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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/92

10:00 a.m., September 25, 1995

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Executive Board Attendance

M. Camdessus, Chairman

Executive Directors

M.-A. Autheman
J. Bergo
L. E. Berrizbeitia

I. Clark

H. Evans
K. P. Geethakrishnan
J. E. Ismael
D. Kaeser

W. Kiekens

G. Lanciotti

K. Lissakers
H. Mesaki

S. Schoenberg
A. S. Shaalan
D. V. Tulin
E. L. Waterman
J. de Beaufort Wijnholds

Alternate Executive Directors

A. A. Al-Tuwaijri
P. Cailleteau, Temporary
E. Srejber
V. J. Fernández
A. Galicia, Temporary

D. Z. Guti
P. A. Akatu, Temporary

W. Hettiarachchi
L. M. Cheong
R. F. Cippa, Temporary
A. Calderón
G. P. Ramdas, Temporary
J. Prader
J. Hamilius, Temporary
H. A. Barro Chambrier
D. Saha, Temporary
N. Coumbis
J. C. Martinez Oliva, Temporary
B. S. Newman

M. Daïri
A. G. Zoccali
B. Esdar
Y. Y. Mohammed
V. Verjbitski, Temporary
J.-H. Kang

Wei B.

L. Van Houtven, Secretary and Counsellor
A. Mountford, Acting Secretary
S. Bhatia, Assistant
S. W. Tenney, Assistant

Also Present

European I Department: M. Russo, Director. External Relations Department: S. J. Anjaria, Director; M. E. Hansen, D. Hawley, C. Hellemaa. Fiscal Affairs Department: M. Sakaguchi. The IMF Institute: S. El-Khouri. Legal Department: F. P. Gianviti, General Counsel; R. H. Munzberg, Deputy General Counsel. Middle Eastern Department: K. Enders. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; N. L. Happe, A. K. McGuirk. Research Department: M. Mussa, Economic Counsellor and Director of Research; P. R. Masson. Secretary's Department: W. S. Tseng. Treasurer's Department: D. Williams, Treasurer; D. Gupta, Deputy Treasurer; G. Wittich, Deputy Treasurer; Y. Atsumi, J. C. Berrigan, J. E. Blalock, J. C. Corr, E. Decarli, L. U. Ecevit, R. H. Floyd, D. M. Hicks, K. M. Kenney, M. Papaioannou, O. Roncesvalles, G. S. Tavlas, T. M. Tran, K. A. Westin. Office of the Managing Director: S. Sugisaki, Special Advisor; G. R. Saunders, Personal Assistant; J. Quick, Personal Assistant Designate. Advisors to Executive Directors: J. M. Abbott, B. Andersen, S. K. Fayyad, R. Kannan, T. Oya, R. Rainford, R. von Kleist. Assistants to Executive Directors: S. Al-Huseini, A. G. Cathcart, A. L. Coronel, C. Duenwald, S. Fukushima, C. M. Gonzalez, A. Guennewich, O. Himani, G. H. Huisman, P. Jilek, W. C. Keller, A. M. Koulizade, T.-M. Kudiwu, N. Laframboise, Ng C. S., J. Pesola, S. Rouai, F. A. Schilthuis, S. Simonsen, Song J., Y. Tahara, V. Trivedi, Zheng H., Zubir bin Abdullah

1. GENERAL ARRANGEMENTS TO BORROW - POSSIBLE ENLARGEMENT - FURTHER CONSIDERATION; ESTABLISHMENT OF SUPPLEMENTARY LINES OF CREDIT; AND LIQUIDITY POSITION AND FINANCING NEEDS - REVIEW

The Executive Directors considered a staff paper on possible enlargement of the General Arrangements to Borrow (EBS/95/117, 7/14/95) together with an aide-mémoire on the establishment of supplementary lines of credit (EBS/95/129, 8/2/95), and a staff paper on the Fund's liquidity position and financing needs (EBS/95/152, 9/11/95).

The Treasurer made the following statement:

The Economic Counsellor and I attended the meeting of the Deputies of the Group of Ten in Rome on September 21, 1995. There were a number of items on the Agenda--the draft study on saving, investment, and real interest rates, and reports on work in progress on the resolution of sovereign liquidity crises and on issues of financial markets stability in response to the Halifax communiqué, as well as increasing General Arrangements to Borrow (GAB) resources. This staff report to Directors, however, will deal only with the discussion on the possible increase of the resources currently available under the GAB as it has a direct bearing on today's agenda. Directors representing countries or institutions comprising the G-10 are also likely to comment on this issue.

The discussion on the possible enlargement of the GAB stems from the recent Halifax summit of the G-7 that asked "the G-10 and other countries with the capacity to support the system to develop financing arrangements with the objective of doubling as soon as possible the amount currently available under the GAB to respond to financial emergencies." You will also recall that the Interim Committee communiqué of last April "saw a need to examine the issues related to borrowing from Fund members, and in particular the role of the GAB."

The Deputies, at their meeting in July 1995, requested a report which would outline various approaches to doubling the resources under the GAB to be prepared by a technical group under the direction of Mr. Thomas Bernes, Assistant Deputy Minister of Finance of Canada. This group met in Toronto on July 18 and in Basle on September 13, 1995. The report of the technical or working group was focused mainly on:

(1) the institutional arrangements that could be considered in order to best achieve a doubling of resources currently available under the GAB to SDR 34 billion--a number of options were considered in its final report;

(2) the conditions for participation by potential new lenders--including the incentives for participation, and the eligibility criteria that should be used to identify potential participants; and

(3) what I might summarize as "constitutional" issues--for example, activation procedures, the possible voting procedures, the treatment of participants and nonparticipants, and the relationship of any new arrangements with the GAB itself.

In view of the relatively large number of options and other issues presented in the report of the technical or working group, the Chairman prepared a short note in which he presented a number of elements which he hoped could constitute the basis for a compromise proposal. It was intended that such a document would focus discussion by the Deputies at their meeting in Rome.

The Chairman's note contained a number of broad principles which were generally accepted by the Deputies:

First, the enlargement of the GAB is not a substitute for a quota increase and should not impinge or impair discussion on the Eleventh General Review;

Second, a new parallel arrangement would be created to complement the GAB financed by G-10 and selected non-G-10 countries;

Third, along with existing participants of the GAB, countries with the financial capacity would be invited to contribute to the new arrangements so as to effectively double the resources now available under the GAB;

Fourth, the existing membership structure and the existing modalities of the GAB will be maintained intact. Countries joining a new lending arrangement would be invited to participate in discussions with G-10 colleagues only for the purpose of activating the arrangement. They would not participate in other fora of the G-10--WP3, BIS, and other G-10 meetings on nonactivation issues;

Fifth, the criteria for activation of the present GAB should be maintained unchanged except that consideration might be given to harmonize the liquidity criteria in paragraphs 6 and 21(b) of the present GAB Decision. The liquidity conditions would be equally applicable for activation of the new facility, which would also maintain the distinction between participants and nonparticipants as regards activation;

Sixth, voting shares would be linked to Fund quotas, but the new arrangement could have the same voting structure of the GAB;

Seventh, there would be limited provisions for opting out;

Eighth, while it was hoped to have 10-15 new participants and broad geographical participation in the new parallel arrangement, the formal establishment of such an arrangement would depend on achieving a "critical mass" of non-G-10 participants. New adherents could be considered in the future with the agreement of a "significant majority" of participating members (this is different from the current GAB which requires unanimity as well as the agreement of the Fund). Lastly, there should be no formal linkage between the emergency financing mechanism (EFM) and the proposed new lending arrangement.

The Deputies generally accepted these elements as a basis for discussion and, mostly, achieved broad agreement on them. Their discussion focused on four main aspects:

(1) the concept of the new parallel lending arrangement which would complement the existing GAB;

(2) the relationship between the GAB and the new arrangement, especially as regards activation procedures;

(3) the criteria for eligibility; and

(4) procedural issues, including the method of approaching potential participants and the presentation of a Report on the meeting of the Deputies to the Ministers and Governors of the G-10 at their meeting on October 8.

Let me briefly summarize what I believe to be the outcome of the discussion on each of these four points, while also noting that on almost each point there were nuances of differences among the Deputies:

First, the structure of the new lending arrangement would be a "parallel arrangement" to complement the GAB, which would itself be maintained intact. The concept of the parallel arrangement was not defined precisely, in part to leave room for new participants to express their own ideas regarding the modalities of possible association. It was generally agreed that the form of the new arrangement would not be put as a proposal to possible new participants, but it was understood by the Deputies that potential lenders would be talked to in practice on the following features: the G-10 and selected non-G-10 countries would participate in the new parallel arrangement on a "comparable basis"--that is, each country would vote separately on the basis of their contributions.

Furthermore, in the case of activation, the arrangement would guarantee non-G-10 countries a "seat at the table" with G-10 colleagues--but, as noted above, only for the purposes of activating the arrangement. The activation procedures of the new arrangement would be separate from the GAB activation arrangements. It was also agreed that the results of the talks with potential lenders would be reported back to the Deputies.

Second, as regards the relationship between the activation procedures for the GAB and the new arrangement, there was considerable, but not complete, support for the proposition that while the existing GAB could be activated without activating the new parallel arrangements, it would be "in the spirit of the exercise" that activation of the new arrangement would be accompanied by an activation of the existing GAB. The Deputies agreed that it was important to retain flexibility on this matter and the issue was not definitively resolved by the Deputies on this occasion.

Third, as regards the criteria for eligibility of new potential lenders, the Deputies emphasized the need to include only relatively long-term creditor countries, those that pursued sound fiscal and monetary policies, which were not eligible for concessional assistance from IDA or the enhanced structural adjustment facility (ESAF), did not have outstanding indebtedness to the Fund, and were not large-scale borrowers from the international capital markets. In practice, the Deputies considered, with certain exclusions, the illustrative list of countries included in Table 4 of the staff's paper on the GAB and which was discussed by the Executive Board at the end of July. However, the Deputies agreed not to select at that time any specific countries which would be approached as regards their participation in the new arrangement, but would leave the issue of which specific countries to approach, at least in the first instance, to the intermediaries of the G-10 who would be assigned the task of talking with potential participants. There was no discussion by the Deputies regarding the possible size of individual contributions in the new arrangement nor was there discussion on the principles for distributing the SDR 17 billion that would be needed to double the size of the GAB. However, as mentioned earlier, there was general agreement that a "critical mass" of non-G-10 participation would be needed to establish a new parallel arrangement and consideration had been given in the technical group that the new arrangement would be conditional on at least six non-G-10 countries participating for an amount of at least SDR 3 billion.

Lastly, on procedures. The Chairman of the Deputies will make an oral report of the discussions in Rome to Ministers and Governors at their meeting on October 8, 1995. If the Ministers agree, two intermediaries--the Deputies proposed Mr. Bernes, Chairman of the Technical Group, and the Chairman of the Paris Club--would talk to some of the strongest creditors about participating in the new parallel arrangement. The Deputies would receive a report from the intermediaries at their next meeting in Paris on December 13, 1995.

Mr. Clark made the following statement:

The staff proposal for supplementary lines of credit is, as you know, one of several possible models for enhancing the existing GAB resources available to the Fund. Among the notable features of the proposal are that this facility would be:

independent of the GAB but have similar lending terms;

complementary to the Fund's resources in exceptional circumstances and activated to meet large scale balance of payments needs of members;

open to all members with an active rotation based on the participation criteria used for the operational budget; and,

require consultation with the Interim Committee for activation, which would require a simple majority vote of the Board.

