus on removing imbalances. The second is to pay special attention to the possible adverse consequences for developing countries. In this repsect, it is very important that the "standstill" and "rollback" provision agreed at Punta del Este be implemented as intended and that the mechanisms of international cooperation that are available to help countries facing difficulties caused by circumstances beyond their control be used in a constructive fashion.

Let me add in conclusion that I have been especially impressed by the unanimous support you have given to the importance of cooperative coordination, and I have been encouraged by your suggestion to take all appropriate steps to strengthen as much as possible the effectiveness of the role of the Fund in this respect.

The Chairman said that before turning to the next item, he wished to inform Directors of his intention to travel over the weekend to a number of countries in Europe.

The Executive Board took note of the Chairman's travel plans. 1/

1/ Formal approval of Managing Director's travel plans recorded in EBM/87/156 (11/17/87).

2. STRUCTURAL ADJUSTMENT FACILITY - ENHANCEMENT OF RESOURCES - PROPOSED FINANCIAL ARRANGEMENTS

The Executive Directors considered a staff paper on proposed financial arrangements for the enhancement of the structural adjustment facility (EBS/87/228, 10/29/87; and Sup. 1, 11/11/87).

Mr. Enoch made the following statement:

We have all come to recognize the special problems of low-income countries and the need to offer exceptional assistance in support of their adjustment efforts. The Managing Director's timely initiative for a significant enhancement of the structural adjustment facility is a welcome attempt to enable the Fund to maintain, and indeed to strengthen, its vital sponsorship of orderly adjustment in the economies of members in exceptional difficulties by mobilizing resources on terms appropriate to their special circumstances. My authorities have warmly welcomed this proposal and have also worked to complement it with their own proposals for lightening the burden of official bilateral debt service.

We are therefore pleased to respond to calls for support for an enhancement of the facility by agreeing to contribute--in conjunction with appropriate contributions from other major creditors and in support of assistance focused on highly indebted, low-income countries, especially in sub-Saharan Africa--to the Subsidy Account to be established in support of the Trust. My authorities envisage a significant contribution over the life of the enhanced facility which, on the basis of preliminary simulations, might amount to a $30 million subsidy on interest charges in the peak year of the facility's operation.

The United Kingdom might also consider a nonbudgetary contribution to the capital of an enhanced facility. However, for a commitment to be possible, the Trust must be completely secure, very liquid, and must offer remuneration at a market rate so that our claims on the Trust, whether funded in sterling or from our foreign exchange reserves, could qualify as reserve assets and avoid public expenditure implications. A capital contribution to a Trust will also require legislation. It is no small task to introduce a new bill but, if other conditions can be satisfied, my authorities are prepared to consider the necessary legislative steps. The legal criteria which must be applied in judging the quality of claims cannot, however, be modified.

While the staff paper represents welcome progress toward the necessary security and liquidity conditions we are seeking, there is still some way to go before a commitment is possible. My authorities retain doubts about the present proposals on the security of claims on the Trust. The proposed Reserve could provide an important guarantee against credit risk, but some additional assurance seems necessary. In this context, we are seeking a definite commitment by the Fund with regard to the residual risk of nonpayment of the Trust's obligations. We recognize the difficulties associated with giving such an assurance, but even if these prove insuperable, the Fund should pledge as a contingent guarantee the small share of its gold that would be necessary to cover any residual risk.

We continue to have serious doubts regarding the liquidity of claims on the Trust. The right of a creditor to encash its claims must be assured. Claims should have liquidity equivalent to that of reserve tranche positions. I strongly urge the staff to continue their examination of possible ways to assure adequate liquidity. Perhaps extending the Reserve in order to meet these concerns could be considered.

More generally, most of the other terms and conditions proposed by the staff seem acceptable to us in principle. We do have definite constraints on the rate of return, and also on the maximum maturity for which we can lend, but the standard SDR interest rate, as suggested in the paper, meets these constraints. A maximum maturity on loans to the Trust of ten years is, other things being equal, possible, but that is the maximum. Moreover, doubts remain about the wisdom of the proposal that the Fund might borrow as Trustee to cover residual credit risks, particularly as that might involve the refinancing of unsound claims against no security. Nevertheless, we strongly support the enhanced facility, we think we are quite a way along where we need to go, and we hope that the remaining issues can be resolved.

Mrs. Ploix remarked that she agreed with the staff proposals on the principal financial conditions of loans by the Trust, except for the proposal that "payments by borrowers of their obligations to the Trust be made in U.S. dollars." Although payments in SDRs entailed some legal difficulties, payments in U.S. dollars entailed some risk as well. She wondered whether there was some mechanism by which the Trust could receive payments in SDRs.

With respect to the security of claims on the Trust, she welcomed the proposal to transfer all resources of the Special Disbursement Account to a Reserve in the Trust, Mrs. Ploix continued. However, part of that Reserve could be subject to a risk of nonpayment. In that regard, she wondered how the Fund could make a pledge with respect to the residual risk knowing that the "use of gold might well not be the preferred course of action."

On liquidity, three points needed clarification, Mrs. Ploix commented. First, with respect to voluntary transfers of claims among "electing lenders," would a mutual agreement be reached at the time of the loan or when a liquidity difficulty arose? Second, on the possible use of Fund resources, the staff paper indicated that liquidity developments in a member's reserves corresponded to an "unfavorable balance of payments position," whereas the usual terminology was "balance of payments difficulties." What did that distinction mean in terms of conditionality? According to the staff, "utilization of the Fund's general resources under this provision would be subject to the Fund's then applicable policies regarding use of its resources, access, charges and repurchase." That statement was somewhat confusing. Was there anything new in the provision proposed by the staff? Finally, the proposal on the commitment date was unclear, and she would appreciate further comment on that point. She agreed with the proposal on the pattern of drawdowns on the commitments of individual lenders of one third before the end of 1989, and two thirds before the end of 1990.

With respect to the Subsidy Account, her authorities would assure the desired concessionality of their loan, which would be made in annual installments, Mrs. Ploix remarked. The staff paper indicated that provision would need to be made for variation of the rate; when would that decision be taken, and what majority would be needed?

