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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/9

10:00 a.m., January 15, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
	M. K. Bush
	M. Lundsager, Temporary
	L. Hubloue, Temporary
	T. Alhaimus
	M. Sugita
G. Grosche	
	Song G., Temporary
J. E. Ismael	Jaafar A.
	J. Hospedales, Temporary
	M. Foot
	O. Isleifsson, Temporary
	G. W. K. Pickering, Temporary
	A. Abdallah
	P. E. Archibong, Temporary
	M. A. Weitz, Temporary
	J. E. Suraisry
	G. Ortiz
	S. de Forges
	J. de Beaufort Wijnholds
	A. V. Romuáldez
	O. Kabbaj
	A. Vasudevan, Temporary
	L. Tornetta, Temporary

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

IBRD: L. Ahamed, H. Findakly, Investment Department; J. Pratt, Eastern and Southern Africa Regional Office. African Department: A. D. Ouattara, Director; A. Basu, G. Devaux, I. A. H. Diogo, A. G. A. Faria, S. N'guiamba. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director. Legal Department: F. P. Gianviti, Director; J. M. Ogoola, S. A. Silard. Treasurer's Department: T. Leddy, Deputy Treasurer; M. P. Blackwell, J. E. Blalock, K. Boese, W. L. Coats, J. A. Gons, A. W. Lake, A. Tas. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. K. Doe, L. P. Ebrill, G. Nguyen. Assistants to Executive Directors: A. Bertuch-Samuels, F. Di Mauro, S. Geadah, N. Haque, G. D. Hodgson, Z. b. Ismail, H. Kobayashi, K. Murakami, A. Mustafa, W. K. Parmena, M. Rasyid, J. Reddy, J. E. Rodríguez, V. Rousset, B. D. White.

1. RWANDA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Rwanda (SM/85/289, 10/31/85; and Cor. 1, 1/8/86). They also had before them a report on recent economic developments in Rwanda (SM/85/293, 11/6/85; and Cor. 1, 1/10/86).

Mr. Alfidja made the following statement:

The reports prepared by the staff on the occasion of the Article IV consultation with Rwanda reflect in a concise and fair manner the views of the Rwandese authorities on the various topics of discussion during the last visit of the Fund staff to Kigali.

Over the past few years, the indications are that the sluggish economic upturn that began in 1982 and continued in 1983 came to a halt in 1984, with an estimated fall in real GDP of 1.5 percent. The principal factor in bringing about this outturn in 1984 was the significant drop in activity in the agricultural and manufacturing sectors. The output of important sectors, such as commerce and tourism and public administration, was stagnant in 1984, while construction and public works recorded only marginal gains. Continued large decreases in the production of important food crops such as bananas, cassava, and sweet potatoes, owing in large part to the scarcity of cultivable land and unfavorable climatic conditions, explain the fall in agricultural output. However, the production of the two main cash crops, coffee and tea, was quite sizable in 1984. Major effort have been undertaken by the Government in recent years with a view to improving agicultural performance and farmers' income. These efforts will be pursued in the years to come. In this context, irrigation facilities are being expanded and the regional specialization of crops based on soil and weather patterns continues to be encouraged. Likewise, steps are being taken to reclaim land normally unsuitable for agriculture, and marketing operations will be enhanced. Regarding the manufacturing sector, while the output of some commodities recovered in 1984, the supply of several other industrial products decreased substantially, thus leading to a fall in the output of the sector as a whole. In the future, emphasis will be placed on the promotion of industrial activities involving the utilization of locally available inputs. A number of provisions of the Investment Code are also being clarified in order to stimulate the creation and operation of manufacturing enterprises in the country.

The fiscal performance in 1984 was characterized by a notable improvement in the overall outturn of government financial operations. Indeed, the consolidated deficit of the Central Government (cash basis) is estimated to have decreased steadily from the four-year record of 2.3 percent of GDP registered in 1982 to 1.3 percent in 1984. While this improvement arose from a sustained expansion of revenue collection, it should be noted that expenditure growth was moderate in 1983 and negative in the following year. With the exception of income and corporate profit taxes, revenue growth was broad-based in 1984. In particular, revenue from import duties expanded rapidly as imports recovered. Likewise, higher earnings from coffee and tea exports led to an increase in receipt from export taxes. On the spending side, a decrease in capital outlays combined with a marginal rise in current expenditure contributed to the smaller deficit registered in 1984. The implementation of prudent employment and wage policies by the Government contributed a great deal toward restraining the increase of current spending. For 1985, the expansion of revenue was adversely affected by lower export prices for coffee and tea. Vigorous efforts were made to improve tax administration, in particular tax auditing. The campaign to educate taxpayers to enhance awareness and compliance with tax laws was stepped up. To avoid a widening of the budgetary deficit, expenditure growth was limited through the use of competitive bids, subsidies were not granted to some public enterprises whereas such transfers to others were frozen. A rise of the overall deficit in 1985 should not be interpreted as a relaxation of the generally cautious fiscal policy followed by the Government of Rwanda over the past several years. In fact, Executive Directors will note that, apart from the increase in capital outlays, prudence continued to be exercised. In any event, my authorities are keenly cognizant of the need for continued fiscal restraint, thereby avoiding undue recourse to bank financing.

In the monetary sector, the sustained expansion of domestic credit registered over a number of years has subsided, as the rate of growth of bank credit granted to public and private economic agents cumulatively decreased from an average of 20 percent recorded during 1981-83 to less than 10 percent in 1984. As a result of the improvement in the overall fiscal outturn of government operations, the net credit position of the Government vis-à-vis the banking sector improved substantially in 1984. Bank financing of private sector activities picked up in 1984, following two years of low growth due to the reduction of coffee stocks and a slowdown of mining operations. The expansion of bank credit was moderate in 1985. The Rwandese authorities intend to continue to implement a monetary policy, taking into consideration the overall demand for credit and the economc and financial objectives of the country.