I must admit that I have several reservations about the viability of this proposal. The broad base of the voting group relative to the lending group is troublesome, particularly since only a simple majority vote is required. It is a window for free-riding. Members with no potential liability to the Fund under the arrangement (and possibly with something to gain directly from a loan to another member) would be able to vote on activation. The voting group and lending group should be the same and it should include only those that are able and willing to put significant resources at risk to maintain stability in the global financial system.

The Board does recognize, I believe, that the activation requirements under any new arrangement will likely be different than those under the existing GAB. I was unclear, however, as to how the arrangement would balance the principle that it is the lender who decides whether or not to lend with the right of the borrower to draw on any approved standby credit line, given that the activation conditions are satisfied. I presume that the assessment of whether or not these activation conditions are met would be the task of the Board. What, then, would be the task of the Interim Committee? Also, financial program changes generally require a substantial voting majority of the Board--70 percent or, in some cases, 85 percent. Why only a simple majority in this case? While I would certainly agree that the Governors of the financing group should be consulted about any potential draws on their commitments, I also believe that the consultation should reflect the fact that the Board agrees substantially with the management's proposal to incur such an extraordinary liability.

Finally, I have some concerns with the rotational nature of the lending group. It seems somewhat cumbersome, which could lead to administrative confusion and to a potentially slow response. It would also result in unnecessary uncertainty about the actual availability of resources since some members may be willing but unable to meet their commitment at the time they are rotated into the group.

While there are clearly some merits to the proposal, the quota-related nature of the commitment and the prospect of broad-based support for example, the proposal's severe drawbacks cannot be ignored. An overview of other proposals, possibly with some of the features of this proposal, should be considered. The concept of a new facility, independent of the existing GAB, which would include GAB as well as non-GAB members is an attractive feature and should be seriously considered in the context of other models.

I will be brief in my comments, on the estimates of the Fund's liquidity position and financing needs over the next couple of years. The estimates are prepared, as usual, under very conservative assumptions such as full drawings on commitments and no early repayments or new arrears. I agree with this approach. However, I also recognize that the sharp deterioration in the liquidity ratio in 1995 and 1996 largely reflects the exceptional circumstances involved in the Mexico program along with the rising demand from transition economies.

Even though the liquidity ratio is projected to fall from its current level of about 105 percent to 97 percent by year-end, and then steadily down to 61 percent by 1997, it is still far above the levels that have preceded past quota increases. There are also exceptional conditions associated with the Mexican program that "cushion" this downtrend. Most notably, the ongoing restabilization of private capital markets and capital inflows to developing countries in general, and Mexico in particular, suggest that the full amount of the Mexican stand-by arrangement may not be drawn. Indeed, with the private market refinancing of tesobonos improving and Mexico's successful re-entry into international capital markets in recent months, there is even a prospect of early repayment of some of the outstanding credit. The staff report indicates that a one billion SDR reduction in projected purchases could raise the liquidity ratio by as much as

4 percentage points, which would move the ratio substantially closer to its long-run average of 70 percent.

I would note as well that, because of the very conservative assumptions, the projections have historically overestimated the demand for credit and underestimated the liquidity ratio. The latter is also likely due to the 20 percent adjustment ratio designed to create an implicit liquidity reserve of unusable resources. One, of course, cannot count on the overestimation to be significant in any given year, but it does represent a built-in bias to the estimation procedure that must be taken into account when considering projected trends in the ratio. In this case, the bias should not affect the direction of the trend, which will undoubtedly be downward, but could affect the size of the reduction relative to the long-run average.

With regard to financing, the downward trend in the liquidity ratio does illustrate the need to consider seriously the Fund's resource position in light of the eleventh annual quota review. However, the fact that the ratio is still relatively close to its long-run average, and is even likely to be closer than projected, suggests that there is no extraordinary urgency in pursuing the quota assessments and that the deliberations should be careful and reasoned.

There is also the issue of the GAB enhancement, which we will discuss today, as an extraordinary source of liquidity to the Fund. Progress on this issue will provide an additional cushion for the downtrend in the liquidity ratio.

Finally, I will end with the note that closer surveillance activities can also reduce pressure on the liquidity ratio. An effective early warning system will allow the Fund and the members to more quickly spot potential problems. Appropriate policy action in this situation may be able to reduce, or even eliminate on occasion, a demand for Fund credit that might otherwise exist. The benefits of this process are, however, unlikely to be achieved over the current forecast horizon and will be difficult to quantify even over a longer-term.

Extending his remarks, Mr. Clark said that the G-10 Deputies did not have a detailed blueprint for increasing the resources of the General Arrangements to Borrow. They had only just begun to consider and discuss the issue. There was broad agreement on the following points: first, it would be appropriate to double the resources available under the Arrangements; second, the changes in the borrowing arrangements should not affect a quota increase; and third, the new borrowing arrangements should involve participation by a defined group of countries with a capacity to support the international system. For that reason, among others, the

G-10 Deputies were not in favor of the Fund staff's proposal to establish supplementary lines of credit. The Deputies hoped that the discussions between Mr. Bernes and Mr. Noyer and potential participants would lead to more detailed proposals that would be discussed by the G-10 Deputies on December 13. They also hoped that substantial progress would be made by the time of the spring 1996 meetings of the G-10 Minsters and of the Interim Committee.

Ms. Lissakers made the following statement:

I would like to comment briefly on each of the three issues before us today.

We recognize that efforts to forecast the Fund's liquidity and financing needs beyond a very short period are extremely difficult given the uncertainties about the demand and supply of Fund resources. Experience suggests that the Fund's financial position can fluctuate widely, up and down, due to unexpected large programs, such as Mexico, or early repurchases. However, the Executive Board needs a clear sense of possible future trends because of the implications for the timing and possible size of a future quota increase and the need to mobilize supplementary lines of credit.

To this end, we have some questions for the staff regarding the latest projections to end-1997.

First, we welcome the use of probabilities in assessing potential demand and the indication of the geographic distribution of outstanding Fund credit in the out-years. It would be useful, however, if the Board could have some sense of the probabilities, possibly on a weighted average basis, for each category and the assumptions regarding average size of programs in each area.

Second, the sharp increase in demand in 1995 largely reflects the extraordinary financing provided to Mexico to deal with a potential threat to the stability of the system. Do the staff's projections include other cases which might fall into the same category?

Third, the staff's projected supply of resources assumed that scheduled repayments are made. In recent years, however, early repurchases have played an important role in strengthening Fund liquidity. Has consideration been given to encouraging additional early repurchases from countries in a position to do so?

Fourth, the staff has made the usual downward adjustment of 20 percent for working balance purposes and to take account of the possibility that some currencies may become unusable. It is not clear, however, what purpose this adjustment really serves as members are required to transfer funds under their quotas within two or three business days to finance drawings and the Fund maintains cash accounts with its fiscal agents to handle administrative expenses. Moreover, the traditional 70 percent trigger point for possible quota increases would appear to serve the same functions as the adjustment factor with regard to the availability of usable currencies.

Fifth, the ability of the Fund to make efficient use of the currencies in the operational budget is constrained by longstanding practices which distribute the financing in proportion to a member's reserves, except the United States, which is allocated a fixed proportion of the budget. Has the staff considered a more flexible approach that would permit larger use of currencies in greater supply by, for example, taking account of the issuers' access to capital markets as well as its actual reserve holdings?

Finally, the staff's projections conclude at end-1997. However, the recent exceptional demand for The Fund resources by a relatively few countries will result in substantial repurchases beginning in 1998, just beyond the staff's projection horizon. We would be interested in knowing the repurchases scheduled to take place in 1998 and the implications for the liquidity ratio.

As stated in our previous discussion, this chair continues to believe that the Fund's permanent quota resources should remain the principal means of addressing members' needs for official financing to deal with temporary balance of payments problems and that the Eleventh General Review of Quotas should be concluded in a timely manner based on the work program that the Board has initiated. Nevertheless, borrowing continues to be a useful means of supplementing the Fund's quota resources to respond to exceptional circumstances.

In this context, our view on the staff's proposals to establish supplementary lines of credit with all members are the same as in our earlier meetings. We do not believe it is necessary or desirable to create entirely new arrangements. Moreover, general lines of credit that are based on quotas and with calls based on the Fund's operational currency budget are virtually indistinguishable from a quota increase. As such, they would seriously undermine support for and the feasibility of successful completion of the Eleventh General Review of Quotas and runs contrary to the need for a clearly defined group of creditors that can provide resources quickly.

At our earlier meeting, a broad consensus emerged that the resources currently available under the General Arrangements to Borrow should be doubled, that additional countries were in a position to participate in this augmentation in view of their expanded role in the world economy, and that the existing GAB should be retained. We would hope that these conclusions could be reported to the Interim Committee.

Clearly, there are many issues that must still be resolved, as the Treasurer and Mr. Clark noted. The outcome will need to take account of the legitimate interests of both existing and new participants. The process of consultation and negotiations is, however, at an early stage. It is therefore premature to conclude which, if any, of the options under consideration will meet the needs of all concerned. We therefore look forward to the successful conclusion of the consultations about to be initiated by the Canadian and French Deputies with potential new participants.

Mr. Ismael made the following statement:

The Fund's financial position has somewhat deteriorated since the last review six months ago. While the stock of usable resources has declined by 7 percent at end-August from end-February, the actual resources available (that is, after excluding undrawn balances already committed, as well as the adjustment factor) has declined by 23 percent over the same six-month period. In addition, although the Fund's liquidity ratio for 1995 is now expected to be slightly higher at (97.2 percent), the projections for 1996 and 1997 indicate that the ratio is now expected to decline faster in 1996 and 1997. This situation could worsen if the staff undertake, as I think they should, a more conservative approach in projecting the demand for Fund credit. At any rate, the staff admitted that projections for 1997 are underestimated (EBS/95/152, page 5, paragraph 2). This underestimation is quite glaring when demand for credit is being halved in 1996 and further halved again in 1997 (from SDR 22.6 billion at end August 1995 to only SDR 10.1 billion at end 1996 and SDR 5.2 billion at end 1997).

In addition, it is important to include shortfalls for estimates on both the demand and supply side. Just as there is an adjustment factor built into estimates of Fund's usable resources, similar adjustment should be included in estimating the demand side, in order to take into account unforseen sudden demand for fund credit. This will provide a more realistic projection of Fund's financial needs.

Given this scenario and the need for the Fund to have adequate resources at all times, early decisions on quota increases is required. Past experience has shown that decisions on quota increases take time. Nevertheless, the process can be accelerated if the political will to deal with the issue expeditiously is mustard. Member countries could demonstrate the political will to effect quota increases quickly for these reasons:

First, an expanded GAB, while useful, cannot be the absolute interim measure. Negotiations for a new expanded GAB will not necessarily be less time consuming than that for quotas. Furthermore, recent discussions indicate that recourse to the GAB will be limited to special circumstances and it will not be utilized to meet the standard Fund credit requirement. Directors also pointed out that the complex procedures of assessing credit under the current GAB will make its access almost impossible to Fund members, especially to nonparticipants of the GAB.

Second, activation of supplementary credit lines would provide the perfect excuse for delays in quota increases. Furthermore, countries already participating in the GAB may find it difficult to also subscribe to the credit lines. More significant, for all intents and purposes, less than SDR 4.2 billion can be practically obtained from the proposed supplementary credit lines at any one time, as only countries with strong external positions will really be considered. Again, the lending countries' status changes according to their balance of payments positions, so that the absolute amount of resources under the supplementary credit lines cannot be guaranteed as forthcoming.