As to the proposal to raise the rate of interest on overdue payments to the Trust to the SDR interest rate, her authorities had not yet taken a firm position, but they saw some value in the staff's proposal, Mrs. Ploix commented. However, they disagreed with the proposal to raise the rate of interest on overdue obligations to the Special Disbursement Account to the SDR rate; there was no reason to change the procedure that had been settled for that Account.

Mr. Grosche remarked that he was generally satisfied with the proposed financial arrangements. He supported in particular the separation of the new Trust from the Fund's general resources. That separation was of great importance for reasons well explained in previous staff papers.

The Trust had to be sufficiently creditworthy to mobilize lending from credit agencies, Mr. Grosche emphasized. The staff had proposed a number of security and liquidity provisions, which he could broadly endorse. At the same time, loans by the Trust would have to be secured by appropriate policies in recipient countries. He therefore placed considerable emphasis on monitoring procedures. Moreover, his authorities attached much importance to the security of claims because they envisaged a contribution to the Trust in the form of loans at market rates, probably to be extended by a credit institution owned by the Federal Republic but independently run. To avoid back-up guarantees by the Federal Republic, the Trust should be able to raise funds without further assistance in the form of guarantees. Therefore, the proposed language with respect to the Fund's pledge relating to the residual risk was appropriate, and the minimum that was needed. In a parallel step, his authorities were willing to contribute to the Subsidy Account a fixed amount from the Federal Budget. The actual amounts would be announced shortly.

While his authorities were prepared to contribute to the enhancement of the facility before commitments to participate were received from all of the major Fund shareholders, they had not forgotten about fair burden sharing, Mr. Grosche commented. It was expected that all industrial countries would contribute their share to the enhancement, particularly, with respect to the Subsidy Account.

Mr. Prader made the following statement:

> My Austrian authorities have concluded that the assets to be set aside for the facility do not meet the criteria of monetary reserves. This assessment applies above all to the inadequate liquidity and security of claims on the proposed Trust. In any case, they are in no position to decide on the financial sources of their contribution so long as there is no final agreement within the Fund on the facility's modalities and so long as financing has not been finalized on a multilateral basis.
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> In contrast, my Belgian authorities have decided that Belgium cannot make a budgetary contribution to the enlargement of the facility, whether for funding its capital or for subsidizing the interest payments on its loans. The reasons for this position have been thoroughly explained during previous discussions on the enhancement. Belgium can thus only consider making a monetary contribution at concessional interest rates. But since concessional lending to the Fund's General Resources Account has been ruled out, a monetary contribution to the enlarged facility essentially depends on the acceptability of the security and liquidity provided for claims on the proposed Trust.
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> The Belgian and Austrian authorities have carefully examined the staff's proposals in response to the security and liquidity concerns of potential participants. They have concluded not only that these proposals present no new elements and do not basically differ from ideas submitted earlier, but also that the proposals still fall short of the standards that their central banks normally set on monetary assets. It is recognized that the staff has explored all of the legal and practical possibilities which exist within the framework of the proposed Trust for accommodating the concerns of monetary authorities. The real problem arises from the Trust proposal itself, which is basically irreconcilable with the high quality that claims on the Fund are supposed to present to its members. The liquidity of claims under this proposal is even less satisfactory than their security.

However, my authorities have tentatively concluded that they could eventually live with the less than perfect security safeguards proposed by the staff, if something is done about residual risk. Even though the proposed Reserve would not cover the Trust's obligations up to the full amount of expected contributions, the staff's simulations convincingly show that the risk of the Trust's defaulting can be considered to be residual. A default could occur only if payments problems on the part of the group of borrowers should attain a systemic dimension. It is precisely in response to this systemic risk that the Fund should formally acknowledge, from the outset, its willingness and its responsibility to take all the initiatives necessary to ensure full payment to lenders. The need for the Fund to take action in the event of such a crisis would go far beyond the mere financial interests of lenders to the enhanced facility. More important, it would reflect the Fund's responsibility for safeguarding the international payments system against the severe strains that are sure to follow the generalized default of a large number of borrowers under the facility.

My authorities consider that use of the Fund's gold would be not only the most logical, but in fact the only effective, measure to take in the event of any such severe systemic crisis. Therefore, an explicit reference to the possibility of using gold in the event of systemic hardship would give important substance to the Fund's pledge. Some of the other possibilities suggested, such as borrowing by the Fund as Trustee or the provision of the Fund's general resources to a borrower under the facility, not only seem unlikely to gain acceptance but would produce undesirable consequences.

Unlike the security safeguards, the liquidity provisions are still largely unsatisfactory, especially when compared with earlier special Fund facilities in which Belgium and Austria have been asked to participate. All of the various liquidity schemes presented by the staff have major drawbacks. The voluntary transfer of claims is a weak reed on which to base the expectation that a claim can be mobilized if a liquidity need should occur. The same is true of the proposed setting up of mutual mobilization arrangements among electing lenders. Although such a scheme is attractive in theory and has even proved effective in the case of the General Arrangements to Borrow, it would be difficult to reconcile with the great diversity of forms which lenders' contributions to the Trust are expected to take. It is doubtful that such a scheme will, in fact, materialize, since it is not clear how many participants making monetary contributions to the enhanced facility would be interested in a mobilization facility.

Still another possibility--using part of the Reserve to meet requests for the encashment of claims--is disparaged by the staff itself. The Reserve would not begin to build up substantial amounts of resources until the mid-1990s, by which time its usefulness as a possible source of liquidity would be limited by the Trust's increasing repayment obligations. Still, in view of the small number of participants likely to be essentially concerned about liquidity, it would be premature to rule out the possibility that claims could be temporarily encashed from the Reserve from the outset, without impairing its principal function of protecting the solvency of claims. A similar possibility of easing liquidity problems, whereby the Reserve could play a bridging role for members that are lending on a rollover basis and that are forced temporarily to suspend the renewal of their loans, is also suggested.

In any case, satisfactory liquidity arrangements can only be established by means of the flexible involvement of the Fund's own resources. My authorities have examined with interest the possibility of access to the Fund's general resources in the event of a liquidity need as proposed by the staff under Article V, Section 3(b). They find that the conditions for activating this scheme, especially the proviso that a member must first have used up its available reserve tranche position, are cumbersome and seriously impair the liquidity of claims which monetary participants have a right to expect.