On the whole, the external accounts improved in 1984 in comparison with the performance during the preceding two years. Indeed, the current account deficit was more than halved, having fallen from 6 percent of GDP in 1982 to less than 3 percent in

1984, whereas the overall balance of payments position shifted from a deficit equivalent to nearly 3 percent of GDP to a surplus of almost 1 percent over the same period. Increased export earnings from coffee--on account of better prices--and tea--thanks to higher volume and prices--contributed to the improvement in the current account balance in 1984. At the same time, the capital account strengthened considerably, thus contributing to the better posture of the overall balance in that year. On present estimates, the external accounts generally evolved less satisfactorily in 1985, owing to lower export earnings arising from the softening of coffee and tea prices and a weaker position of the service account. The capital account balance remained virtually unchanged. The external debt service ratio remained fairly low, although interest payments have risen in 1984 and 1985.

In summary, despite the decrease in total output in 1984, financial developments in the economy were generally satisfactory: export earnings rose substantially, and the current account deficit narrowed, hence reinforcing the overall balance of payments position. Similarly, government revenue expanded while spending declined, leading to a significant improvement in the fiscal situation. For these achievements to be sustained, major difficulties need to be overcome. The Rwandese authorities intend to continue to seek and implement appropriate solutions to resolve them.

Mr. Archibong noted that the past few years had been difficult for Rwanda. As in many other countries in Africa, and indeed in the developing world in general, various adverse factors had come together to stifle economic growth and create financial and balance of payments problems. Recent drought, low market prices for major exports, and a reduction in external aid had made it difficult for Rwanda to achieve the balance of payments objective envisaged in its Third Five-Year Development Plan. As the staff had noted in the report on recent economic developments "the authorities were obliged to tighten import and exchange restrictions during the last three years." Poor export performance had also contributed to difficulties in raising revenues.

The problems affecting the economy were clearly structural in nature and would have to be addressed over the longer term through careful planning aimed at the most efficient utilization of scarce resources, Mr. Archibong continued. Recalling the underutilization of capacity in the mineral company, which had had to be closed because of financial problems, he considered it important for the authorities to be more careful in devising future investment programs to ensure that projects, when they became operational, were intended to contribute to the

Government's budget and did not turn out to be a drain on the budget. The high rate of population growth was another important issue that must be addressed.

The slight rise projected for the budget deficit should not be interpreted as a relaxation of the Government's policy of fiscal restraint, Mr. Archibong remarked. In fact, a budget deficit of 2.1 percent relative to GDP compared favorably with the ratio of many other countries. The effort being made to keep the Government's wage bill in check and the decision to limit subsidies and transfers were encouraging. Steps to improve tax administration must continue although to be realistic, note would have to be taken of the difficulties the Government was likely to experience in raising revenue, given the decline in the rate of economic growth.

He had noted the concern of the staff that Rwanda's balance of payments was likely to remain under severe strain over the medium term, Mr. Archibong said. The country seemed to have very little room for maneuver, given the uncertain future in international markets for its major exports. In the circumstances, the authorities would have to continue to pursue prudent policies, and it would be most helpful if Rwanda also continued to receive concessional aid to help diversify its productive base.

Mr. Hubloue noted that the straightforward staff analysis pointed to conclusions similar to those reached in previous Article IV consultations with Rwanda. Despite a certain stabilization of the real effective exchange rate of the Rwanda franc since 1984, the economy was still suffering greatly from the steep real appreciation that had occurred since 1980 and 1983. After a slight improvement in Rwanda's trade balance and financial position in 1984, owing to higher world prices for coffee and tea, the external situation was expected to deteriorate again in 1985, while overall the economy remained trapped on a blocked growth path. The transmission channels through which the misalignment of the Rwanda franc affected the economy had been discussed extensively on the occasion of earlier consultations and had been spelled out again in the staff report for the 1985 Article IV consultation. He fully endorsed the staff analysis and recommendation for a correction of the exchange rate.

The reluctance of the Rwandese authorities to accept the staff views seemed to stem from an incomplete assessment of the exchange rate issue, Mr. Hubloue continued. They were partly correct in claiming that a depreciation of the Rwanda franc would immediately increase the prices of those imports accounting for a large share of the costs of productive activity, and that exchange rate action could have no significant effect on coffee exports, which were limited by quota and subject to international price quotations. But those were not the only consequences of corrective exchange rate action for Rwanda's economic prospects. As the staff had pointed out, the share in production costs and consumption represented by imports was at least partly a reflection of the current overvalued exchange rate. Any corrective action therefore would have a direct beneficial impact on domestic production and consumption patterns since it would open the way for import substitution and decrease the balance of payments burden without resort to additional import restrictions.

On the export side, the benefits of an exchange rate correction might be even greater, Mr. Hubloue added. In fact, it was because of the existing misalignment that export performance was increasingly determined by events in the coffee market, while other export industries were suffering huge market losses and were being forced, one after another, to close down. The decline in the share of noncoffee exports in total exports from 53 percent to 30 percent between 1980 and 1985 underscored the urgent need for export diversification. In sum, a correction of the exchange rate would bring about a shift of Rwanda's resources from the domestic consumption of imported goods, which was heavily subsidized at present by the high exchange rate, toward the productive sectors of the economy where they would generate higher export and tax revenues based on higher levels of activity and higher nominal values of exports and imports.

In other policy areas, the Rwandese authorities had continued by and large to pursue prudent demand policies, despite the steady deterioration of the external situation and its adverse impact on the financial situation of export industries and on domestic growth, Mr. Hubloue remarked. To their credit, they had not relaxed domestic financial policies in an attempt to compensate for the recessionary forces unleashed by external sector developments, even though that meant that the entire burden of adjustment to the misalignment of the Rwanda franc had fallen on the real sector of the economy. That was evident from the unsustainable level of domestic consumption as a percentage of GDP, from the buildup of a large excess capacity in industry, and from the low profitability of investments. In the end, even the tightening of financial and import policies could not, of course, prevent the external imbalance from generating financial disequilibria that were sure to widen steadily if they were not tackled through a fundamental correction of the balance of payments. The widening of the budget deficit caused by the falling off in tax revenue from enterprises, and the staff's projection that the external debt service ratio would double by the end of the decade, were worrisome indications that without corrective action Rwanda's economy threatened to become unmanageable.