Mr. Waterman stressed that it was very important that the Fund's liquidity be adequate to meet potential demand. In that context, he strongly supported a quota increase. However, he considered that the staff's estimates of the Fund's liquidity position were somewhat pessimistic, as the staff had assumed that Mexico would be drawing the full amount of resources committed. Furthermore, the liquidity position would improve after 1997, when a number of countries to whom large amounts of Fund resources had been committed would be making repurchases.

Mr. Evans asked whether the staff had assumed that Mexico would be drawing the full amount of resources committed under the stand-by arrangement.

The Treasurer remarked that, for the period up to 1997, the staff had assumed that countries would be making repurchases as scheduled; in some cases the staff had been informed that certain countries with Fund-supported programs would be making advanced repurchases and that had been factored into the projections. Chile was one of the countries that had recently made repurchases ahead of schedule. The staff had not made projections for the period beyond 1997 because it was very difficult to judge the level of demand for Fund resources beyond the next few years. The staff's preliminary estimates indicated that demand would drop off markedly in 1997, but it was possible that those projections were underestimating demand for Fund resources.

The Economic Counsellor observed that the staff projections of demand for Fund resources included the amounts committed to Mexico.

The Treasurer added that, in estimating the Fund's liquidity position for the coming period, the staff had assumed that Mexico would draw the full amount of resources committed.

Mr. Wijnholds made the following statement:

> The staff's projection for the liquidity ratio in the coming years is a cause for concern. The sharp fall in the ratio in the beginning of this year, due to a large increase in undrawn balances (reflecting Fund arrangements for Mexico, Argentina, Russia and Ukraine), is projected to result in a liquidity ratio of 61 percent at the end of 1997. My authorities and I consider this to be uncomfortably low. Moreover, as the staff rightly points out, the projections are subject to considerable uncertainties. It is, for instance, assumed that no new financing facilities will be established during the projection period. However, while not constituting a new facility, Fund financing for currency stabilization funds could certainly have a significant impact on the Fund's liquidity position. Were another Mexico-type crisis to occur with use of Fund resources under the exceptional circumstances clause, a further substantial erosion of the Fund's liquidity position could result. Some colleagues have pointed to the possibility that the situation could improve after 1997. However, since the uncertainties for the outlying years are greater, I would prefer to err on the side of caution and not rely too much on the possibility of early repurchases.
>
> The obvious conclusion to be drawn from these trends and uncertainties is that there is a clear need for a fundamental strengthening of the Fund's financial position. Therefore, I would again emphasize the importance of an early agreement on the Eleventh Quota Review, so that an actual quota increase can occur in preferably two or, at most, three years. Keeping in mind the uncertainties that I mentioned earlier, I believe it is not a luxury to aim for a comfortable level for the liquidity ratio. A modest overall increase in quotas of, say 25 percent, would not achieve this goal. We should, therefore, aim at bringing about a substantial increase in quotas, which I would specify meaning an increase of at least 60 percent.
>
> On the GAB, I refer to the statements by the Treasurer and Mr. Clark and note that the process for doubling and renewing the arrangement is now solidly under way.

The Chairman stated that in order for the Fund's resources to be at the level they had been in the early 1990s, as a proportion of the world economy, the Fund's quota-based resources would have to increase by 60 percent, and for them to be at the same level as they had been in the early 1980s, the resources would have to increase by 70 percent. He wondered whether, in light of the remarkable changes in global financial markets, it was necessary for the Fund's resources to be even stronger in the coming period than in earlier periods.

Mr. Wijnholds emphasized that he considered that, at a minimum, the Fund's quota-based resources should increase by 60 percent, but he could support a larger increase. However, he was not convinced that the Fund's resources should increase in line with the growth of the world economy. He supported an early conclusion of the Eleventh General Review of Quotas, as well as a doubling of the resources of the General Arrangements to Borrow.

Mr. Shaalan made the following statement:

We note that, on current projections, the liquidity ratio will fall to somewhat below its long-run average of 70 percent by the end of 1996. While this may not be a cause for alarm, it strongly suggests that we can ill afford being too sanguine about the adequacy of the Fund's financial resources over the medium term and beyond. The liquidity ratio did on past occasions fall considerably below the long run average. But, as noted by the staff, this typically occurred at times when there was an expectation of an imminent quota increase and when the Fund was engaged in large-scale borrowing to supplement its ordinary resources.

The staff paper contains tentative projections on resource commitments in 1997. On the basis of these projections, the liquidity ratio is expected to decline to 61 percent by year's end. I submit that this may be viewed as not too alarming. However, such a judgment would, in my view, be inevitably based on an unduly optimistic assumption of what might be expected to happen after 1997. While optimism is not always or necessarily at variance with realism, I believe it would be imprudent to view Mexico's financial crisis as an isolated historical accident.

To be sure, the increased integration and globalization of capital markets in recent years has brought about considerable benefits to the world economy. But, it should be kept in mind that a substantial segment of the membership still has little or no access to the capital markets, and many of the members with access cannot count on the continued availability of private financing, certainly not on reasonable terms, at times of serious balance of payments difficulties. Moreover, official bilateral assistance is on the decline. In such circumstances, and given the increased scope for contagion effects, it is especially important that the Fund's ability to provide adequate financing in support of appropriate policies must always be fully assured.

Ensuring that the Fund has at its disposal adequate financial resources to respond effectively to members' balance of payments financing needs requires, first and foremost, an adequate availability of ordinary resources. After all, the Fund is, and it should continue to be, a quota-based institution. The use of borrowed resources, whether in the context of the GAB or other borrowing arrangements, is not, and it should not be seen as being, inconsistent with this important principle.

Accordingly, we hope that the effort currently under way to enlarge the GAB will soon come to a successful conclusion. But, in addition to the question of the size of the GAB, there are also important issues related to the extent to which the resources available under these arrangements are readily usable. In this connection, I wish to simply reiterate the views expressed by this Chair at EBM/95/72 regarding the desirability of simplifying the activation procedures and making them more directly focused on the Executive Board. I hope I am wrong, but I have the feeling that the Treasurer's report with regard to procedures does not seem to be very encouraging.

Finally, the approach suggested by the staff regarding the possibility of establishing supplementary lines of credit would seem to provide a reasonable framework within which the effort in this area may be pursued.

Mr. Mesaki made the following statement:

First of all, I would like to touch upon the Fund's liquidity and financing needs. As a result of the staff's analysis, the staff has revised down its projection of the Fund's liquidity ratio to 68.5 percent in 1996, which is below the long-term average, and it is expected to fall to 61 percent in 1997. The staff notes that there are a number of uncertainties surrounding the projection of both demand for, and supply of, the Fund's usable resources. In view of the possibility that there might be a sudden large-scale demand for resources or that the Fund might establish new facilities, it seems to me that there are more negative factors that might lead to a decrease in the liquidity ratio than there are positive factors. The staff suggests that this result supports the necessity to strengthen the Fund's financial base through a timely conclusion of the Eleventh General Review of Quotas. I fully share this view. In light of the uncertainty surrounding the future level of the liquidity ratio, we need to continue to monitor the ratio closely.

Let me turn now to the discussion of the GAB and supplementary lines of credit. This chair's basic position on the GAB has not changed since the last Board meeting. I believe that it is crucial to reach an agreement as soon as possible on doubling the amount currently available under the GAB, with the participation of non-G-10 countries. I also believe that, in order to facilitate wide-ranging participation of non-G-10 countries, utmost importance should be attached to providing appropriate incentives to the potential participants to join the new GAB.

With regard to supplementary lines of credit for the Fund proposed by the staff, I would echo Mr. Clark's comment. In addition to the reasons provided by other Directors, I would like to add one comment. As I just mentioned, incentives are important. The proposed supplementary lines of credit do not appear to offer sufficient incentives to potential participants to join the proposed arrangement. In other words, the proposed arrangement does not have the mutual assistance aspect that the GAB has. In conclusion, I hope that the discussions between the G-10 and potential additional countries would lead to a more concrete agreement as soon as possible.

Mr. Kaeser made the following statement:

The current review shows that the liquidity ratio will fall close to its long run average by the end of 1996. Not only have projected commitments for 1995-96 been increased by 15 percent, but also the possibilities of unforeseen demand for Fund resources stemming from liquidity crises, exchange rate stabilization, and post conflict situations, have to be taken into account.

However, when considering the potential demands ensuing from such possible extensions of Fund involvement, we should remember that the amounts in these cases will not be comparable to the exceptional support given in the case of Mexico. Furthermore, the liquidity ratio could be positively influenced by early repurchases, as in the case of Poland. This is why the liquidity ratio should be carefully monitored.

The current discussions on the enlargement of the GAB and the initiation of work on the Eleventh General Review of Quotas demonstrate the willingness of members to proceed with the strengthening of the Fund's financial basis. The statement made by Mr. Wijnholds and other speakers suggest that a wide consensus might be reached quite soon on a quota increase of unprecedented size. However, the willingness to strengthen the liquidity position should remain in line with the core tasks of our institution and not prevent a realistic assessment of the risks involved in broadening the scope of Fund support, especially as regards financing of emergency situations.

Following up on the request formulated in the communiqué of the G-7 Halifax summit, G-10 deputies are actively discussing various options on how to best achieve a substantial increase of the resources currently available under the borrowing agreement. It is certainly in our interest to make sure that the Fund has the capacity to respond effectively and efficiently to major international crises with systemic risks and to ensure that the stability of the international financial system is not endangered. However, we would like to reiterate that although an adjustment of the Fund's borrowing capacity appears necessary, we do not think that the need to double the resources has been fully demonstrated.

We are ready to join a broad G-10 consensus according to which the present GAB would be maintained and a new parallel arrangement would be created to complement the GAB. The new arrangement would be financed by G-10 and selected non-G-10 countries. But much remains to be done to sort out and to finalize the rules of activation, the voting procedures and the relations between the GAB and the new borrowing arrangement. Needless to say, this arrangement will have to take into account the view of the non-G-10 countries willing to participate.

The fact that we favor a new formal borrowing arrangement shows that we are not supporting the idea of supplementary lines of credit for the Fund. This represents a solution that is elegant by its simplicity and straightforwardness. But it looks too much like a "self-service" facility. The relatively easy access to the supplementary credit lines could change the basic character of the Fund from a quota-based institution to one relying on borrowed resources.

Second, the Fund's borrowing capacity under supplementary credit lines would probably be less reliable than the one that would be based on a formal borrowing arrangement entered upon with a well-defined group of members with a durably good track record, long-lasting strong external position, large reserve assets, and a credit status with the Fund. The supplementary credit lines would behave like the vapor, which would come out of the jar in good weather and disappear in the jar in the wake of a systemic crisis. Furthermore, it would be questionable to list as creditors ready to lend money to the Fund at market-conditions countries that finance themselves fully or partly on concessional terms.

Third, if they have to provide the Fund an amount of resources going beyond their quota-based obligations, the creditors and the creditors only, should decide in the last resort upon the activation of a borrowing agreement. A consultation of the Interim Committee does not represent an appropriate substitute for a decision, which in all financial matters belongs to the creditors.

Mr. Lanciotti made the following statement:

Under the current access policy, the staff projects significant declines in the liquidity ratio, falling to 97 percent by the end of 1995, and to 69 percent by the end of 1996. For 1997, although the reliability of the estimates is understandably much lower, the ratio should continue to fall, reaching the level of 61 percent, considerably below the long-run average of 70 percent

The staff correctly points out that at other times in the past the liquidity ratio has fallen below 70 percent, and that this generally has occurred in the proximity to a general quota increase, as it is in the present circumstances. For instance, the ratio fell to 34 percent just before the seventh general quota increase.