Accordingly, my Belgian authorities are keeping their decision under advisement, the more so since the partial information that they have received concerning contributions from other donors does not allow them to evaluate the burden sharing which will result with respect to financing the enlargement. They hope that each of these impending issues will receive further clarification in the coming days, so that they will be able to submit, if possible by the first weeks of 1988, a decision for the approval of the new Government, which is soon to be elected.

Finally, my authorities agree with the staff that special charges on overdue obligations to the existing facility, the 1976 Trust Fund, and the proposed Trust should all be based on the SDR interest rate.

Mr. Yamazaki remarked that his authorities would contribute to the enlargement of the structural adjustment facility, but they had not yet reached a decision regarding the size of their pledge. In that connection, they regarded the quota share as an appropriate premise for determining the size of the grant contribution. His authorities also had broadly endorsed the proposed Trust arrangement, although it still posed some technical difficulties.

On the proposed financial arrangements, he would, first, urge the staff to allow flexibility in arrangements to accommodate various contributions, Mr. Yamazaki continued. In particular, the denomination of payments to the Trust should not be limited to SDRs. Second, more market-oriented instruments should be used as the basis for calculating the interest on loans to the Trust so that the fund-raising costs would be covered. Third, he wondered whether contributions could be comprised of loans at both ten-year fixed interest rates and floating interest rates.

A flexible approach to arrangements was needed to facilitate the effective and timely initiation of the enhanced facility's operations, Mr. Yamazaki emphasized. At the same time, some countries might wish to contribute to the enlarged facility at a later time, and it therefore seemed appropriate not to presume at the outset the specific size of the enlargement, but rather its feasible size. If the amount secured determined the size of the enhanced facility, his suggestion on previous occasions regarding the sale of gold might prove to be unnecessary. In any event, he urged the staff to explore the possibility of the sale of gold as a remedial action against the residual risk of nonpayment of the obligations of the Trust.

The Chairman, commenting on the possibility of making contributions after the deadline of December 31, 1987, remarked that every contribution received in addition to the proposed amount--namely, an enhancement of the structural adjustment facility of at least SDR 6 billion--would indeed be welcome, the sooner the better.

Mr. Sengupta made the following statement:

> We are impressed by the progress made in formulating mechanisms to provide increased assistance to countries eligible to use the structural adjustment facility, and we hope that the enhanced facility would indeed be operational by the beginning of 1988.
>
> The main purpose of the enhancement is to supplement the resources of the existing facility. In that context, the existing facility's operations, particularly with respect to access and conditionality, should not be tightened. The staff, however, has suggested that overdue obligations to the Trust should not be subsidized, but rather that overdue obligations to the existing facility and to the 1976 Trust Fund should also be subject to the SDR interest rate. Some explanation justifying the withdrawal of these particular subsidies would be appreciated.
>
> The creation of the Reserve and its size is an important area of concern. Creditors' expectation that security against their claims should be provided, should be met by the proposals for establishing the Reserve. However, the Reserve is to be funded by sources--including the resources of the Special Disbursement Account--that affect the flow of resources into that

Account. Because the Special Disbursement Account is basically intended to help developing countries, particularly low-income developing countries which require concessional assistance, any diversion or transfer of its resources to another account should be examined carefully. In particular, the estimated cost of the transfer of the Account's resources to finance the Reserve to be established in the Trust should be considered.

The staff paper mentions that the proposed transfers to the Reserve are in accordance with Article V, Section 12(f)(ii), which relates to the disposal of the assets of the Special Disbursement Account. I understand that the Account's assets are to be used for the benefit of the developing members, except when they are transferred to the General Resources Account for immediate use. More specifically, the Commentary on the Second Amendment indicates that the operative words in Article V, Section 12(f)(ii) concerning the use of the Account's assets are "for the benefit of members in need, and on a uniform basis." If members are developing countries, particularly low-income developing countries, the Account's assets could be used for balance of payments assistance and on concessionary terms. I am not sure whether the transfer of these assets to a Reserve corresponds to the provision of balance of payments assistance to countries in need on concessional terms. The purposes of the Reserve, as far as I can see, are to provide security to creditors of the Trust, and to help the Trust make repayment to its creditors in the event of the failure of borrowers to repay their obligations to the Trust. Perhaps this point of interpretation is worth referring to the Committee on Interpretations.

In any event, it should be made clear that transfers from the Special Disbursement Account to the Reserve are temporary and that retransfers from the Reserve should be made automatically whenever balances in the Reserve exceed repayment obligations to the Trust. The staff postulates that balances held in the Reserve would exceed the remaining obligations of the Trust around early 1998 and suggests that at that stage, resources could be retransferred to the Special Disbursement Account, but also that some part of the Reserve could be used for the payment of interest subsidies on outstanding obligations of borrowers under the enhanced facility. I am opposed to this suggestion; instead, a decision should be taken to retransfer those resources to the Special Disbursement Account.

The financing for the Subsidy Account should complement loans to the Trust so as to ensure that lending under the enhanced facility is low cost and quick disbursing. The purpose of the enhancement would be defeated if donors provided money at market rates of interest, without providing grants to cover the difference between the market rate and the interest rate on loans under the facility. Indeed, subsidization is an essential feature of the facility and should be a condition for accepting contributions from donors.

The staff paper does not mention the provision under the existing facility whereby repayment can be rescheduled if the Fund finds that repayment on the due date would result in serious hardship to the concerned member, and if such rescheduling does not impair the ability of the Special Disbursement Account to meet the liabilities of the facility. We do not condone overdue obligations; this specific provision was, however, deliberately incorporated when the existing facility was created, and we hope that a similar clause would be incorporated in the decisions establishing the enhanced facility.

On liquidity, commitments to the enhanced facility should be irrevocable. In the unlikely event that a country suddenly faces a liquidity problem, the preferred course would be to make use of Fund resources under the relevant provisions of the Articles, with all the conditionalities attached to such arrangements. Moreover, in an earlier staff paper the creation of a mobilization facility had been suggested, whereby the Fund would stand ready to provide access to its general resources beyond any available reserve tranche position. That proposal, which has been dropped in the present paper, should be examined more carefully.