Unambiguous recommendations should therefore be made to the Rwandese authorities, Mr. Hubloue considered. Their reliance on tight financial policies, the welcome program under preparation for rehabilitating the productive sectors, and the access to foreign borrowing on concessional terms on which Rwanda had traditionally relied would not succeed in improving the prospects for sustainable growth unless they were supported by a major reallocation of domestic resources brought about by the correction of the exchange rate. There was no alternative course of action. Therefore, he strongly encouraged the staff to continue its discussion with the authorities on that politically delicate issue and to seek ways of accomplishing the necessary correction while taking into account the authorities' concern with domestic price stability. The suggestion to adjust the exchange rate progressively might therefore be a workable course of action and would in any case be better than a further tightening of exchange and trade restrictions.

Ms. Lundsager remarked that while there had been some improvement in economic performance in Rwanda in 1984, a deterioration had occurred in 1985, as evidenced by budgetary and external developments. Furthermore, despite some relaxation of restrictions in 1984, Rwanda's extensive reliance on trade and exchange controls was hardly likely to permit a revitalization of the productive base of the economy. On the contrary, over the years the result had been a substantial real effective appreciation of the Rwandese currency, further inhibiting the diversification and strengthening of the export base. Unfortunately, with coffee comprising some 65 percent of exports in 1984, the expected increase in the world market price of coffee could lead to temporary improvements in the payments position, easing any sense of urgency the authorities might have had about the need for a broadly based reform program.

She would not dwell on the many particular points that deserved attention because they were covered in detail in the staff report, Ms. Lundsager commented. Rather, she would emphasize the most important problems, beginning with the most obvious one whose solution was the most opposed by the authorities. As the chart on trade-weighted nominal and real effective exchange rates showed, page 2a in the staff report, the Rwanda franc continued to be highly overvalued. The export base of the economy was very narrow, consisting mainly of coffee and tea. Once the world market price dropped, as it most probably would once production elsewhere recovered, Rwanda would feel the direct impact. There was thus an overriding need for export diversification, and at the present exchange rate, it was difficult to imagine new exportables emerging in the economy. Furthermore, there seemed to be some scope for increased tea production if adequate producer incentives were restored. Given the long time lag that could surround the generation of new production, Rwanda should not wait for the terms of trade and balance of payments position to deteriorate before deciding to stimulate production but should move aggressively to create the incentives needed to improve the export profile over the medium term. An exchange rate adjustment was the most direct and the most efficient means of stimulating the needed supply response. While laying the basis for a longer-term improvement in the payments position, that adjustment could also generate a higher rate of economic growth in Rwanda.

Such a move would probably have some generalized inflationary effects, given the high degree of overvaluation, but cautious monetary and fiscal policies could contain those pressures, Ms. Lundsager observed. The authorities had reportedly begun an effort to contain expenditure in 1985 and she urged them to strengthen that effort. Furthermore, adoption of a comprehensive reform program could permit an easing of trade and exchange restrictions, thereby limiting the scope for domestic price increases and improving the productivity of individual producers and the economy in general by stimulating a badly needed reallocation of domestic resources.

The revitalization of currently stagnant sectors could greatly expand producer confidence and lead to increased domestic investment. Complementary financial policies, including perhaps interest rate adjustments as needed, could induce a higher rate of domestic savings, increasing the growth potential.

The authorities reportedly were initiating a reform of the public enterprise sector, including some divestment to the private sector, Ms. Lundsager remarked. Those steps were welcome and might enhance interest on the part of foreign investors if the general performance of the economy improved. Finally, a more comprehensive statistical base could increase the authorities' ability to monitor economic developments and thus implement appropriate economic policies in a timely fashion.

Mr. de Forges noted that in comparison with that of other African countries, Rwanda's economy had been relatively healthy in 1985. Yet the staff had drawn attention to the weaknesses and to the worrisome balance of payments and budgetary prospects for the medium term. He too was inclined to share the staff view about the appropriateness of an adjustment--no matter how modest initially--of the Rwandese franc, which had risen by 13 percent against the SDR and by 39 percent in real terms since 1980. He understood that the authorities had misgivings on that matter, tending to believe that the negative effects of such an adjustment would outweigh the positive effects.

In order to clarify that issue, Mr. de Forges asked the staff to address three points. First, given the relative scarcity of arable land and the increased output of coffee and tea, he asked whether a rise in the producer prices of those crops would have any impact on the current production level. Second, if production increased, would the additional output be sold on export markets? He had in mind particularly coffee exports in light of Rwanda's coffee quota. Third, to what extent was the manufacturing sector able to respond promptly to a devaluation by turning to import substitution? If the answers to those questions were sufficiently reassuring, he would urge the Rwandese authorities to take a broader view of exchange rate action.

The staff representative from the African Department noted that on the assumption that the area of arable land planted with tea would not be increased over the medium term, an increase in productivity would be necessary if the authorities were to reach their objective of producing 10,000-15,000 tons of dried tea leaves from the acreage devoted to tea cultivation. Nominal producer prices had been fixed since 1980 and had declined substantially in real terms--nominal prices deflated by either the consumer price index or the GDP deflator. Accurate supply elasticities for tea production in Rwanda were not available but studies made in other countries indicated that comparable short-term elasticities would be in the range of 0.2 or 0.4 in the short term, and about 1 in the longer term, say, within three to five years, depending on the individual countries' circumstances. The judgment that had to be made was whether the overvalued rate and the decline in producer prices called for action before the negative effects were fully felt.

The producer price for coffee had also been constant in nominal terms since 1980, the staff representative added. Although Rwanda had to meet a quota on coffee exports, its problem was in part due to its reliance on the inadequate producer pricing policies of neighboring countries to help meet its quota. Again, it could be argued that even if producer prices were considered to be adequate, an exchange rate adjustment that would benefit the noncoffee sectors would also have the effect of increasing tax revenue in the coffee sector. A strong case could be made for increasing savings through that channel mainly because, as indicated in the medium-term scenario, there would be a rapid buildup of foreign debt, a sharp rise in the debt service ratio, and a drastic fall in foreign reserves over the five years ahead. Financial pressures on the budget and on the balance of payments could be reduced if such an additional source of revenue and savings were opened up.