I would refrain, however, from an excessive reliance on comparisons with past experiences, in view of the significant changes that have occurred in the international financial markets, especially in terms of increased volatility and speed of capital movements. In this light, a low liquidity ratio is more worrisome today than it would have been ten years ago.

The decline in the liquidity ratio is due both to a decline in the supply of usable resources and a higher demand for Fund credit. The former is, by and large, what was estimated at last March's review (see Table 2 in EBS/95/29). On the contrary, we seriously underestimated the demand for Fund credit. In fact, leaving aside the year 1997, which remains highly uncertain, and taking together the years 1995 and 1996, demand is projected to be higher than previously expected by SDR 4.4 billion (15 percent).

This being said, let me comment very briefly on the factors behind the higher demand for credit. One third of the projected increase is due solely to the augmentation of the arrangement for Argentina. The remaining two-thirds reflect both new possible arrangements and an increase in the probability of arrangements being completed. This implies that a larger number of countries, especially transition economies, will be able to meet the conditions to access the resources of the General Resources Account (GRA), which is a welcome development.

In conclusion, it remains that the decline in the liquidity position is to be carefully monitored. Indeed, the uncertainty about future supply and demand of Fund resources is high, and hence any deviations from the official projections should be promptly submitted to the Board's attention.

Concerning the GAB, I am convinced that financing arrangements aimed at substantially increasing as soon as possible the amount currently available under the GAB are of paramount importance, in the face of the need to respond to financial emergencies. Providing a mechanism to respond timely and effectively to large-scale financial crises affecting member countries, and the whole international community, is essential. A doubling of the resources available under the Arrangement would be appropriate, restoring its size as a percentage of Fund quotas and reserves of the participating countries to the levels prevailing in 1983. The enlargement of the borrowing arrangements should not be a substitute for a quota increase. The latter should be aimed at allowing the Fund to be able to undertake its ordinary business, that is meeting the financing needs of the membership in coming years without putting its resources under strain. Complementarily, the purpose of the former should be to cope with extraordinary circumstances impinging on the stability of the international monetary system.

An extension of the GAB to new contributors able to provide their financial support appears a suitable way to reach this target. This does not necessarily require modifying the present structure of the GAB, should a parallel arrangement be created, involving both G-10 and non-G-10 countries that are able to contribute. In particular, I favor the maintenance of current procedures for GAB activation be maintained, though possibly simplified, and their use for activation of the new facility.

As far as the issue of the establishment of supplementary lines of credit for the Fund is concerned, the staff document provides useful information on the way the member countries may help supplement the existing resources of the Fund with additional financing at short notice.

While I find the existence, at least in theory, of such a possibility reassuring, I do not see particular reasons why the issue should be explored in further detail at the present juncture. While the historical experience has demonstrated that in some particular occasions the Fund has resorted to borrowing, this has mainly been aimed at providing a temporary supplement to quota resources from time to time, before increases of quotas came into effect following a general quota review.

Accordingly, while I see that such a possibility must be taken into account, before the Eleventh General Review of Quotas is completed, and in the face of exceptional liquidity needs which cannot be otherwise met, it seems to me that the establishment of supplementary lines of credit cannot be considered as a supplement to other extraordinary resources like the GAB. In this respect I believe that they would overlap with, rather than being a supplement to, the GAB, currently under our consideration. In particular, an additional financial commitment by actual and potential contributors to the GAB and the parallel arrangement would face their individual budget and official reserves constraints, especially concerning the actual and the potential contributors to the GAB.

Mr. Tulin made the following statement:

Two months ago I had an opportunity to present our general views on the role of the GAB and associated borrowing arrangements in the context of the Fund. As my authorities' position has not changed much since that time, today I shall limit myself to reiterating briefly our support for the enlargement and possible modification of the GAB along the lines of the management's proposals and the Halifax summit request of the G-7.

Doubling of the size of the participants' commitments under the current GAB can be justified on the basis of the estimated collective depreciation of the currencies in the SDR basket in real terms since 1962, as the inflation-adjusted equivalent of the original amount of SDR 6 billion would be presently about five times this amount. However, the work to increase the Fund's ordinary resources in the course of the Eleventh General Review of Quotas must continue on a fast track and should not be substituted for or delayed by our consideration of various borrowing alternatives.

Nevertheless, in light of the lessons of the Mexican crisis, and taking into account the new initiatives that have been recently discussed and approved by the Executive Board--and which may occasionally require higher access by members to Fund resources in truly exceptional circumstances--it seems prudent, in parallel to our quota-increase exercise, to look at ways of further strengthening the Fund's protection against large unforeseen demand pressures, and to buttress the Fund's liquidity with additional borrowed resources before, and not after, the quota increase. It is also important to underpin soon the on-going efforts in setting the framework for an emergency financing procedure with an adequately fast procedure to access financing available under the Fund's borrowing arrangements. It would be also appropriate to apply the Fund's traditional quota-based principle toward sharing lenders' collective responsibility while taking into account the balance of payments situation of each potential contributor.

To my mind, practically all these criteria are met by the staff's proposals on establishment of supplementary lines of credit for the Fund outside, and in addition to the GAB, as set out in the aide-mémoire. As I said back in July, the use of the quarterly list of members with sufficiently strong balance of payments positions would considerably expand the number of the Fund's potential creditors and increase the total size of emergency credit lines available to the Fund.

On balance, I could go along with all the suggestions in the aide-mémoire, and I remain supportive of the ideas contained therein, although several Directors mentioned today that their authorities did not look favorably upon the proposal by management to introduce the supplementary lines of credit. In this respect, I have to admit that the Fund's financing through borrowing fully depends on the goodwill of its actual lenders under the GAB and of potential lenders under the contemplated supplementary credit lines.

Finally, I have some comments on the Fund's liquidity position and financing needs. The Fund's liquidity ratio has fallen by almost one-third since our previous review earlier this year, reflecting a considerable decline in the level of uncommitted and adjusted resources on account of four large arrangements. Under current staff projections, by the end of next year the liquidity ratio is expected to fall below its long-run average of 70 percent, which is a clear indication that the Executive Board needs to make early progress in its work on the Eleventh General Review of Quotas. Moreover, I note that the staff, for obvious reasons, has not taken into account any future consequences for the Fund's liquidity position of several new initiatives under discussion now. Thus, one cannot but agree with the view that the staff estimates of possible demand for the Fund's resources over the following two years are rather conservative, particularly with regard to 1997. An enlargement of the GAB and establishment of supplementary lines of credit along the lines of the management's proposals would represent a prudent and forward-looking approach, as it will go a considerable way toward strengthening the Fund's hand for dealing with future emergencies.

Mr. Wei made the following statement:

At the outset, let me join the previous speakers in welcoming today's discussion on the issue of the Fund's liquidity and financing needs. On one side, we do see reasons to combine the discussion of this issue with that of the Fund's borrowing arrangement--whether the GAB or supplementary lines of credit--as pointed out in the staff paper; the Fund's liquidity could be strengthened through an early agreement on an enlargement of the

GAB or the establishment of the supplementary lines of credit. On the other side, we are very much concerned that the progress on the Fund's borrowing arrangements might have a negative impact on the Executive Board's efforts in pushing forward a quota increase in the Eleventh Review. In this connection, it is encouraging to hear from the Treasurer that the G-10 countries have agreed that their efforts to double the GAB resources will not be a substitute for, nor impinge on, the process of the Eleventh General Review of Quotas. I must emphasize again that as a quota-based institution, Fund resources, as well as the Fund's liquidity position, must be addressed first and foremost through a timely quota increase. With this general remark, let me comment briefly on the three topics for today's discussion.

On the Fund's liquidity and financing needs, we fully share the staff's analysis on the demand of the Fund resources and the related issues. Like the staff, we also believe that the projections for demands of the Fund's resources contain a number of inherent uncertainties, especially taking into account the possible use of the Fund's resources in exceptional cases or members seeking financial support under the Currency Stabilization Funds. In such circumstances, the level of demand projections for Fund resources will have to be adjusted upward significantly. Correspondingly, the Fund's liquidity will deteriorate further. Furthermore, in our recent World Economic Outlook discussions, many of us recognized that, due to the integration of the world economy and the volatility of the international capital market, the Fund should be well prepared to assist its members in cases of emergency. Therefore, we fully share the staff's conclusion, given that the Fund's liquidity ratio at end-1996 will be below its long-term ratio of 70 percent and would decline further to 61 percent at end-1997--its lowest level since late 1983--it is of critical importance for the Board to accelerate the process of the Eleventh General Review of Quotas. In this context, I sincerely hope that the Board will reach agreement on a substantial quota increase as early as possible.

On the issue of the GAB, I do not have much to add to our views expressed in Mr. Zhang's statement for the previous discussion. Like others, we believe that the Executive Board should play an important role in considering the Managing Director's proposal to activate the arrangement under the existing GAB in view of the necessity to improve the procedures. We also support the Managing Director's suggestion that the Interim Committee be given a particular role in the activation of emergency financing.

On the link between the emergency financing mechanism and the GAB, I would say that when a member comes to the Fund seeking financial support under the emergency financing mechanism, its financial needs should be met through using the Fund's own resources. In the exceptional cases where the Fund cannot provide sufficient funds to member countries, an activation of the GAB could be considered, or the Fund could rely on its other borrowing arrangements with member countries. We are not in favor of the idea that the Fund borrows from private markets.

On the proposed supplementary lines of credit, we support, in general, the proposal to mobilize the resources for the following reasons.

First, because the resources will be provided by the member countries, such resources will be reliable.

Second, because each member will lend to the Fund in line with its quota share, such an approach is in line with the principle of the Fund as a quota-based institution.

Third, the operational features of the supplementary lines of credit are basically the same as those of the Fund's operational budget with which members are familiar.

Mr. Bergo made the following statement:

The staff projections show that the outlook for the Fund's liquidity position has changed markedly during 1995. I have in general no problems with the assumptions underlying the projections. The staff underlines, and rightly so, a number of risks which might lead to a sharper fall in the liquidity than presently projected. However, there are up-side risks also. I certainly expect that Mexico will not make all the purchases under the stand-by arrangement, and I would also assume that there is a fair chance of some early repurchases. On the balance of risks, however, I share Mr. Mesaki's view that there are probably more negative elements than positive ones.

I draw the conclusion that the liquidity outlook calls for a substantial increase in quotas. This has been the well known position of this chair already for some time and the present projections add further to our arguments. Moreover, taking into account the relatively long time lags involved, we should move swiftly to conclude the 11th quota review.

Regarding possible borrowing arrangements, like others I would stress that any such arrangement must not be a substitute for an increase in quotas and should not impinge or impair the discussions on the 11th review.

With regard to possible augmentation and broadening of the GAB, it is certainly to be welcomed that substantial progress has been made in the G-10 discussions, with a view to doubling the resources available.

Given the progress on the GAB, the urgency of the matter of supplementary credit lines seems sharply reduced. Already in our discussion back in July, this chair was rather skeptical to establishing a system of supplementary lines of credit for the Fund. Having read the aide-mémoire where these ideas have been further expanded, I have become strengthened in my skepticism, and I cannot support the proposal for reasons given by Mr. Schoenberg and a number of other Directors.

Against this background, I see no need to go further into the details of the sketch and would consider that we should leave this subject aside. Let us accelerate our quota exercise with a view to coming to an early decision on a substantial quota increase. Given a successful outcome of the deliberations on an expanded and broadened GAB, there should be no need to revisit the issue of supplementary credit lines.

Mr. Zoccali made the following statement:

As noted in our intervention last March on this issue, preparedness is required on the part of the Fund to adequately support members' adjustment efforts in the new external environment of integrated trade and financial markets.