Mr. Mawakani made the following statement:

I welcome this opportunity to clarify most of the difficulties remaining with respect to the financial arrangements and the operations of the enhanced facility so that we can progress toward meeting our January 1988 deadline for its implementation.

On the financial conditions of loans by the Trust, the staff indicates that provisions would need to be made for variations of the interest rate on loans under certain circumstances. Such a practice would not only create uncertainties and add to the complexity of the facility's operations, it would also make it difficult to ensure the uniformity of treatment of eligible countries.

With respect to the borrowing operations of the Trust, a number of provisions are proposed, including the use of the Fund's general resources under Article V, Section 3(b)(ii) and the use of the Trust's Reserve, to ensure the liquidity of claims on the Trust. The staff states that the adequacy of safeguards for the temporary use of the resources of the General Resources Account would be judged on a case-by-case basis and that under certain circumstances the claims on the Trust could be taken into account as a safeguard. At present, the Fund requires the adoption of an adjustment program as an adequate safeguard for the temporary use of the resources of the General Account. Can the existence of a claim on the Trust be equated with the adoption of an adjustment program? As I understand it, Article V, Section 3(a) provides the Fund with some flexibility, as it "may adopt special policies for special balance of payments problems...." Is there a need to define such special policies for lenders to the Trust who experience special balance of payments problems?

The use of the Reserve for the encashment of claims on the Trust would erode the Reserve's ability to cover the risk of nonpayment of the Trust's obligations. Even when the Reserve exceeds the Trust's obligations, I am of the view that excess balances should be retransferred to the Special Disbursement Account for use in line with the provisions of Article V, Section 12(f)(iii). Accordingly, I do not support the staff proposal on the use of the Reserve for the encashment of claims on the Trust.

Concerning the commitment periods for loans to the Trust, the limitations on drawings on lenders' commitments, the procedures for calls on loans to the Trust, and the maturity of loans to the Trust, I have no difficulty with the staff's proposals. Nevertheless, I would appreciate staff comment on the rationale for incorporating protected provisions in the Trust Instrument that would not be subject to amendments by the Board.

On Subsidy Account operations, assuming that potential contributors extend loans to the Trust on terms similar to those applying to purchases under the existing facility or provide a subsidy directly to the agency extending the loan, there will be no need for a Subsidy Account. In the event an Account is needed, it will have to be provided with sufficient resources to ensure that all borrowers receive an effective interest rate of 0.5 percent on Trust loans.

Finally, since bilateral lending is likely to be a feature of the enlargement process, I would appreciate more information on the practical modalities of such an arrangement. In particular, how would parallel bilateral lending affect the timing of disbursements and the level of access of a country receiving such a loan?

Mr. Dallara made the following statement:

We welcome this discussion. We support the Managing Director's initiative, although my authorities regrettably are not in a position to make a financial commitment to the enhanced facility. In spite of this, substantial progress has been made, and we admire the energy and skill with which management and staff have proceeded. Furthermore, we appreciate the willingness of others to move ahead without the United States, and I will report faithfully to my authorities the concerns that others have expressed about our decision not to contribute.

I would also like to express our appreciation for the efforts of the staff to design an instrument that will encourage contributions and still remain consistent with the original purposes of the structural adjustment facility and preserve the monetary character of the Fund. We particularly welcome the decision to proceed on the basis of a trust fund rather than direct lending from the General Resources Account.

Regarding the conditions of loans from the Trust to eligible countries, we strongly support the objective of matching the conditions of loans from the Trust with those of structural adjustment facility loans to the maximum extent possible. Moreover, we agree generally with the staff proposals on commitments, maturities, interest, denomination, and media. In particular, we support the proposal that overdue payments to the Trust should not be subsidized.

On the issue of the security offered to contributors, we understand its importance and can support establishing a Reserve of SDR 4.8 billion. We regret the necessity of committing to the Reserve the repayments of principal on structural adjustment facility loans because they are such a substantial amount. But we are willing to accept it in the circumstances, in view of the need to provide security. We look forward to the early release of these funds for other purposes, and hope that the decision to etablish the Reserve will include a specific and uncomplicated mechanism for releasing funds that are no longer needed.

On a related matter, we are not convinced that these funds should be used to subsidize interest payments on loans from the Trust, but would be willing to consider that approach further since it would be a way for all Fund members to contribute indirectly to the Subsidy Account.

Regarding other initiatives that could be taken to assure full repayment to contributors, we appreciate the desire of a number of contributors that the Fund should make a further commitment with respect to the residual risk. My authorities are not entirely comfortable with the position suggested by the staff, and I am concerned by the thrust of the comments on this point by Mr. Enoch, Mr. Prader, and others. It is not clear to me how far the Fund could or should go in providing comfort, and we wish to reflect further on the wording of such an assurance. We also share the view of management that the use of gold might not be a preferable course of action. Also, we have doubts about the appropriateness of possible lending by the General Resources Account to a borrower under the facility.

On liquidity, we have no problems with the various proposals made by the staff. In particular, the staff takes a position against the use of the Reserve to encash claims, and we agree with this position.

Regarding commitment periods, we have no special views, and support the staff's proposals. Our position is the same regarding limits on, and procedures for, calls on contributors. We support the flexible approach proposed by the staff with the objective of maintaining broad proportionality over time in calls on contributors.

Regarding the maturity of loans to the Trust, we agree with the staff that contributions in the form of renewable obligations should provide little basis for a contributor to deny renewal.

On interest on loans to the Trust, we place considerable importance on adopting arrangements that reduce as much as possible uncertainties regarding the amount of subsidies required to maintain the rate of 0.5 percent per annum. While the staff notes that rates are not currently available for all of the SDR basket currencies for average maturities in the ten-year range, we hope the staff would undertake some further work on this question.

We have no objection to denominating loans to the Trust in SDRs and using dollars as the medium of repayment.

Finally, regarding the Subsidy Account, we would like to stress the extent to which operational problems are minimized when contributions are made in the form of loans at 0.5 percent rate of interest, and steps should be taken to ensure that the effective rate for borrowing is 0.5 percent. Regarding the possibility that the Subsidy Account should have the authority to borrow funds, we are not comfortable with this idea and believe it should be given further thought.