It was difficult to predict whether any additional output, particularly of coffee, would find a market abroad, the staff representative commented. The general point that deserved emphasis was that all exports--other than coffee, tea, hides and skins--had been declining, a trend that had emerged alongside the appreciation of the real effective exchange rate. Rwandese products were not only uncompetitive in export markets; operations in the domestic market were not profitable at world prices. An exchange rate adjustment could therefore have a significant impact at the producer level and in the economy overall, for instance, through the value added in processing and marketing. The decline in exports in general might then be reversed since for the most part restrictions and quotas were not a constraint. Of course, the market for tin had been depressed for the past three or four years, but a recovery in output based on existing capacity might help to solve the problems in the tin sector.

The World Bank had recently published a report on the manufacturing sector, covering policy issues and performance, the staff representative noted. There were two salient policy issues for consideration within the overall topic of the appreciation of the real exchange rate. First, the manufacturing sector benefited from high and varying levels of effective tariff protection, which had moreover increased substantially since the import licensing controls and import deposit schemes were introduced in 1983. Second, the sector also profited from the natural landlocked position of the country and high transport costs, which provided a good measure of protection. The implicit protection afforded by restrictions proper and transport costs probably reached 100 percent. The issue was whether the manufacturing sector was being helped or hurt by such protection as distinct from the neutrality of exchange rate action, which would lead to a more uniform, reasonable level of tariffs.

In analyzing the cost-price situation, it was necessary to take into account the small size of the domestic market, the staff representative noted. Production was below capacity and unit costs were high so that output could not compete with imports; an increase in output was the only way in which domestic industry could become competitive, but domestic demand was insufficient. Furthermore, the consumer was not getting the benefit from increased production and lower prices that a more competitive system would provide; that fact was especially true with respect to the products of one or two small companies--for instance, the breweries--which were able to operate as monopolies because of the growing level of protection. Rwanda had been active in promoting preferential trade agreements in the region, but it would have to find other markets in which to compete efficiently in order to be able to use its excess productive capacity.

Two other points stressed in the report of the World Bank were first that it would be to Rwanda's advantage to limit investment in future to small-scale industrial endeavors that drew support from and benefited the agricultural sector--for instance, agro-based industry, rather than large public sector projects with production that had a high import content and was capital intensive, the staff representative noted. The second point was related to real wage levels in Rwanda, which apparently fell in the middle of the range of wages in comparable countries in, say, South Asia and in parts of Western Africa. Relative wage levels in Rwanda therefore had not necessarily been beneficial in terms of the competitiveness of the domestic cost structure.

In the short term, the budget deficit would be improved only moderately by an exchange rate adjustment, the staff representative noted. Over the medium term, and even with only small supply-side effects, the cumulative impact on the deficit would be considerable. Revenue was based almost entirely on international trade, whereas the foreign component of expenditure in the budget was much less heavy. An exchange rate depreciation would have a positive impact on savings, permitting a larger share of a given level of investment to be financed with domestic rather than with foreign borrowing.

The price effects of a devaluation would also be more restrained in the budgetary context if revenues were increased, thereby permitting a reduction in bank financing of the deficit, the staff representative from the African Department concluded. Continued wage restraint would be necessary, bearing in mind the comparative wage level. Any initial inflationary impact in terms of domestic prices should be offset as the economy responded to the improvement on the supply side, once the first relative price adjustments being sought had been made. The authorities were concerned that the immediate impact on the structure of production, given its high import content, would be an increase in costs and prices. However, the staff had explained that for the structure of production to evolve in the direction desired by the authorities, imports and capital goods obtained from abroad could not be underpriced. If anything, the argument was most forceful in respect of consumption, which accounted for 42 percent of imports.

Mr. Alfidja noted that discussions were continuing between the Fund, the World Bank, and the Rwandese authorities, who were not yet convinced that a move on the exchange rate was timely. The possible benefits of such action, taken in combination with measures in various other fields, should continue to be discussed. In that connection, he would convey to the authorities the recommendations and comments made during the discussion.

The Chairman made the following summing up:

> Executive Directors generally agreed with the thrust of the appraisal in the staff report for the 1985 Article IV consultation with Rwanda. Directors noted with concern that in recent years the annual rate of growth of real GDP had been slow, in part because of drought and declining export prices; domestic savings had been low; the deficits in the external current account had been sizable; and the exchange rate had appreciated strongly in real effective terms. Moreover, producer prices of major export crops had declined significantly in real terms. The major tin mining company had shut down due to financial and managerial problems, and the manufacturing sector has experienced financial problems attributable to the erosion of competitiveness. Directors also expressed concern about the weak prospects for export growth, the projected steady rise in the external debt service burden, and the resulting likelihood of a further deterioration in external performance.
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> In the circumstances, Directors felt that the important objectives of achieving higher growth rates of production, an increase in domestic savings, and a fundamental improvement in the balance of payments would require well-coordinated action in a number of key policy areas; tight financial policies alone would not be sufficient to achieve these three goals. Accordingly, the authorities were urged to adopt without further delay a flexible and realistic exchange rate policy in order to correct the large overvaluation of the currency. Such a policy should be combined with appropriate adjustments in official pricing policies, as well as cost-saving reform measures to improve the profitability of both exportoriented and import-substitution activities, and to limit price rises.
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> Directors also stressed the need to reduce reliance on trade and payments restrictions so as to prevent the emergence of serious distortions in the use of scarce foreign exchange resources. It was stressed that an improved domestic savings

performance would help to achieve an adequate degree of restraint in monetary expansion and to raise the share of investment financed by domestic resources.

As regards fiscal and domestic credit policies, Directors cautioned against a possible weakening in fiscal performance. They urged the authorities to pursue their policy of holding down the growth of budgetary expenditure and to improve its monitoring and control. They felt that a continuation of tight fiscal and credit policies would be essential, coupled with a depreciation of the exchange rate to a realistic level, for both price stability and external adjustment.