Given the projected decline in the Fund's liquidity ratio by the end of 1996, to close to its long-term average of 70 percent and the further reduction envisaged by end-1997--to the lowest level since late 1983 prior to the Eighth General Review of Quotas--we endorse the staff's conclusion regarding the need to monitor closely developments in the Fund's liquidity and to strengthen the Fund's financial base in a manner that is consistent with keeping quotas as the primary source of funding for its operations.

Assessing the appropriateness of the Fund's financial base remains very much an exercise in judgment, and must be safeguarded by very conservative assumptions on the part of the staff and Management, endorsed by the Board over time.

Nevertheless, it should be noted on the supply side, that maintaining the 20 percent adjustment factor represents a reduction in uncommitted usable currency holdings of SDR 11.7 billion, covering 100 percent of the projected increase in total fund credit outstanding from the GRA in 1995. This prudential margin is particularly significant as 1995 also represents the year of the largest increase in outstanding Fund credit since 1990. Without negating the risk of exclusion of one or two large countries from the transfers side of the operational budget--highlighted in the paper--that risk has existed in the past and its funding impact is attenuated by the zero-sum character of changes in members' balance of payments positions. In addition, as repurchases in 1995-97 would amount to some SDR 14 billion, the expected impact on the Fund's liquidity should not be gauged solely on the basis of the probable increase in outstanding credit demand, but rather on a net basis.

Having said this, we consider that while the present liquidity situation should not constitute an impairment for the Fund's ordinary financial activities in the very near term, the Fund must also not be perceived as lacking the necessary resources to ensure, in the new external environment, that potentially destabilizing situations requiring urgent and large-scale balance of payments assistance will continue to be overcome with minimal consequences for the membership.

In this light, we reiterate our support for an early agreement on a substantial and largely equiproportional quota increase under the Eleventh General Review of Quotas supplemented in the interim by a set of financial arrangements to respond to emergencies in the context of upper credit-tranche conditionality. The sketch outlined in the aide-mémoire contains a number of attractive features, namely that of a stable supplementary funding base and, as importantly, speedy and equitable conditions of activation and use regardless of whether the country in need is a participant or a nonparticipant in the GAB.

We are also attracted to the new process of consultation envisaged with the Interim Committee, to factor in the political dimension before activating the credit lines, and consider it essential that decisions on activation should be simple and based on a proposal by the Managing Director.

Finally, it is to be hoped that such features will find their way into a final framework agreement to ensure the enlarged contributions envisaged for the GAB.

Mr. Fernández made the following statement:

We share the views of the other Directors regarding the prospective decline of the liquidity ratio. The expected fall of this ratio to 61 percent at the end of 1997 is worrisome.

This chair supports an early and substantial increase in quotas, and today's staff paper on Fund's liquidity is an additional argument to maintain such a position.

We are open-minded about the specific form of the borrowing arrangement. However, all lenders must be treated on equal footing. This means that either present GAB lines of credit should be merged with new lines from new countries participating, or if the GAB remains as it is and a new borrowing arrangement is created, GAB members should open new lines of credit on comparable amounts and terms with non-GAB members. A two-tier approach in the amounts, terms, and nature of the lines of credit or in the decision-making process would be difficult to accept.

The main problem we have with the supplementary lines of credit proposal is that it discourages an agreement on the increase in quotas because it may be seen as a close substitute of it.

In concluding, on the general issue of borrowing, we maintain the views expressed in this chair's statement of July 27, 1995.

Mr. Calderón made the following statement:

The staff paper provides us with a calculation of the projected liquidity ratio for the next two years and concludes that this ratio will fall below its long-run average of 70 percent by end-1996.

These projections contemplate the strong demand for Fund resources in the context of major changes in the size and volatility of international capital flows, but they seem to be conservative given the role of the Fund in supporting currency stabilization funds and post conflict situations. This suggests that although the present liquidity ratio seems to be still adequate, the liquidity of the Fund for the coming years is becoming too low.

In dealing with the need to strengthen the Fund's liquidity position, a general increase in quotas is the most appropriate way to achieve this goal. We strongly support a substantial, essentially equiproportional increase in quotas that will allow us to conclude successfully and timely the Eleventh General Review of Quotas, and will enable the Fund to play its role efficiently in the international monetary system.

Of course, the staff recommendations of an enlargement of the General Arrangements to Borrow, and the establishment of the supplementary lines of credit would be useful to strengthen the Fund's liquidity position. However, these credit lines would certainly not strengthen the overall financial position of the Fund. Hence, they should be seen only as complementary measures while the more structural and permanent solution of the quota increase is reached.

On the issue of the GAB, we share other speakers' concern that its conditions for activation are restrictive, complex, and time consuming, especially for non-GAB members. It is highly desirable to improve the conditions and procedures for GAB activation, and to establish that the conditions for activation are the same, regardless of whether the borrowing country is a participant or a non-GAB member. However, the recent discussions of the Deputies of the Group of Ten do not seem to point in this direction.

Hence, we believe that the establishment of supplementary lines of credit for the Fund is a good idea. We agree with the comprehensive set of arrangements described in the aide-mémoire and would like to highlight what we consider are the most essential elements of such an arrangement:

First, the financing should be used to overcome critical and urgent balance of payments difficulties that are relatively large, particularly when there are systemic risks involved.

Second, each member of the Fund would be invited to enter in a lending agreement with the Fund, subject to completion of national procedures, in an amount proportional to members' quotas.

Third, the Fund would determine at the beginning of each quarter which lines of credit could be drawn upon on the basis of the relative strength of a member's balance of payments. However, the overwhelming benefit of doubt would be given to members who manifest that, for external financial reasons, they would have serious difficulties in participating in the credit line system.

Fourth, the Fund would bear the lending risk.

Finally, the Fund would pay interest quarterly on the amount of the credit line drawn at 100 percent of the combined market rate.

Mr. Kiekens made the following statement:

On the review of the Fund's liquidity position I would like to make the following remarks.

The staff's projections of the Fund's liquidity position are based on conservative assumptions. For instance, it was assumed that Mexico would draw all tranches of the stand-by arrangement with the Fund and that it would not make early repurchases. I believe that such an approach is warranted. In assessing the Fund's future liquidity position, we should err on the safe side rather than being overoptimistic. Given the many uncertainties about the future demand on Fund resources, the Fund's liquidity position must continue to be monitored closely. During the Board's discussion of the second review of the stand-by arrangement with Mexico, the Board saw a strong presumption that beyond August 1995 the arrangement will be of a precautionary nature, and the Mexican authorities confirmed their intention to forgo future purchases and make early repurchases. I believe that the Board's finding on Mexico remains valid. However, this does not preclude taking the Fund's legal commitments into consideration when estimating the future liquidity position.

I note from the staff report that the Fund's usable assets have declined sharply since the last review, and that this decline is expected to continue over the next two years. As a result, the liquidity ratio is rapidly descending toward its long-run average, and at 61 percent by the end of 1997, will even dip below it. This indicates a need to speed up our work on the Eleventh General Review of Quotas. Since the GAB, or any other borrowing arrangement, can only be a supplementary source of contingency financing, an early increase of the GAB cannot be allowed to delay a quota increase.

In reply to Mr. Wijnholds, the Chairman raised the fundamental question whether the globalized financial markets and the increased free capital movements do not require a stronger financial position for the Fund. This was precisely the point of the Board's recent discussion on the Fund's role in the changing world environment that you referred to. I believe the outcome of that discussion confirmed that there is a need for more effective Fund surveillance, but was rather inconclusive as to whether an extraordinary and very large real increase is needed to enable the Fund to maintain its financial role in the globalized markets. The idea of reducing the Fund's financial means in real terms, is of course out of the question. Therefore I believe that the next quota increase must aim at keeping the Fund's resources commensurate with the growing world economy. The staff pointed out that this will require a 60 percent of increase in quotas, which I consider a fair basis for discussion. Of course, the actual outcome of the negotiations will also depend on our final assessment of what the Fund's liquidity position will be in the coming years.

Let me now turn to the proposal on supplementary lines of credit to the Fund. For the creditor countries, this scheme imposes additional financial obligations very much like a quota increase, but does not accompany them with adequate additional rights. Implementing these proposals could create a pretext for opposing a quota increase. The GAB, on the contrary, strikes the right balance between financial obligations and decision-making rights. For these reasons, I do not favor this proposal.

One feature in the staff's scheme of supplementary lines of credit has attracted the attention of my Austrian authorities. Under this scheme, once a country's balance of payments position is considered sufficiently strong to participate, its actual contribution would be based solely on its quota and not on its external reserves. This makes the scheme easy to administer. They wonder whether this particular idea of equiproportional quota-based contribution would be worth exploring for application to the operational budget.

Further considering the General Arrangements to Borrow, I can confirm that the Belgian authorities support the intended doubling of their size. They also support the recent proposal for a new parallel arrangement to complement the existing GAB, to be financed by the G-10 members and selected non-G-10 countries. The Treasurer reported extensively on this proposal at the outset of this meeting. I believe it is a proposal that takes care of the legitimate interest of both the present GAB members and the new countries willing to participate in a borrowing arrangement with the Fund. It is now the task of the GAB representatives, Mr. Bernes and Mr. Noyer, to further clarify all the details of the new proposal to possible new lenders, and receive their comments.

Let me, however, inform the Board on the preliminary reaction of my Austrian authorities. Not unexpectedly, they very much share certain principles espoused by Mr. Fernández and other Directors representing possible new lenders. The principle of equal treatment with respect to rights and responsibilities for old and new participants is certainly crucial to their willingness to participate in any proposed new financing arrangement. Any scheme that does not meet this criterion will not be acceptable.

On the proposal submitted today by the G-10 countries to establish a new parallel arrangement, my Austrian authorities will need more time to give it adequate and constructive consideration. In particular, the issue of the relationship between the old GAB and the new parallel arrangement needs to be addressed. There can be no doubt that a two-tiered approach to the decision-making process, and the size of the commitments, would raise problems for Austrian participation. In any event, both the contributions and the commitments should be quota-related, with no distinction made between "old" and "new" members. In addition, the question of the activation rules for the two pools of funds will have to be resolved on the basis of a fair and democratic process.

Mrs. Guti made the following statement:

The liquidity position of the Fund is broadly adequate for the current year; however, the liquidity ratio is projected to fall sharply over the next two years, which raises concern about the ability of the Fund to respond to needs of the member countries, to say nothing about responding to emergencies that may require large-scale balance of payments financing by some of the members.

The uncertainties created by the potential for large swings in capital flows underscores the need for the Fund to strengthen its role in the international monetary system.

This, in our view, suggests the need for early consideration of an increase in quota under the Eleventh General Review of Quotas.

With regard to the supplementary arrangements, we can support the proposed doubling of the GAB. However, all potential lenders should be accorded equal status. On the supplementary lines of credit, we can go along with the scheme outlined in the staff paper.

Finally, these arrangements should not impinge on work toward an early conclusion of the Eleventh General Review of Quotas.

Mr. Evans made the following statement:

Let me just start with the liquidity ratio. My impression of the forecasts is that, as they go further ahead, they are subject to quite wide margins of error. In the past they have been generally conservative, and more often than not they have turned out to be rather too pessimistic, although on occasion they have been too optimistic. No doubt 1995 was one of those occasions, owing to the large drawings by Mexico, and other countries.

The present liquidity ratio is about 106 percent. It is forecast to go down to about 70 percent next year, and to below 70 percent in 1997. If there were no further drawings by Mexico, I think the ratio would stay comfortably above 70 percent throughout this period. I make that point not because I believe there is one single correct way of making this forecast--clearly there is not--but just to indicate that there is considerable uncertainty about all this.