Mr. Abdallah made the following statement:

Let me begin by addressing a personal appeal to Mr. Dallara and, through him, to the U.S. authorities. While there is no doubt that the enhanced structural adjustment facility is intended to assist the low-income countries of all continents, the general attitude in Africa, in view of the critical situation there, is that the facility is primarily intended for it. The spokesman for Africa, the Chairman of the Organization of African Unity, is currently from my constituency. He met last month with the

Managing Director and with the President of the United States. In both meetings he made a strong appeal for substantial increases of aid to Africa.

It is inconceivable in Africa that an effort of this magnitude could be made and that the United States, while supporting it in principle, can make no commitment of resources. When in 1984-85 the situation in Africa was considered sufficiently serious that the Special Facility for sub-Saharan Africa was established under the aegis of the World Bank, based on voluntary contributions, the United States also supported the idea in principle but could make no commitment. It is important that the U.S. authorities take note of the strong feeling that when Africa is facing its most critical moment, when massive assistance is urgently needed, the United States appears to be unconcerned.

I would like to commend management and staff for making imaginative changes to their original proposals in order to accommodate the various requirements of creditors. We hope the revised modalities will prove broadly acceptable so that necessary resources are made available to make the enhanced facility fully operational by January 1, 1988.

Although establishment of a Reserve in the Trust is rightly intended to give creditors an additional sense of security, the main protection, as emphasized by the staff, will be the quality and strength of the adjustment programs to be supported by these resources, together with the Fund standing ready as a Trustee to consider fully and in good faith, if it appeared that any delay in payment by the Trust would be protracted, all such initiatives as may be necessary to assure full payments to lenders.

I have no hesitation in endorsing the proposals for funding the Reserve. My authorities' only concern about the funds flowing into the Reserve is that they should continue to be made available in the long term. I have noted that the proposed Reserve will begin to exceed the remaining Trust obligations by 1998 and eventually reach SDR 4.8 billion by the year 2002. My authorities would prefer a disposition mechanism through which most, if not all, of this Reserve could be transferred back to the Special Disbursement Account so as to provide revolving resources for future use on comparable terms. We suggest that other possible sources to finance the Subsidy Account be considered rather than resorting to the Reserve as from 1998, which is the possibility suggested by the staff.

As to the Subsidy Account itself, I fully agree that considerable uncertainty will remain as to the funds that will be required to subsidize and ensure an effective interest rate of 0.5 percent per annum. I therefore support the proposal that the Subsidy Account be authorized to borrow. In any case, the frequent Board reviews of this issue during the period of the enhanced facility should provide the opportunity to decide what action to take in the light of developments, including the possibility of seeking further contributions. I would appreciate a clarification of one aspect of financing the Subsidy Account. One source of funding mentioned on page 21 of EBS/87/228 is interest charged to borrowers under the structural adjustment facility, and on page 4 reference is made to all receipts of interest on loans under that facility as a source of funding. We hope that this source of Subsidy Account funding does not involve a surcharge on borrowers, which would have the effect of raising the effective interest rate on loans under the enhanced facility by 40 percent.

I can go along with the proposal to simplify the treatment of charges on overdue obligations to the Trust so that these obligations carry the SDR interest rate. So far as obligations to the existing structural adjustment facility and the 1976 Trust Fund are concerned, the present charges should continue to apply since there has been no change in the cost of the funds that financed those obligations in the first place.

Mr. Dallara, responding to Mr. Abdallah's appeal, remarked that if the inability of the United States to participate in the enhancement at the present time was seen as a total lack of concern, that was a fundamental misperception. Everyone was aware of the severe fiscal imbalances facing the U.S. economy. Nevertheless, his authorities recognized the extremely difficult circumstances in Africa and that the U.S. fiscal imbalance did not in any way reduce their responsibility to find a way to play a constructive role in supporting Africa's efforts to address its critical situation. At the same time, his authorities were engaged in an effort to secure appropriations for a substantial participation in the next funding of the International Development Association, and he understood that a substantial portion of those funds would be directed to Africa. The efforts that were under way within the Administration to protect aid programs in Africa also reflected their concern. Finally, it should be noted that the U.S. position had been formulated carefully in an effort not to close doors.

Mr. Ovi made the following statement:

Four of the five countries in my constituency have been asked to contribute to the enlargement of the structural adjustment facility. I am glad to report that all four have responded favorably. Also, although amounts have not been specified so far, indications are that they might come close to the range suggested by the staff. The capital contribution will have to come from exchange reserves of the central banks. However, Sweden's central bank will not be able to participate because legislation prevents such lending. In all four countries, grants will come from--in most countries, rapidly increasing--development assistance resources.

Nevertheless, these countries are some distance from actual commitments of precise amounts, at a time when the deadline for commitments is rapidly approaching. In this regard, they continue to place strong emphasis, first, on widespread participation by other industrial countries. Second, a fair burden sharing is also vital. Third, two of the central banks are not satisfied with the security and liquidity provisions outlined by the staff. We do recognize that the staff has further developed its proposals. A number of operational features have been outlined and, broadly speaking, these proposals do not give rise to any major problems. However, with respect to the more basic elements of security and liquidity little change has taken place.

More specifically, it is stated that "in recognition of the residual risk, the Fund could commit itself...to consider fully and in good faith all such initiatives as might be necessary to assure full payment to lenders." What is the precise meaning of this statement; and what kind of commitment would such a declaration entail? Moreover, this pledge seems to be put forward as a possibility only. In the view of the central banks I represent, it is not only more information that is needed; it is also essential that a sufficient commitment actually be given by the Fund regarding the security of claims. Indeed, it may be necessary to be more specific regarding the various ways such an informal guarantee could manifest itself in practice.