In conclusion, Directors recommended that the next Article IV consultation with Rwanda be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Rwanda's exchange measures subject to Article VIII, Section 2(a) and in concluding the 1985 Article XIV consultation with Rwanda, in the light of the 1985 Article IV consultation with Rwanda conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Rwanda continues to maintain exchange restrictions on payments and transfers for current international transactions, including restrictions arising from the suspension of travel allowances, as described in SM/85/289. The Fund encourages the authorities to adopt adjustment measures that would enable them to eliminate, as soon as possible, the exchange restrictions that are subject to approval under Article VIII.

Decision No. 8183-(86/9), adopted
January 15, 1986

2. SUPPLEMENTARY FINANCING FACILITY SUBSIDY ACCOUNT - INVESTMENT, MEANS OF SUBSIDY PAYMENTS, AND USE OF SDRS IN SUBSIDY PAYMENTS

The Executive Directors considered a staff paper proposing certain modifications in the investment practices of the Supplementary Financing Facility Subsidy Account, together with proposed decisions and a draft text of the proposed investment agreement with the World Bank (EBS/85/284, 12/18/85; and Sup. 1, 1/13/86).

Mr. Foot said that he could endorse the staff proposals, which seemed eminently sensible, and as long as the beneficiaries of the subsidy were content to receive the subsidies in SDRs, a welcome administrative simplification of the existing procedures. Presumably, the Bank for

International Settlements (BIS) was aware of the proposals and the World Bank was aware of the possible volatility of the amount of SDRs in its investment account within the limits set.

Mr. de Forges said that if he understood the rationale for the proposals in the staff paper, the two factors to be taken into account were better yield and the promotion of the use of the SDR. Those were commendable objectives that could not be questioned. However, he had more of a problem understanding why the Fund should limit itself to opening up the possibilities for more competitive investment to the World Bank only. He asked what the response was likely to be if other financial institutions that were allowed to hold SDRs were willing to offer a better yield or a wider range of services. He also inquired whether there were any legal problems compelling the Fund to be restrictive as to the institutions concerned in the management of the assets of the Supplementary Financing Facility Subsidy Account. As he read Decision No. 6683-(80/185) G/TR, adopted on December 17, 1980, and reproduced in Attachment I to EBS/85/284, nothing prevented the Fund from investing the resources of the Subsidy Account in denominations other than the SDR or with institutions other than the BIS. As a newcomer, he was curious to know the rationale for the decision adopted in 1981 (Decision No. 6854-(81/78), SBS) authorizing investment with the BIS. His question was whether it would be difficult to revert to Decision No. 6683, which seemed to give more freedom to the staff to invest and manage the resources of the Supplementary Financing Facility Subsidy Account to the best advantage.

Finally, Mr. de Forges said that he would welcome staff comment first on the projected level of the World Bank's out-of-pocket expenses compared with those charged by the BIS, and second on the additional yield expected from the shift.

Mr. Ismael noted that the importance of ensuring maximum returns on the temporary investment of Fund resources while they were not being used in Fund operations could not be overemphasized. That was especially true at the present time when the Fund was confronted with rising demands on its resources and administrative costs that had led to repeated increases in the rate of charge on the use of those resources. In the particular case of resources administered in the Supplementary Financing Facility Subsidy Account, the amounts involved could be quite significant as they included subsidy payments temporarily withheld by the Fund pending settlement by the beneficiary members of their overdue charges. The staff's initiative and ingenuity in finding more profitable investments for such idle resources were thus most welcome. The proposed investment in SDRs through an arrangement with the World Bank, which was a prescribed holder, was in his view most appropriate in terms of safety and rate of return, and at the same time was not inconsistent with the objectives and rules of the Special Drawing Rights Department. Therefore, he had no major problem in supporting the proposed decisions, including those relating to the SDR Department.

Nevertheless, he wished to raise a few points for clarification relating to the implications for the operation of the Subsidy Account of the Executive Board's recent decisions on special charges on overdue obligations, Mr. Ismael continued. First, he had noted that the Fund had withheld SDR 8.5 million as of July 1984 and SDR 5.9 million as of November 1985 in subsidy payments payable to five countries that had failed to pay charges on drawings of supplementary financing facility resources on time. The question that came to his mind was how the liability of such members with respect to special charges on their overdue charges would be treated, in accordance with the decision adopted by the Executive Board at EBM/85/189 (12/30/85). The two elements of the problem were that the withholding of subsidy payments would provide extra interest income to the Subsidy Account, whereas the member would incur a loss if it was required to pay special charges on its overdue charges for which it had been entitled to a subsidy in the first place. In order to be equitable to both the member and the Subsidy Account, a case could perhaps be made for a provision to exempt members in such a situation from special charges on the amounts to be offset by subsidies. That could be done by giving retroactive effect to the subsidy payments when they were eventually made after the member became current. Such a provision appeared consistent with the objective of the Subsidy Account as well as with the Executive Board's decision on special charges, which had been intended only to recover administrative costs relating to overdue obligations.

His second point concerned the possible impact on the Subsidy Account of the most recent increase in the rate of charge at a time when the cost to the Fund of borrowed resources had been declining as a result of a downward trend in the rates on U.S. five-year Treasury bonds, Mr. Ismael said. More specifically, he wondered how those developments would affect the disbursements as well as the future resource requirements of the Subsidy Account. The question was particularly relevant in light of the provision limiting the amount of subsidy to the equivalent of the excess of the actual rate of charge on supplementary financing over the rate applicable to use of the Fund's ordinary resources. At the time of the Executive Board's discussions in May 1985 of special charges (EBM/85/90, 6/5/85), the staff had estimated total disbursements until 1991 at SDR 508.3 million and total resources to be provided at SDR 509.4 million. He would be grateful for an indication of whether recent developments would affect those estimates.