The Chairman has made the case that the Fund's resources should grow at least in he would say more than in line--with the growth in the world economy. I would agree with Mr. Kiekens that when we talked about the role of the Fund we did not come to a firm conclusion about whether a stronger Fund meant having more resources to deal with future Mexico-type situations. I suppose I am something of an optimist, in the sense that I do look forward to the day when fewer countries will need Fund resources on a large scale. I think there are some big questions here about the size of any quota increase; I do not want to come to a conclusion on that issue at present. As far as supplementary lines of credit are concerned, my view, like some earlier speakers, is that this proposal rather blurs the distinction between borrowing and quotas, and it would indeed be seen by some as a substitute for a quota increase.

On the General Arrangements to Borrow, the G-10 would like to involve some more countries in these arrangements, but the G-10 has not laid down a blueprint. We very much want to hear the views of others, and we look forward to some discussions in a spirit of cooperation so that we can anticipate a successful outcome.

My final point is on the link between the GAB and the emergency financing mechanism. I am not arguing for a necessary formal link, but there may be times when we may need to activate both simultaneously. I believe we have to ensure that both arrangements can indeed be activated in a compatible and swift way.

The Chairman said that he shared Mr. Evans's optimism that fewer countries would need to rely on the Fund's resources in the future. It was for that reason that the Fund assisted members in strengthening their financial bases. In addition, if globalized financial markets worked well, resources should flow from countries with high saving rates to countries with large investment needs. The globalization of financial markets was an unprecedented phenomenon and it was necessary for the Fund to have adequate resources to assist countries in such times. As more countries liberalized their capital accounts, they might need Fund support to assist them in the transition to full capital account convertibility, and the Fund should have the necessary resources to provide such support. The Fund had been created to assist members dismantle exchange controls, and while the objective of the Fund was not undergoing change, it was necessary to strengthen the Fund's resources in order to assist countries.

Mr. Evans observed that, over the past 15 years, a number of countries had made substantial progress in dismantling exchange controls, and he would encourage further progress in that area. It was not clear whether further liberalization of capital accounts would lead to a substantial increase in demand for Fund resources, but it was a factor that should be borne in mind.

Mr. Al-Tuwaijri made the following statement:

The paper on the Fund's liquidity position and financing needs suggests, at first glance, a substantial decline in the Fund's liquidity position by end-1997. However, there are a number of reasons to believe that this outlook is overly cautious.

First, the assumption that countries will make use of available purchases under Fund arrangements is routine. In this particular paper, however, this assumption significantly affects the results given that the Mexican authorities have expressed the expectation of not making further purchases and the likelihood of early repurchases.

Second, as Ms. Lissakers pointed out, even in the absence of early repurchases, the Fund's liquidity position will likely improve in 1998.

Under the circumstances, and given the tendency to overestimate the use of Fund resources, I consider that our liquidity position remains broadly adequate. Clearly, however, our liquidity position will need to be kept under close scrutiny.

Turning to issues regarding borrowing by the Fund, I share the view that an increase in the magnitude of borrowed resources that can be made available to the Fund is desirable. One can argue that options being presented have their merits, but if an early consensus is to be reached, it seems worthwhile to focus our efforts initially on options that could easily garner support and are easy to implement. I hope that early progress can be made in this area.

Mr. Autheman made the following statement:

Regarding the review of our liquidity needs, I conclude that there is no emergency but a clear need to act. I would have preferred a different reference scenario, built under the assumption that Mexico will no longer draw on the stand-by, since this is the present understanding between Mexico and the Fund. In my view this does not change the conclusion, because the risk that Mexico may need to draw the full amount of the stand-by is one of the downward risks identified by Mr. Mesaki and other speakers. So I would have preferred a more realistic reference scenario with greater emphasis on the downward risks.

My conclusion is that there is a case for strengthening the Fund's financial base--not through a timely conclusion of the 11th general review of quotas, as the report says. My understanding is that "timely" would mean before March 31, 1998, which in my view would be too late. I would rather stress the need for an early conclusion.

Second, regarding the GAB, it is important that, whatever happens, the Fund remain able to finance members. We should be confident that it will never be caught off guard by unexpected events. I take comfort from the positive indications given by Mr. Fernández and by Mr. Kiekens, on behalf of his Austrian authorities, that we should be able to look forward to a rapid conclusion of this negotiation.

Like many speakers, I am not attracted by the proposed establishment of a supplementary line of credit. I think the proposal is inconsistent with the purpose of Fund borrowing. Fund borrowing should remain exceptional and transitory. It should not develop into a standard feature. The proposal looks like a de facto quota increase, restricted to creditors, which I find quite strange, and it could create the risk of encouraging the development of sponsored arrangements supported by ad hoc lists of creditors, depending on the beneficiary of the arrangement.

I think that Mr. Kaeser had a strong point when he implied that it would be difficult for a creditor to act on a decision not taken by itself. If we were to work on this proposal, we would have to look carefully at Mr. Kaeser's objection that no creditor could be presumed to provide loans without deciding them himself. That is why I see a risk that the staff's interesting proposal may at the end lead to such a consequence, which I am pleased to see it is not supporting.

The Chairman asked Mr. Autheman to elaborate on his statement that the supplementary lines of credit would risk creating sponsored arrangements.

Mr. Autheman replied that the supplementary lines of credit could result in arrangements that were supported by an ad hoc list of creditors, which would vary depending on the intended beneficiary of the borrowing arrangement.

The Chairman responded that the supplementary lines of credit as proposed by the staff would not operate in that manner. The list of participants would be determined by the Executive Board and would consist of countries whose currencies were included in the quarterly operational budget. Furthermore, the procedures for activating the lines of credit also included an advisory role for the Interim Committee.

Mr. Autheman said that he agreed with Mr. Kaeser that the drawback of the staff proposal was that, although creditors would be asked to provide emergency financing, the decision to lend to a member would not rest with them.

The Chairman observed that several Directors preferred the G-10 proposal to establish parallel borrowing arrangements and there were merits to that proposal. However, he saw merits in the staff proposal to establish supplementary lines of credit and that proposal should also be kept under consideration. At the same time, the concerns raised by Mr. Kaeser would need to be addressed.

Mr. Schoenberg asked how the Interim Committee, which was an advisory body, could play a role in the decision to activate the supplementary lines of credit.

The Treasurer remarked that the staff was not proposing a decision-making role for the Interim Committee, but was suggesting that the Managing Director consult with the Interim Committee on the occasion of a proposal to activate the lines of credit.

The Chairman commented that the staff was not suggesting a change in the advisory role of the Interim Committee. He recalled that, in the Executive Board discussions on access policy and a quota increase, Directors had expressed a wish to hear the views of Ministers. The staff proposal to involve the Interim Committee provided a way to meet two important objectives: political consultation and effective, speedy advice.

Mr. Schoenberg pointed out that the Interim Committee would become involved in every single case when the proposal to activate the supplementary lines of credit was made. As such, in practice, the Committee would not be providing general policy guidance but would be making a decision in each and every case.

The Treasurer said that the staff had stressed that the supplementary lines of credit would only be activated to deal with a request for emergency financing to address an urgent balance of payments problem, and not for regular requests for Fund support. The staff considered that there would be very few cases that would require activating the supplementary lines of credit, and thus very few instances in which the Managing Director would consult with the Interim Committee on use of Fund resources.

Ms. Lissakers said that, according to the staff proposal, the supplementary lines of credit would be established in addition to increasing the resources of the General Arrangements to Borrow. Furthermore, the resources under the lines of credit would supplement any increase in the Fund's ordinary resources. In her view, it was not necessary to establish supplementary lines of credit, as the G-10 was proposing a doubling of the resources of the General Arrangements to Borrow. She was puzzled about whether or not the credit lines and the borrowing arrangements would be activated simultaneously. The supplementary lines of credit would complicate procedures without adding significantly to the institution's capacity to respond to demands for emergency financing.

The Chairman noted that the General Arrangements to Borrow were important because they enhanced the credibility of the institution to address sudden, systemic balance of payments problems. All Directors agreed that it was necessary to increase the resources available under the Arrangements in line with the changes in the world economy. In addition, as Mr. Mesaki had pointed out, there was an element of "mutual assistance" in the Arrangements, which should be preserved. The General Arrangements to Borrow had been originally conceived in 1962 as a way of responding to a potential systemic crisis arising from weaknesses in a participating member's balance of payments position. Such a risk was always present, and in order to effectively deal with such risks, it was necessary to strengthen the resources available. Since the 1960s, the world economy had undergone profound changes and new challenges had emerged; the number of countries whose balance of payments problems could pose a systemic risk had increased. Furthermore, a few of the countries that were participants in the General Arrangements to Borrow were not in a position to lend to the Fund. In light of those circumstances, the staff considered that it was necessary to broaden the list of countries that could be called upon to lend to the Fund, and the most objective criterion to determine which members were in a position to lend was the inclusion of a member's currency in the Fund's quarterly operational budget. Although the supplementary lines of credit might lack the element of "mutual assistance" of the G-10, all the participants would have equal status and would be contributing to burden sharing.

He was not proposing setting up the supplementary lines of credit as an alternative to increasing the resources under the General Arrangements to Borrow, the Chairman continued. The G-10 Deputies were proceeding with their proposal to set up parallel borrowing arrangements, and it would be worthwhile to await the outcome of those deliberations. At the same time, as a number of Directors had suggested, the idea of establishing supplementary lines of credit should also be kept under consideration.

Mr. Geethakrishnan made the following statement:

> The data before us clearly show, subject to various assumptions, how the liquidity ratio, which was about 185.4 percent toward the end of 1994, is expected to come down to 69 percent by the end of 1996 and to 61 percent by the end of 1997. As I said on an earlier occasion, after all, the beauty lies in the eyes of the beholder. There are some of us who are born optimists who feel that the staff projections are made on a very pessimistic basis, that Mexico will not draw the balance of the amount sanctioned, that many countries will improve in their economy to such an extent that they will either not seek resources from the Fund of the order projected, or even make faster repurchases than what has been projected. There are, of course, many who are, shall we say, born pessimists, Cassandras, people like me, who feel the staff projections are made on an extremely optimistic basis, that there are far too many assumptions. After all, there is an American truism that if anything can go wrong, it will go wrong. We worry about the 61 percent. But the basic point that everybody misses is that these projections are made on a business-as-usual basis. These projections do not take into account the requirements that may suddenly emerge as a result of, for example, the emergency financing procedures that we have discussed earlier; the currency stabilization procedures that we have discussed earlier; and our being asked to play a major role

in the post-conflict countries. This has been tucked away in one sentence in the last paragraph--on page 11, last paragraph I wish the paragraphs were numbered; I can say it comes in 5(c)--that these projections do not provide for any of these things that we have been discussing.

I am really concerned about this. We seem to be progressing on two parallel tracks. Where it comes to a concept, we are putting it on a fast track, proceeding at a terrific speed in a forward direction. We have spelled out the currency stabilization fund in great detail. We have said who will be eligible, how we will process it, how much access we will give. On the emergency procedures we have even dotted the i's and crossed the t's. We have spelled out everything, and we are now ready and gung ho to meet the next Mexico II and Mexico III, and so on. On the post-conflict case, we are ready with all the basic procedures spelled out. But when it comes to the question of resources necessary for meeting the situation, we find that on the quotas we have not made much progress. On SDRs, which would have benefited a large number of countries, we have put it on a back burner. Right now we have consigned it to a seminar to take place in six months. Maybe at the end of six months there will be a seminar report, and it is to be hoped that we will set up a subcommittee of either the staff or the Board to examine it further. And it will go on.