Why do we place such emphasis on security? First, central banks generally have little scope for lending without full security. Second, in my countries burden sharing is not only a concept applying to the number of countries participating, but it has an important domestic dimension as well. Aid authorities in general have few problems in spending their resources, even without contributions to an enlarged facility. To them, contributions to the enhanced facility can to some extent even be seen as a diversion of funds. Accordingly, they place considerable emphasis on the participation of Fund members' central banks. Without such participation, there is a clear risk that the corresponding grant element might not be forthcoming. Therefore, I strongly encourage the staff to accommodate central banks' concerns regarding further security. Finally, it is important that a number of other countries, and not only the smaller ones, should be able to contribute exchange reserves. As in the case of, for instance, bridging operations in favor of countries with acute liquidity problems, it is an argument in itself that a number of other central banks should feel able to participate.

The participation of a number of central banks in the enlarged facility is also most vital for achieving the liquidity needed to make swap arrangements possible. The staff has outlined a number of other suggestions on liquidity. In this regard, my countries would not like to see the Reserve used to meet requests for the encashment of claims. Moreover, as regards the provision of liquidity through the use of Fund resources, I would appreciate confirmation that the conditionality associated with such a transaction would be the same as that applied to ordinary reserve tranche drawings. I should add that at least one of my central banks would like to see a more direct liquidity guarantee from the Fund, and, more specifically, a formal guarantee. None of the central banks expect to request the mobilization of their claims.

In earlier staff papers, it was expected that the interest rate risk would be borne by the lender. Although it is not explicitly stated in EBS/87/228, the staff seems to have given up this expectation. I should like a confirmation of this point. The staff suggests instead periodic reviews, thus leaving open the exact response to potential shortfalls. I should like to support this suggestion while underlining that it is vital to my countries that we stick as closely as possible to the original terms of an interest rate of 0.5 percent.

On the Subsidy Account, we can accept the idea of giving the Account authority to borrow, but from official sources only.

In sum, if we are to stick as closely as possible to the original schedule for the enlargement of the structural adjustment facility, which we consider to be of the utmost importance, the staff must now seriously consider proposals by the Board to improve the security and liquidity of claims on the Trust. Only a reasonable meeting of the demands of potential contributors can make the enlargement feasible.

Mr. Donoso made the following statement:

My authorities have analyzed carefully the proposed financial arrangements for the enhancement of the structural adjustment facility and find them generally satisfactory. They see no problems with respect to the proposals to strengthen the security of claims on the Trust. They consider that the proposed Reserve as well as the commitment of the Fund "to consider fully and in good faith all such initiatives as might be necessary to assure full payment to lenders" constitute sufficient assurances. They agree with the staff that the use of the Fund's gold could be unnecessary, especially if the residual obligations of the Trust are small. However, they consider that not ruling out gold sales adds strength to the Fund's commitment to consider all possible ways to assure the payment of the Trust's obligations and that this commitment is very important.

It is also important that contributions to the enhancement of the facility maintain their quality as international reserves. Moreover, for countries undertaking adjustment in the framework of a Fund-supported program, it is important that the claims on the Trust can be counted as international reserves. The staff considers that the mechanisms contemplated to provide liquidity to claims on the Trust are sufficient to assure the encashment of claims in case liquidity needs emerge. If this is so, then probably there is no difficulty with treating claims on the Trust as international reserves.

If this is not the case, perhaps additional ways could be found to assure that requests for the encashment of claims can always be met. The staff has proposed that some lenders temporarily buy the claims held by other lenders in need of liquidity. This would not imply that the lender buying these claims is in any way assuming the risk of nonpayment or the commitment to subsidize the loan to the final borrower attached to those claims. Similarly, the Fund could stand ready to buy the claims on the Trust held by a lender in need of liquidity, on a temporary basis, if no other participant in the enhancement is willing to buy those claims, at least if that lender already has a Fund arrangement in the upper credit tranches at the time the liquidity need appears. I am sure there are ways to deal with this aspect of the financial arrangement so as to avoid the problems mentioned, which are a concern of my authorities.

My authorities believe that in the present circumstances it is especially important that the Fund receives the necessary resources and mobilizes the membership in support of the less developed countries. They fully support the objectives of the enhancement, and they are interested in participating in the initiative.

I would appreciate further clarification on one point. I understand that it is possible to make only reasonable estimates of the amount of the subsidy required for the Trust to borrow at market rates and lend at an interest rate of 0.5 percent. The staff proposes that if over time the amounts required are higher than originally estimated, the Subsidy Account should be allowed to borrow from lenders prepared to provide bridge financing. What would be the source of the additional resources to cancel the bridge financing? Would additional contributions be required or would the resources in the Reserve be used once the liabilities of the Trust were extinguished?

Mr. Kyriazidis made the following statement:

While we can endorse most of the proposals put forward in the staff paper, we still have some points of disagreement on the issues of security, liquidity, and other aspects of the financial arrangements for the enhancement of the structural adjustment facility.

On the issue of security, we favor establishing a Reserve, and we agree with the provisions envisaged by the staff for funding such Reserve. However, two additional measures are necessary to provide full security for claims on the Trust. The first measure is the subordination of claims of the Special Disbursement Account to claims on the Trust, along the lines proposed in EBS/87/190 (9/2/87). We consider that subordination--by establishing a one-to-one relationship between repayments to the Account and credits to the Trust--provides a more automatic guarantee to lenders than the pooling of resources in the Reserve. The second measure is the assurance by the Fund that it will utilize all its means to repay lenders if the resources available in the Reserve are not sufficient to meet the Trust's obligations. Such assurance is required to provide absolute certainty of repayment to lenders. In fact, as clearly recognized by the staff, "notwithstanding the added security that would be provided by the proposed Reserve, some residual risk of nonpayment of the Trust's obligations would remain, at least in theory."

As for using part of the Reserve to meet requests for encashment of claims, we agree with the staff that such a possibility should be considered at a later stage and only when balances in the Reserve exceed the Trust's obligations.

On liquidity, we have no objections to the transfer of claims among contributors on a voluntary basis. As for the "electing lender" mechanism, at this stage our authorities are not ready to participate in such a scheme. Finally, we have no objection to recourse to the Fund's general resources in the event of a liquidity need by a contributor under Article V, Section 3(b)(ii).