His third and final point related to the legal justification for the Fund's practice of withholding subsidy payments due to members that had overdue obligations, Mr. Ismael stated. In its paper, the staff had explicitly attributed the current practice of withholding subsidy payments to the member's failure to pay supplementary financing facility charges, but no legal reasoning or justification was given. He would be interested to know whether overdue obligations other than supplementary financing facility charges were also a factor in the Fund's considerations in withholding subsidy payments.

Mr. Wijnholds said that he had no difficulty at all in supporting the proposed decisions. The willingness of the World Bank to provide the service was a useful instance of cooperation between the Fund and the Bank, albeit in a somewhat unusual area. He would not be in favor of involving financial institutions other than the BIS and the World Bank in the investment of the resources of the Supplementary Financing Facility Subsidy Account.

Mr. Song remarked that in his opinion the measures in the three proposed decisions were appropriate. The change in the conditions for investment of Subsidy Account resources would benefit the recipients and also help to promote the wider use of the SDR. He commended the staff of both the Fund and the World Bank for their initiative and cooperation in the undertaking.

Mr. Alhaimus said that he could endorse the proposals to open an SDR-denominated investment account with the World Bank and to allow subsidy disbursements to be made in SDRs. The higher yield on those short-term investments that had prompted the proposal was quite a legitimate justification even though the amounts involved were small. He had wondered whether consideration had been given to the possibility of earning a higher yield on SDR deposits in excess of SDR 2.5 million. In footnote 5 on page 2 of EBS/85/284, it was stated that "the BIS offers satisfactory terms for most of the Fund's investments." The question was whether any thought had been given to an arrangement with the World Bank that might achieve an even higher yield on larger SDR deposits. In that connection, he asked whether the World Bank already had any such arrangements with other institutions.

Mr. Grosche remarked that his authorities appreciated the staff's efforts to seek attractive yields for the short-term investments of the Supplementary Financing Facility Subsidy Account resources. However, they believed that those efforts had to be in full accordance with the monetary character of the Fund. The different functions and character of the World Bank and the Fund made it advisable to proceed carefully to avoid mingling the financial operations of the two institutions. The Fund's opening of an investment account with the World Bank could eventually--whether that was the intention or not--pave the way for the partial financing of World Bank operations with Fund resources. Because of those considerations, his authorities would have preferred an alternative investment opportunity offering comparable rates of return. The staff paper did not go into great detail on other options, and he would be interested in having additional information on the results of the staff's inquiries with the BIS or with other prescribed holders of SDRs or participants in the Special Drawing Rights Department.

Despite those reservations, his authorities could go along with the proposal, first, because the amounts involved were rather small, Mr. Grosche added, and second, because the resources concerned were administered by the Fund as trustee. Third, it was stipulated as noted on page 3 of EBS/85/284 that the World Bank could hold amounts received at all times in SDRs until the investment was liquidated by the Fund, thus ensuring that the investments would not become available to finance the World Bank's own operations. In addition, he would greatly welcome an agreement that the SDRs held by the Bank in the investment account would not be considered part of the Bank's liquidity holdings. A brief comment by the staff on the treatment of the new account in the Bank's balance sheet would be helpful.

Finally, Mr. Grosche said that his authorities had no objection to allowing subsidy disbursements to be made in SDRs.

Mr. Sugita commented that it would have been much simpler and more straightforward if the Subsidy Account itself had been able to hold SDRs. But because the Subsidy Account was not considered to be a qualified SDR holder under Article XVII, Section 3, and also because the World Bank staff had been willing to propose to the Executive Directors of the Bank that a new investment account be opened, the proposal under discussion was a pragmatic way of raising the yields on very short-term investments of Supplementary Financing Facility Subsidy Account resources. He could also support the proposals to make subsidy payments in SDRs, subject to the consent of the beneficiaries, and to transfer the SDRs directly from the investment account to the beneficiaries.

Mr. Suraisry said that he shared Mr. Foot's view that the proposals were sensible. He supported the proposed decisions. The Supplementary Financing Facility Subsidy Account would be in a position to earn an appropriate rate of return, and the recipients of subsidy payments would benefit from the flexibility entailed in the option to receive some payments directly without the need for a prior conversion of U.S. dollars into SDRs. Finally, he took the occasion to express his gratitude to the staff of the World Bank for its cooperation with the Fund staff, which was also to be commended for its initiative.

Mr. Romuâldez said that he supported the proposed decisions. His authorities, particularly those who could be affected by the proposal, had indicated that they saw no difficulties in subsidy disbursements in SDRs. His Australian authorities had raised the same questions as Mr. de Forges concerning the exploration of investment possibilities with other financial institutions. Some simplicity and flexibility in the management of the funds to be invested might be gained in that way.

Finally, Mr. Romuâldez observed that the proposed arrangements illustrated well how the World Bank and Fund could work closely together without detriment to their separate interests, making the proposal all the more welcome.

Mr. Alfidja noted that reference was made on page 6 of EBS/85/284 to the fact that the Instrument establishing the Subsidy Account left it to the Fund to determine the medium of payment. The draft decision on the means of subsidy payments also referred to the discretion of the Fund.

Therefore, he wondered whether members would actually have the flexibility that had been mentioned as being inherent in the proposals. At least one country in his constituency had a preference for being paid in U.S. dollars, or in a combination of U.S. dollars and SDRs, and he sought assurance that that would be possible under the proposed decision on the means of subsidy payments.

Mr. Ortiz said that he had no problem in supporting the proposed decisions. Like other Directors, he expressed the appreciation of his chair to the World Bank for the cooperation it had shown in the matter. Unlike Mr. Grosche, he had not been left with the impression that the World Bank would use the funds in its operations; indeed, he had been surprised by the suggestion of that possibility.

Mr. Kabbaj stated that the authorities of the countries concerned in his constituency had been consulted and had already conveyed their agreement with the proposed scheme. He wished to express appreciation to the staffs of the Fund and the World Bank for moving into a new field of cooperation. Finally, he would be interested in the staff's replies to Mr. Ismael's remarks.

Mr. Pickering expressed thanks to the staff for its efforts to find a higher rate of return, with the help of the World Bank, for the Supplementary Financing Facility Subsidy Account, and to contact the countries in his constituency that were recipients of the Subsidy Account. He had no difficulties in supporting the proposed decision.