On General Arrangements to Borrow, I was hopeful that thanks to the Halifax communiqué there would be momentum, it would be double. Maybe after the meetings of the Ministers we will know the details but, from what the Treasurer briefed us on earlier, it is not clear whether we are talking of a General Arrangements to Borrow I and a General Arrangements to Borrow II. Maybe it will be called a General Arrangements to Borrow, senior, and a General Arrangements to Borrow, junior. I have a suspicion--maybe I am wrong as usual--that persuading a number of new entrants to join the junior club is going to be a time-consuming process. Maybe it is not around the corner; even if you stretch the corner to quite a distance, it is not around there either.

On the supplementary lines of credit, it is not necessary to go into the merits or the demerits. After all, the G-10 has spoken through Mr. Clark's opening statement that the Deputies wanted him to convey that they do not favor it. So I take it, however much some of us may support it, or the Chairman supports it, we can proceed on the basis at least at the back of our mind that the issue of supplementary lines of credit is dead as a dodo.

So, if you look at the practical realities, we are going on a fast track, on a very, very speedy basis, as far as the concepts are concerned; but when it comes to the question of providing the resources for support, we seem to be going on a parallel track and in the backward direction.

We notice something very similar in the ESAF. After three rounds of discussions, I believe we are very close to a consensus on how the ESAF should be continued without a break. That has been a very good development. But, there are three sources of financing.

One is gold sales. The Chairman's summing up says the required majority is not there.

The second is the surpluses of the SCA-2. We all noticed how difficult it was going to be to push it through our parliaments.

The third is bilateral contributions. We have noticed the budgetary constraints of all the creditor countries.

There again, you see a fast track for the concept, and a reverse direction on the parallel track as far as the resources are concerned.

What bothers me is that the Interim Committee meeting is to be held, I think, on October 8. In the evening we will come out with the communiqué. The communiqué will be very, very positive. It will talk about ESAF being continued, and how we are ready and fit and capable to handle a Mexico II or a Mexico III; how the currency stabilization fund is to be supported; how in the post-conflict cases we will be able to respond very aggressively; but then maybe we will be silent on the resources necessary, or maybe it will figure in a footnote. In other words, as I see it, the communiqué will be like the election manifestos that all the political parties release before they have an election in most of the countries. They will promise lots of things, but if you ask them confidentially, "Look, how do you expect to deliver it?", they will say, "We do not expect to win the election. If we had thought of winning the election, we would not have made these promises. This is only to queer the picture of the party that will win so that they will collapse at the end of the second year, and we have one more year."

I am even more worried by another factor and for this I would like to seek the permission of the Chairman and the Board to relate a story from 30 years ago. It was the time of my first daughter's birth. We had a serious shortage of baby food, milk powder, in the part of the country where I was living. I was a deputy secretary of finance. The chief minister said, "Please, do something about it." We all met at our level. We immediately brought the baby food under the Essential Commodities Act, and we said from today onward only the Government will deal with it.

Second, we issued an eligibility card, a ration card; who would be eligible for it was spelled out in great detail, including the income--because you need money to buy it--the periodicity, the quantity, just like the way we have done in the case of the emergency financing mechanism, in the case of the currency stabilization fund, et cetera.

So one day my wife prodded me, "Look, there is no baby powder for tomorrow. Will you go and get it?" I picked up my ration card, went to the shop. Half of the shops said no. The other shops said, "Do you have a ration card?" I happily beamed, "Yes, here it is." Then, he said, "Sorry, I do not have the baby food." I said, "Why did you ask me whether I had the ration card?" He told me the truism that holds good even today. "Don't you realize, my friend" he said, "if the Government had baby food, they would have given you baby food and not a ration card."

I am not sure whether we are heading for a similar situation. While on the fast track we have gone far ahead on the ESAF, on the emergency financing mechanism, on the currency stabilization fund, on the post-conflict, et cetera, but when it comes to resources, we are going backward. I say it because I feel pain. Let us all look at the data presented by the staff. Supposing there should be another Mexico II in the middle of 1996. Supposing for the next Mexico II the demand of drawings on the Fund is about SDR 25 billion, where are we? I think we need to reflect on it.

If we are going to talk about business as usual and say that 61 percent is high or low, whether 61 percent is optimistic or pessimistic, let us not talk about all the other facilities that we are now recommending to the Interim Committee for adoption. If we are going to talk in terms of the currency stabilization fund, and if the Interim Committee is going to claim credit for that announcement, if we are going to talk about post-conflict cases, if we are going to talk about the emergency financing mechanism, then we should also back it up with some forward movement on the resources--something that I do not see now.

Mr. Kaeser said that if there were another case like Mexico, the Fund could mobilize the resources of the General Arrangements to Borrow to assist the country to address its balance of payments problems.

Mr. Geethakrishnan observed that, from what the Treasurer had said, it would appear that the existing rules governing the use of the resources available under the General Arrangements to Borrow would remain unchanged, even if the number of participants increased. It was not clear whether the distinction between participants and nonparticipants would continue to exist, and what the rules would be with regard to access to resources. If one of the participants of the General Arrangements to Borrow was faced with a Mexican-style crisis, it could rely on the resources of the Arrangements to help it meet the emergency situation; however, the real concern was how the Fund would assist a member that was not a participant in the borrowing arrangements. Furthermore, the projections of the Fund's liquidity position were based on the assumption that there would be no more Mexican-style crises in the coming period.

Mr. Daïri made the following statement:

This chair has constantly stressed the importance of a strengthening of the Fund's financial resources to permit the growing needs of members and to consolidate the Fund's financial resources in relation to the world economy. The decline in bilateral assistance referred to by Mr. Shaalan strengthens the case for a wider role for the Fund in the financing of the developing and transition economies.

I concur with other Directors that we should preserve the role of quotas as the normal source of financing for the Fund and continue to believe that the substantial increase in quotas of up to 100 percent is warranted. I share Ms. Lissakers's view that the group of countries that stand ready to supplement Fund resources through lending should be clearly identified. I therefore feel that consideration should be given to extension of the general arrangements to borrow within the existing structure without creating parallel arrangements.

However, I believe that it should be made clear that such arrangements are put in place for the purpose of financing the membership at large and I would favor the elimination of any discrimination between participating and nonparticipating members in terms of activation criteria. I join other Directors in calling for simplification of the criteria and procedures for activation so that this financing will be readily available when needed.

I also feel that we should be cautious in considering supplementary lines of credit as they may further blur the distinction between quotas and borrowing, as stated by Mr. Evans, and may jeopardize the role of quotas. However, I have an open mind on this issue.

Mr. Barro Chambrier made the following statement:

The Fund's liquidity must remain strong in order to enable it to be effective in assisting member countries that are confronted with large external financing difficulties. Because of that, we need to pay a particular attention to the fact that Fund's liquidity ratio is expected to fall considerably during the next two years, if there were sudden large scale demands for the use of

Fund resources and if some large creditors presently included in the operational budget were to drop.

To avoid a further deterioration in the Fund's liquidity position, we support both a substantial increase in resources that the Fund can obtain (1) under the General Arrangements to Borrow, and (2) the establishment of supplementary lines of credit for the Fund which are currently under consideration.

On the GAB, this chair has recently expressed its strong support for an early enlargement of GAB resources. However, we would like to reiterate our view that an increase in the GAB should not constitute a substitute for an increase in quotas which is expected within the framework of the Eleventh General Review of Quotas. An enlargement of GAB will certainly strengthen the Fund's liquidity position prior to this review.

Concerning the establishment of supplementary lines of credit for the Fund, they will also help the Fund to improve its liquidity position. However, we would like to understand more about what is meant by all members in a position to contribute, will provide lines of credit to the Fund. Could the staff give additional information about the criteria which will be used to put member countries in that position?

On page 3 of the document, it is stated that "the terms of lending and the supplementary arrangements would be the same as under the GAB." We would be interested to know whether countries which have not provided such "credit lines" to the Fund will also be eligible for the use of resources available under these lines?

Finally, while we generally agree with the idea of improving the Fund's liquidity from various sources of financing, including the establishment of supplementary credit lines, we believe that such an establishment should be considered only after the proposed enlargement in GAB has taken place. In addition, we are of the view that an early increase in quota under the Eleventh General Review of Quotas is urgently needed.

Mr. Waterman made the following statement:

In terms of the Fund's liquidity position, I do not embrace Murphy's law, namely that what can go wrong will go wrong, quite as strongly as Mr. Geethakrishnan. But even though I am not as worried, I, nevertheless, support an early quota increase. Personally, I would not have any problem with the 60 percent benchmark, but it seems to me that you can argue both sides of that reference point for reasons others have mentioned.

On the General Arrangements to Borrow, I welcome the reports by the staff and Mr. Clark, and I know the larger members of this constituency will go into any discussions with the proposed interlocutors in a positive frame of mind, but clearly the modalities are important, and it is reassuring to note that there is no blueprint that has been established to date. Also, the relationship between the existing General Arrangements to Borrow and the parallel arrangements will be important, including the decision-making process. I might just note in passing, it has always seemed to me that the decision-making processes of the existing General Arrangements to Borrow need to be streamlined somewhat, and I am not sure how you can do it for one side of the equation without doing it for the other.

On supplementary lines of credit, this constituency does not have a definitive position. Personally, I would not have any problem with some further discussion on the subject, but I did not detect much support for the proposal today. I suspect it is partly because these lines of credit seem somewhat similar to a quota increase in effect, but, as Mr. Kaeser was arguing, without giving creditors any increase in their general voting rights in the Fund, or the control that they might otherwise desire.

The Treasurer observed that it would be difficult to base the projections of the Fund's liquidity on estimates of the average size of programs using probabilities on a weighted-average basis. The staff could, however, estimate the average access for new programs that the Fund would be supporting over the succeeding two years. In making the projections, the staff had assumed that there would not be any Mexican-style crises in the coming period. Some countries, such as the Czech Republic, Poland, and Chile had made early repurchases, which had contributed more than SDR 1 billion to the Fund's usable resources. Under the 1979 decision on the subject, the Fund had the legal right to ask a member to make an early repurchase when the member had met the conditions as laid down in that decision; in practice, however, the staff did not seek early repurchases by members, until the conditions of the early repurchase decision were met.

As regards the downward adjustment of 20 percent in the estimates of usable currencies, that was normal practice by the staff, the Treasurer stated. It was an issue of longstanding contention between the staff, on the one hand, and the U.K. and U.S. authorities, on the other. With respect to the estimates of the Fund's working balances, it should be borne in mind that the Fund had to have the necessary currency to pay remuneration to a member in its own currency if requested. A classic example was the reserve tranche drawing by the United States in 1978-79. As the Fund had had insufficient holdings, the Fund had had to borrow from Germany and Japan, through the General Arrangements to Borrow, to finance the reserve tranche purchase by the United States. In view of the potential demand from members participating in the European exchange rate mechanism, it was important that the Fund's working balances be sufficient to meet future requests, which would be for specific currencies. Furthermore, there were countries whose currencies were included in the operational budget, but whose balance of payments positions were not strong enough to support relatively large-scale requests for financing. The staff took that into consideration in its periodic assessment and revision of the 20 percent adjustment factor. If the staff reduced the size of the adjustment factor, the Fund's liquidity ratio would improve, but in practice, the Fund would not have liquid assets to meet members' needs.

The Board had reviewed the guidelines for the selection and use of currencies in the operational budget in February 1995 and had agreed that another review should be conducted before the end of 1996, the Treasurer stated. It was incorrect to state that the selection and amounts of currencies included in the operational budget were based on a member's reserve position for all countries except the United States. Since June 1990, the staff had taken into account members' quotas and reserves in the distribution of currencies for sale. The distribution of currencies for repurchases was in proportion to members' reserve tranche positions. The Board could call for an early review of the guidelines for the use of currencies, if it so wished.