On the procedure for calls on loans to the Trust, we prefer a distribution of calls utilizing a mechanism based on the balance of payments criterion in a fashion similar to that used in the operational budget. However, if other contributors do not consider that criterion appropriate to the Trust Account then, as a second-best solution, we should utilize a distribution key based on a criterion of proportionality and not of "broad" proportionality as indicated in the staff paper. In any case, calls should not exceed the amount that the lender has committed for the individual year of operation. In this respect we agree with the staff proposal that disbursements should not exceed one third of total commitments in each of the three years from 1988 to 1990 in which the lending will be concentrated.

The method for determining interest rates on loans to the Trust should be uniform and comparable across countries. The setting of market rates should be left to the agreement between each contributor and the Fund. Moreover, in setting the market rate due consideration should be given to the greater risk that loans to the Trust carry compared with loans to the Fund or other monetary authorities. Hence, market rates on loans to the Trust should embody a risk premium.

On the Subsidy Account, in order to define our position on the provision for allowing the Subsidy Account authority to borrow, two clarifications are needed. First, who will be the potential lenders? Second, who will pay the interest on such borrowing? As for the liquidation of the Subsidy Account, we can agree that amounts remaining upon termination should be returned to contributors. On the related proposal to return amounts to the Special Disbursement Account, we are still uncommitted.

Since our authorities did not have enough time to consider the issue of the interest rate on overdue obligations, we cannot take a position. However, in principle, we would prefer that the interest rate on overdue payments to the Trust be set so as to match ex[illegible]y the costs for the Trust arising from the delayed payments.

Mr. Massé made the following statement:

It is important that we continue to build momentum and have a sufficient pool of resources to start disbursements under the enhanced facility as soon as possible after January 1, 1988. My Canadian authorities have announced a contribution of SDR 200 million with a grant to the Subsidy Account sufficient to assure the concessional terms of the structural adjustment facility. Certain aspects concerning the modalities of payment still need to be clarified, and my Canadian authorities are at present working toward solving these problems.

As for the proposed financial arrangements, my authorities envisage that loans by the Trust will carry, to the extent possible, the same financial terms and conditions as those applied to loans under the existing facility. The staff's proposals regarding the borrowing operations of the Trust and the operations of a separate Subsidy Account are generally acceptable to my authorities. They also agree that there will need to be variations among individual lending agreements so as to reflect the particular legal and institutional requirements or preferences of the lenders. Regardless of how lenders provide their financing, it is important that the agreements be somewhat comparable in substance as regards the principal provisions. A Canadian contribution would require amendments to existing legislation, and my authorities are considering how best to achieve this result. Of course, the precise timing of the conclusion of this process is at this stage unclear.

As regards the security of claims, the establishment of a Reserve--short of a full guarantee by the Fund--is acceptable to us. The suggested funding of some SDR 4.8 billion should provide adequate security for conditions which can be reasonably expected to prevail. Nevertheless, some residual risk of nonpayment of obligations would remain, and my authorities agree that it would be prudent for the Fund to leave open the possibility of other initiatives to assure full payment to lenders.

Since our contribution would likely involve a government loan over a ten-year period, rather than be financed from international reserves, liquidity is not a major consideration. As a result, my authorities would not be in a position to enter into mutual arrangements for the provision of liquidity, and they would not wish to be an "electing lender." As to whether the Trust could use part of the Reserve to meet requests for encashment of claims, we agree with the staff that this would be undesirable.

The proposal that the loan commitments of lenders run to a common date is a reasonable objective. The potential delay caused by the legal complications for a Canadian loan, as well as the possibility that the timing of the payment of the interest subsidy of our contribution may be affected by our budgetary process, suggest that there will need to be flexibility in the timing of drawdowns on the commitments of individual lenders. The limitations suggested by the staff on the rate of drawdown are reasonable.

With respect to procedures for calls, my authorities are not sure at this stage if it would be most practical for them if commitments to the Trust took the form of lines of credit. A preferred option might be a deposit of notes that could be encashed from time to time. Otherwise, my authorities can go along with the suggested procedures for making calls.

As regards interest on loans to the Trust, my authorities envisage making a loan at market rates and providing grants to permit the required concessionality. At this stage, however, they do not have a final view on how they will structure the contributions so as to meet all of the objectives outlined by the staff.

While we can understand the purpose of denominating all operations, assets, and liabilities of the Trust in SDRs, my authorities have not yet determined how feasible this approach will be in making their own contribution. The chief concern here is how the exchange rate risk can be dealt with.

On the Subsidy Account, given the uncertainties noted by the staff about the adequacy of subsidy contributions to achieve the targeted interest rate of 0.5 percent, it would be appropriate to have periodic reviews to assess the situation and to consider the possible need for further subsidy contributions. Also, it could be useful to permit the Subsidy Account to borrow for bridging operations or to gain net investment earnings on concessional loans.

Mr. Hospedales remarked that the progress made by the staff in designing appropriate funding techniques for enlarging the structural adjustment facility was encouraging. The exercise had been complex as well as delicate in view of the different sources and nature of financing being provided and the need to minimize the concerns of potential lenders regarding the security and liquidity of their claims on the Trust. The Managing Director's initiative to mobilize additional development financing with appropriate concessionality was expected to alleviate the heavy debt burden of low-income countries eligible to use the facility, and, in the process, to sustain an adjustment which had been weakening. The reversal of the significant economic decline and of standards of living in those countries was a key challenge facing the international financial community.

The establishment of a Reserve in the Trust and its proposed funding--mainly from repayments on loans under the structural adjustment facility as they accrued and investment earnings held in the Special Disbursement Account--could provide adequate security under all possible and reasonable scenarios of the evolution of those obligations, Mr. Hospedales continued. In that respect, the staff assumptions regarding the viability of the Reserve to cover outstanding obligations were overly conservative. Such a high risk of nonrepayment could only occur in the context of a systemic crisis, which would merit an appropriate international response. Absolute protection of claims as suggested by some Executive Directors, therefore, did not seem to be necessary.