Mr. Abdallah joined other Directors in thanking the staff for its constructive proposals. He also associated himself with the reservations expressed by Mr. Alfidja concerning the reference in the decision on the subsidy payments having to be made only in SDRs, at the discretion of the Fund. The deletion of the restriction would leave beneficiaries with complete freedom to receive the subsidy either in U.S. dollars, other currencies, or SDRs.

Mr. Weitz said that he endorsed the proposed decisions. The participation of the World Bank in the exercise was a good example of collaboration between the Fund and the Bank.

Mr. Vasudevan expressed support for the proposed decisions.

Ms. Bush stated that she supported the three decisions proposed in EBS/85/284, which would establish an investment account denominated in SDRs for short-term investments of the Supplementary Financing Facility Subsidy Account. The possibility of receiving higher rates of interest on short-term investments than those previously obtained in the two-day notice account with the BIS was welcome. It was good financial management to locate higher rates of return with little or no assumed increase in risk.

She appreciated the staff clarification that the funds in the investment account with the World Bank would not be available to the Bank for the financing of its own operations, Ms. Bush added, particularly since the technical nature and uniqueness of that type of account could lead to misperceptions about its use. It was important not to leave any impression that Fund-related assets were in any way supporting or facilitating World Bank operations. Her authorities would also prefer the amounts invested in the account with the World Bank to be limited to the smallest amounts possible, taking into account overdue charges and the timing of the disbursement of subsidies.

Finally, as indicated in the staff paper, the U.S. authorities had concurred with the use of U.S. dollars for the investment of short-term resources of the Supplementary Financing Facility Subsidy Account in the World Bank Investment Account, Ms. Bush said. As she understood it, however, any other but similar arrangements that might be proposed for investments of a short-term nature by the Special Disbursement Account would be brought to the Executive Board and separate concurrence by the U.S. authorities would be required.

Mr. Hospedales joined other Directors in supporting the proposed decisions. The modification in the investment strategy that had been effected after due consultation with the World Bank was consistent with the objective of improving the return on resources held temporarily by the Subsidy Account. The new procedures obviously would provide financial benefits to the recipients. He expressed his appreciation to the World Bank for providing the useful service.

The Deputy Treasurer noted that the need for the proposed investment arrangement with the World Bank had arisen from a rather unique set of circumstances--namely, the very short-term nature of the investment that might be required. While the yield offered by the BIS on longer-term investments was satisfactory, the high transaction costs of short-term investment could dominate the nominal yield. For instance, on a deposit placed for one day, the annualized transactions cost was about 11 percent. The objective had been to improve the yield on short-term investments by finding an investment arrangement that would provide a yield equal to that on the SDR, which was based on three-month maturities, and that would involve no transaction costs. The staffs of the Fund and the World Bank had reached agreement on such an arrangement, which was the most financially advantageous one presently available for investing the resources of the Supplementary Financing Facility Subsidy Account. Alternative arrangements had been and would continue to be explored actively, particularly with respect to amounts that were accruing in the Special Disbursement Account. Acceptance of the investment arrangement with the World Bank did not mean that all other possibilities had been exhausted. Nor did the specific reference in the proposed decision to deposits with the BIS or investments in a call account with the IBRD indicate that alternative sources for investment could not be considered.

If the staff found other advantageous possibilities for investment, proposals to amend the decision could be submitted to the Executive Board for its consideration.

The staff would wish to reflect on the suggestion by Mr. Ismael that some way be found to use the yield on the amount of subsidies withheld due to the nonpayment of SFF charges with a view to offsetting the special charges on the amount of overdue SFF charges, the Deputy Treasurer said. It appeared that recent changes in the rate of interest on supplementary financing facility resources and the rate of charge on ordinary resources would imply some small reduction in the amount of subsidy, although the actual position for the year as a whole would not be known until some time in early July. The outcome would depend on movements in the actual rate of interest and charges in the first half of 1986. Overdue obligations other than overdue supplementary financing facility charges were not a factor in the withholding of payments from the Subsidy Account. Only the obligation to pay charges on which a subsidy was paid was taken into account in withholding the subsidy.

In response to Mr. Alfidja and Mr. Abdallah, the Deputy Treasurer confirmed that if countries preferred, they would receive U.S. dollars rather than SDRs. The use of SDRs in the payment of subsidies would require in all cases the prior agreement of the countries concerned. However, the manner of operating the subsidy account and investing its resources meant that only U.S. dollars might be available on a given occasion. Therefore, even though the country might have agreed to accept SDRs, the Fund would not be in a position to disburse the subsidy payment in SDRs and would have to make the payment in U.S. dollars. Thus, flexibility had to be built into the decision to enable the Fund to exercise that discretion. It should be noted that of the 23 countries eligible to receive subsidies, 21 had responded positively to the staff inquiry about their willingness to receive SDRs. Those 21 countries accounted for about 97 percent of the total subsidies paid in 1985.

The investment arrangement with the World Bank had been carefully designed to meet the concern on the part of some Executive Directors that the funds might in some way affect the World Bank's liquidity and lending operations, the Deputy Treasurer stated.

Consideration had not been given so far to placing larger amounts for longer-term periods in an investment arrangement with the World Bank, the Deputy Treasurer commented. To date, virtually all of the investments of the Fund in various accounts--the Subsidy Account, the Borrowed Resources Suspense Account, and the Special Disbursement Account--had to be held in relatively short-term maturities to meet the Fund's disbursement requirements. Even though those investment maturities were longer than the two-day notice account, say, for one or two or several months--they were for the most part well under a year, with the exception of a few investments of the Subsidy Account. Thus, in general, the Fund did not have a need to make longer-term investments. Furthermore, the short-term investments were all in fairly liquid form, in that the BIS provided a facility for early liquidation and early withdrawal to meet the Fund's needs, as required. Before taking any investment decision, the staff made comparisons with rates available in the market and had found so far that the yields offered by the BIS--with the exception of the very short two-day notice accounts, for the reasons explained--were satisfactory.