On liquidity, the proposed arrangements went a long way toward overcoming the technical difficulties so as to ensure that claims on the Trust had an appropriate degree of liquidity, Mr. Hospedales commented. The other characteristics of the proposed funding techniques, including the operations of the Subsidy Account, were broadly acceptable. Every effort should be made to seek subsidy contributions to ensure that the effective interest rate to be charged on loans under the enhanced facility did not exceed the targeted rate of 0.5 percent. Periodic reviews of the Subsidy Account instrument would therefore be necessary. In that connection, he wondered why overdue interest payments to the Trust should not be subsidized by the resources of the Subsidy Account; also, he did not agree that the Trust's Reserve should be used for the payment of subsidies.

He hoped that a consensus mutually satisfactory to the Fund and other potential contributors could be reached to ensure that the enhanced facility would become operational as envisaged, in January 1988, Mr. Hospedales concluded.

Mr. Lim remarked that he endorsed the principal financial conditions of the Trust outlined in Section II of the staff paper, including the proposal not to subsidize overdue interest payments to the Trust.

He continued to believe that the best way to maximize contributions to the Trust was to offer absolute security for the loans, Mr. Lim added. The staff proposals to establish a Reserve went a considerable way in that regard. The staff had indicated that "the Reserve in all likelihood would provide adequate security in any conditions that could realistically be anticipated." Indeed, the staff had estimated that the Reserve would be sufficient to cover all the Trust's obligations, even on the assumption that borrowers failed to repay some 40 percent of their obligations to the Trust and some 25 percent of their obligations to the existing facility. Given the confidence of the staff and management in that regard, and the advantage absolute protection would afford potential contributors in their efforts to secure domestic political support for their contribution to the enhanced facility, his Korean authorities believed it would be appropriate for the Fund to show flexibility by providing a supplemental guarantee, by using the gold holdings of the Fund, to cover any possible--although according to staff, most improbable--residual risk. That would not impose any serious probable burden on the Fund.

Mr. Ortiz made the following statement:

> My Spanish authorities have indicated that they will contribute to the enhancement of the structural adjustment facility. They are presently considering both the modalities and the amount of participation in accordance with their own economic constraints. They have also indicated that they regard their contribution to the enhancement in the context of a broad participation and adequate burden sharing; they would have preferred this initiative to be launched and implemented in tandem with Chancellor Lawson's proposals regarding the treatment of official debt for countries eligible to use the existing facility. Moreover, they view the possible contribution as a broadly based regional effort aimed at promoting international cooperation. In this sense, the indications of the U.S. authorities that they will not contribute to the enhancement of the facility--at least in its initial stages--represent a difficult problem for my authorities.
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> Although the financing modalities for the enhanced facility have been substantially narrowed down to the establishment of a Trust to be administered by the Fund, my authorities would have preferred a more thorough consideration of alternative financing arrangements. Nevertheless, they are prepared to broadly endorse the proposed arrangement. Like Mr. Grosche, we see the need for separation of the Trust from the General Resources Account.
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> The limited flexibility envisaged in these arrangements regarding the timing of commitments and the lending interest

rates are certainly welcome, since they will provide broader possibilities for participation. It is also important, however, that agreements remain comparable regarding repayment terms, denomination, and risk exposure. The operative aspects of the facility are important, so it is essential to strike the right balance between the flexibility provided to potential contributors and the need for the operations of the Trust to be as simple and cost effective as possible.

My comments on the security and liquidity aspects of the proposed Trust are only preliminary, since my authorities are still considering the various issues involved. On the security of claims on the Trust, we regard the proposed sources and amounts of the Reserve as broadly appropriate to face delays in payments of principal and interest by the borrowers. Although there is a certain amount of risk involved in the constitution of the Reserve--since it largely depends on the timely repayment of loans under the existing facility--we agree that it should prove sufficient to cover payment shortfalls under reasonably pessimistic scenarios, as shown by the simulations provided by the staff.

Nonetheless, there remains a residual risk that the amounts envisaged for the constitution of the Reserve will not be sufficient to cover payment shortfalls. Although my authorities appreciate the Fund's intention "to consider fully and in good faith all such initiatives as might be necessary to assume full payment to lenders," they would prefer a more specific commitment. For example, the Fund could pledge its gold, subject to the possibility of finding alternative arrangements that may be satisfactory to creditors, such as the provision of general resources to specific borrowers.

The question of liquidity of claims on the Trust is of special concern to my authorities. Although we consider that the staff's proposals in this regard are broadly in line with the needs of monetary authorities, I have a few additional comments. First, lenders should be able to suspend commitments temporarily for short periods of time--say, up to three months--without having to justify such suspension to the Fund. Justification would, however, be provided for longer periods. Second, we have some doubts on the effectiveness of swap arrangements for "electing lenders," since it would appear unlikely that major creditors will opt for this arrangement. Finally, in light of these comments, we regard the use of the Fund's resources as the most promising avenue for the provision of adequate liquidity for claims on the Trust. We are in general agreement with the staff's interpretation of the possibilities offered under Article V, Section 3(b)(2). However, my authorities consider that creditors' claims on the Trust should be regarded as an adequate safeguard by the Fund with respect to the potential extension of credit under the provisions already mentioned. Since the staff considers that the security provisions proposed for the enhancement of the facility are sufficient, the Fund ought to be consistent and consider this claim on the Trust to be an adequate safeguard against borrowing from the General Department.

Mr. Nimatallah remarked that his authorities strongly supported and would contribute to the enhancement of the structural adjustment facility. Despite Saudi Arabia's fiscal and current account problems, it was finding a way to contribute to the enhancement. For that reason, he could not understand the inability of the United States to find a way to participate. Mr. Abdallah's appeal was cause for concern about the U.S. image in Africa, particularly as it was not the first time that the United States had failed to contribute to an effort to alleviate the severe difficulties facing the African continent. Some rearrangement of priorities, or the diversion of a small portion of its foreign assistance, to enable U.S. participation would be helpful to the entire initiative.

The timing of the enhancement was important and he urged speedy action, Mr. Nimatallah continued. In that regard, he invited the staff to redouble its effort to meet the requests and allay the apprehensions of potential donors, contributors, and users of the enhanced facility. He also appealed to potential contributors and donors to hasten their efforts so that the operation of the enhanced facility could start as early as possible in 1988.

He was in general agreement with the staff's proposal on financial arrangements, Mr. Nimatallah concluded.

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

LEO VAN HOUTVEN
Secretary