The staff representative from the Legal Department said that the basis for withholding the payment of subsidies to countries that were not paying current charges on the use of Supplementary Financing Facility resources was to be found in the Instrument establishing the Subsidy Account. In Section 7, it was stated that "the Fund shall draw upon the resources of the Account...to reduce the cost to eligible members of the periodic charges paid by them to the General Resources Account...." Thus, if the periodic charges were not paid, there could be no subsidy.

The Subsidy Account Instrument authorized a wide variety of possible investments, the staff representative explained. The proposed decision, under which investments would be made with the BIS and the World Bank, did not preclude the use of other investment outlets, if the staff were in a position to make such proposals to the Executive Board for its consideration. However, it had been felt advisable to present the specific decisions to the Executive Board, and not to provide for investment that did not seem practicable for the time being.

The decision adopted by the Executive Board on December 30, 1985, (EBM/85/189) relating to special charges on overdue financial obligations did impose special charges in respect of overdue charges in the General Resources Account, including charges due to the Fund on the use of supplementary financing, the staff representative indicated. Therefore, the staff would consider the question raised by Mr. Ismael on the possibility of a rebate when the member became current of the special charges applied in respect of charges under the Supplementary Financing Facility.

Finally, the staff representative from the Legal Department confirmed that, as the Deputy Treasurer had explained, it was essential to retain the reference in the decision on the means of subsidy payments to "the discretion of the Fund" to permit the Fund to decide whether a member requesting SDRs could receive SDRs. It was the Fund that might not be able in all cases to provide SDRs, and the Fund therefore had to have discretion.

The staff representative from the World Bank recalled that ever since the Fund staff had broached the issue with the staff of the World Bank, the first and foremost concern had been to design an agreement that would strictly separate the resources to be placed with the World Bank from the normal resources that the Bank borrowed in the official or private markets. The staff of the World Bank had taken considerable time, both on the legal as well as on the accounting and financial management aspects, to work out an arrangement having that objective in mind. The World Bank viewed itself strictly as a vehicle to provide a service that would assist the Supplementary Financing Facility Subsidy Account to earn slightly higher yields. In that connection, he wished to mention that the proposal to the Executive Directors of the World Bank on the investment arrangement referred to the financial impact and the liability of the World Bank in the following words:

> The Bank would not be exposed to exchange risk nor to financial risk by the arrangement contemplated under the proposed agreement. Dollars could be received by the investment account only if and to the extent the Fund had arranged for the sale of such dollars in exchange for SDRs. The Bank's obligations to repay would be denominated in SDRs and would always be equal to the SDRs held by the Bank in the subaccount at the IMF. The Bank would be an investment vehicle for the Subsidy Account by permitting these resources access to official SDR rates. Therefore, these transactions would not be viewed as borrowings. They would be accounted for in the balance sheet of the Bank, and therefore there would be no impact on the Bank's lending rate or earnings.

Similarly, there would be no impact on the Bank's liquidity.

There was precedent for such arrangements in the trust agreements and management agreements that the World Bank had with a number of institutions, mostly in the U.N. family, the staff representative added. In addition, the World Bank had specific agreements with IFC and IDA in particular.

Finally, the staff representative from the World Bank confirmed that the out-of-pocket expenses were minimal.

The Chairman observed that the World Bank had indeed been most cooperative in setting up the investment arrangement, for which it had no need itself. The Bank was rendering a service for which the Fund was grateful. The arrangement had its origin in the curious inability of the Subsidy Account to hold SDRs, a legal constraint that necessitated the use of more complicated channels for investment.

It had always been made clear to the BIS that, if the Fund were not satisfied by the rate of interest offered by the BIS, it would seek alternative arrangements, including possibly market investments, the Chairman noted. Nothing in the Instrument would prevent the Fund from doing so, and he would not hesitate to bring a proposal before the Executive Board if a better investment opportunity could be found. So far, the arrangements with the BIS had been satisfactory and had operated efficiently.

The staff would take up the matter raised by Mr. Ismael on the question of special charges that had been levied in respect of unpaid charges in relation to the supplementary amounts earned on the investment of withheld subsidy payments.

The Executive Board then took the following decisions:

Supplementary Financing Facility Subsidy Account

(a) Investment

Decision No. 6854-(81/78) SBS (5/8/81) shall be amended to read:

The Managing Director shall place in deposits, denominated in SDRs, with the Bank for International Settlements, or in investments in a call account, denominated in SDRs, with the International Bank for Reconstruction and Development, the currencies received by the SFF Subsidy Account, unless the Managing Director considers that the terms offered are not sufficiently attractive. In that event, the Managing Director shall inform the Executive Board promptly and make other proposals to it for investment in SDR-denominated obligations.

Decision No. 8184-(86/9) SBS, adopted
January 15, 1986

(b) Means of Subsidy Payments

Subsidy payments made after the effective date of this Decision with respect to charges paid on holdings of currency referred to in Section 7 of the Instrument establishing the SFF Subsidy Account may be made, at the discretion of the Fund, in SDRs to beneficiaries agreeing to receive them, or in U.S. dollars, or in a combination of these two assets. Subsidy payments in U.S. dollars shall be made on the basis of the SDR/U.S. dollar exchange rate in effect three business days before the payment date.

Decision No. 8185-(86/9) SBS/S, adopted
January 15, 1986

(c) Use of SDRs in Subsidy Payments

In accordance with Article XIX, Section 2(c), the Fund prescribes that:

1. A prescribed holder, by agreement with a participant, may transfer SDRs to the participant in discharge of subsidy payable from the Supplementary Financing Facility Subsidy Account, at the instruction of the Fund as Trustee of that Account.

2. The Fund shall record operations pursuant to this prescription in accordance with Rule P-9.

Decision No. 8186-(86/9) SBS/S, adopted
January 15, 1986

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/8 (1/13/86) and EBM/86/9 (1/15/86).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/9 (1/10/86) and EBAP/86/11 (1/13/86) is approved.

APPROVED: September 10, 1986

LEO VAN HOUTVEN
Secretary