With respect to repurchases after 1997, according to the staff's estimates, scheduled repurchases would amount to SDR 6.7 billion in 1998, SDR 10.1 billion in 1999, and SDR 9.2 billion in 2000, the Treasurer noted. Based on the assumption that average commitments under arrangements and reserve tranche drawings and drawings under the special facilities would be the same as the past eight years through the present, excluding Mexico--an assumption he considered to be relatively low--about SDR 6 billion a year would be committed under arrangements and about SDR 1.2 billion a year would be purchased under special facilities and in reserve tranche drawings. Based on those assumptions, the Fund's liquidity ratio would be about 60 percent by end-1998, would rise gradually to about 72 percent at end-1999, and would rise to about 85 percent at end-2000. Although the Fund's liquidity position would begin to improve in 1999 and 2000 when repurchases of substantial amounts would be made, as the projections were based on the assumption of no change in average demand from the past eight years and that repurchases would be made on schedule, the projections were largely hypothetical. Furthermore, it was assumed that there would be no change in the list of usable currencies. The fact that between 1995 and 1998, the Fund's liquidity ratio was projected to decline markedly, to about 70 percent in 1996 and about 60 percent in 1997, was a cause for concern.

The staff had not assumed that Mexico would not draw the full amount of resources committed, because at present there was no firm indication to that effect, the Treasurer observed. The staff had based its assumptions on the Chairman's summing up at the conclusion of the previous Article IV consultation, in which he had stated that, "Directors welcomed the reiteration by the authorities of their intention to forego some purchases from the Fund if the economic situation stabilizes, and to make early repurchases from the Fund if reserves permit." The staff did not have any specific commitments by the authorities that would allow the staff to draw up an alternative scenario. If Mexico were to make no further purchases under the stand-by arrangement and the arrangement were to become a precautionary arrangement, the Fund's liquidity ratio would be about 110 percent in 1995--instead of 106 percent as stated in the staff paper--and it would be about 80 percent in 1996 instead of 70 percent, as projected in the staff paper.

Ms. Lissakers asked whether it was necessary to make a 20 percent adjustment, as a decline in the liquidity ratio served the same function with respect to the availability of usable resources.

The Treasurer remarked that the 70 percent figure for the Fund's liquidity ratio factored in the 20 percent downward adjustment to the Fund's usable assets; the adjustment factor cushioned the Fund's liquidity position from the effects of large-scale changes in the list of usable currencies. Table 2 in the staff paper showed how the staff had reached its estimates of the Fund's liquidity ratio. Ms. Lissakers's suggestion that the staff calculate the Fund's liquidity based only on the Fund's liabilities and usable assets, without factoring in the adjustment factor, would make the Fund's liquidity position appear more favorable than it actually was. It would also make it seem more unstable. The staff would assess the appropriateness of the current size of the adjustment factor.

Mr. Geethakrishnan asked whether the staff had always included the 20 percent adjustment factor in its projections or whether that was the first time. Perhaps the size of the adjustment factor should be reviewed.

The Treasurer recalled that in the first paper on the Fund's liquidity position that the staff had prepared in 1976, the calculations of the liquidity ratio had been based on a downward adjustment of the Fund's usable assets to take into account the factors mentioned earlier. At that time, and since then, the Executive Directors for the United Kingdom and the United States had objected to the incorporation of the adjustment factor in the calculations of the Fund's liquidity position. The size of the adjustment factor had varied over the years; at one time, it had been 30 percent, when the currencies of marginally strong economies had been included in the operational budget. For a long time, the adjustment factor had been 25 percent, and over the past four years, it had come down to 20 percent.

As regards the supplementary lines of credit, he considered that the Executive Board was also a forum for "mutual assistance" that Mr. Mesaki had mentioned, the Treasurer remarked. According to the proposal to establish supplementary lines of credit, the decision to activate the lines of credit would rest with the entire membership, and not just with a particular group of members. Furthermore, those lines of credit would be activated only in response to an emergency situation and would not be used to support regular programs of members. In that respect, the supplementary lines of credit were similar to the General Arrangements to Borrow. Also, the supplementary lines of credit could be renewed if necessary after five years. He recalled that the General Arrangements to Borrow had been established in 1961-62 because some countries, particularly the two main reserve currency countries, had not wished to pursue a quota increase, as that would have led to a loss of gold to the Fund. It was only after the staff had devised a system of gold deposits, under which the gold payments that were made to the Fund were redeposited with the reserve centers, that the Fund had been able to proceed with a quota review. Thus, the General Arrangements to Borrow, like any other borrowing arrangement, supplemented the Fund's ordinary resources, but did not substitute for a quota increase.

Mr. Fernández said that the main problem with supplementary lines of credit was that they would discourage agreement on an increase in quotas, because a number of Directors considered that the lines of credit should substitute for a quota increase. However, his chair considered that the proposal to establish supplementary lines of credit should be kept under consideration. He was not as optimistic as Mr. Autheman and Mr. Wijnholds regarding the establishment of parallel borrowing arrangements. At the Board discussion on July 27, his chair had stated its reservations about an enlargement of the General Arrangements to Borrow, and had stressed the need to change the procedures. If the new parallel arrangements were similar to the General Arrangements to Borrow in terms of procedures, his chair could not participate in such a borrowing arrangement. As regards the Fund's liquidity, he considered that the staff should also take into account potential emergency situations in its projections of the liquidity ratio.

Mr. Geethakrishnan stated that he too supported further consideration of the staff proposal.

The Chairman noted that a number of Directors had said that the staff proposal to establish supplementary lines of credit should be kept under consideration.

The Chairman made the following concluding remarks:

Liquidity

Most Directors could accept the staff's projections of demand for Fund resources. There is, of course, always a large element of uncertainty in these matters, but no one doubted that the demand for Fund resources was, for the time being, continuing at a rapid pace. Indeed, the staff is projecting that about 50 countries are likely to request use of the Fund's resources from the General Resources Account for a probability-weighted amount of close to SDR 16.5 billion in the period to end-1997. This is large, but not abnormal. In addition, there are uncertainties associated with the impact on the Fund's liquidity of unforeseen requests, including for emergency financing as well as of initiatives that the Board has recently endorsed, such as the currency stabilization fund. These are new elements that we must henceforth take into account. We must, indeed, continue to be alert to and, as we have been requested, be ready to inform the Executive Board of any revisions to these projections. In this context, it was noted that one member to whom substantial commitments had been made might not need to utilize the full amount of committed resources, depending on the improvement in its economic situation.

The staff has projected the Fund's liquidity ratio at close to 70 percent by end-1996 and close to 60 percent by end-1997. A number of Directors pointed out that such a projection rested not only on indications of relatively strong and, perhaps, conservative demand, but also on the assumption that there would be no further additions to the list of countries whose currencies could be used by the Fund and that countries would make only scheduled repurchases. I believe that most Directors doubt whether we can expect a substantial boost to the Fund's liquidity from early repurchases or from adding to the list of usable currencies those countries not yet included in the quarterly operational budget. The Board will, as always, monitor closely the evolution of the Fund's liquidity position, and most Directors agreed that the present projections underscored the need to move expeditiously to strengthen the Fund's financial base through an early conclusion of the Eleventh General Review of Quotas.

Borrowing

Against the background of a weakening trend in the Fund's liquidity position, it is opportune that we are discussing a possible strengthening of the Fund's borrowing arrangements. You have received the report of the Treasurer on the meeting of the Deputies of the Group of Ten (G-10) in Rome on doubling the resources now available under the General Arrangements to Borrow through the possible establishment of a new parallel arrangement comprising G-10 and selected non-G-10 countries. In this regard, I welcome the statement, to which all Directors agreed, that the strengthening of the Fund's borrowing arrangements does not in any way substitute for an increase in quotas, nor impinge on our discussions on the Eleventh General Review.

I very much welcome the initiative of the G-10 countries following the Halifax communiqué, and the position taken by the Interim Committee last April. As the Executive Board indicated in its preliminary review of the General Arrangements to Borrow at the end of July, a doubling of the resources available under the General Arrangements to Borrow would seem appropriate. Support for such an increase was reiterated today, and such action will strengthen the Fund.

The details of the structure and modalities of the new arrangement will need to be worked out in due course by the G-10, by other countries that agree to participate, and by this Executive Board. In practice, this will mean that a draft model agreement will need to be developed, and issues, such as which members will participate in the arrangement and for what amounts, as well as activation and voting arrangements, will need to be considered by the Board and by participating countries. In this respect, I noted that several Directors stressed their expectation that procedures be made simpler, and more centered on this Executive Board. I also noted that the intermediaries who will be approaching potential lenders will report back to the G-10 Deputies at their meeting in Paris on December 13, 1995.

Most Directors also commented on the aide-mémoire outlining the modalities of a possible establishment of supplementary lines of credit that could be made available to the Fund on a temporary basis, and subject to periodic renewal. Many Directors felt that the proposed initiative of the G-10 was a preferred solution to the need to supplement the Fund's borrowing arrangements. At the same time, many other Directors felt there was merit in the idea and structure of the system of supplementary lines of credit put forward in the aide-mémoire, as the system was aimed at identifying creditors additional to those of today that would be in a position to lend to the Fund at a given moment of need some time in the future.

This debate will continue during the coming months, but we need to proceed in the Board on the issues in an orderly manner. For the immediate future, we look forward to the further work of the G-10, including the report on the mission of the intermediaries in their contacts with a number of non-G-10 countries. In the meantime, we must proceed expeditiously with consideration of the next quota increase. In closing these remarks, I note that many of you emphasized the need to come to an early conclusion of the Eleventh Review, and that many of you stressed that a substantial increase in quotas was called for.

After adjourning at 1:30 p.m., the meeting reconvened at 3:15 p.m.

2. SDR VALUATION - REVIEW

The Executive Directors considered a staff paper on the review of the method of valuation of the SDR (SM/95/201, 8/14/95; and Sup. 1, 9/13/95).

Mr. Clark made the following statement:

The staff report provides valuable insights into the previous discussions of the Board on the valuation of the SDR instrument and on the calculation of the SDR interest rate. Since this issue arises for discussion only at five-year intervals, such a historical perspective is especially useful. The staff's current recommendations in this regard are guided, quite correctly I believe, by the decisions taken at previous discussions--most notably Decision No. 6631 -(80/145) G/S, adopted September 17, 1980 on the valuation of the SDR and its reaffirmation in the 1985 and 1990 reviews. I agree for the most part with the conclusions of the current report and support the staff's recommendation that no fundamental changes in the composition of the valuation basket or in the valuation procedures for the SDR and its corresponding interest rate are required at this time. Accordingly, I support the proposed updates in the component weights and the corresponding currency amounts for SDR valuation.

However, I wish to look ahead a bit and pick up on a point made in the report on possible changes in the procedures and valuation basket over the next 5 years. Although the staff considered this prospect only in regard to European Monetary Union and a single currency, the issue is really more general. The staff report indicates that the Fund emphasizes "stability" as a desirable property for SDR valuation. There is a risk, however, that we may become too attached to the stability property of the existing valuation process at the expense of other desirable properties such as accuracy in valuation.

The primary role of the SDR is as a unit of account and stability of value clearly enhances this function. However, by definition, a unit of account weighs the fundamental economic values of different items under consideration and expresses them in a common measure that accurately reflects valuation differences. It is not clear that the current procedures still accurately evaluate the economic forces that drive the valuation of the reserve currencies from which the SDR value is derived.

Specifically, the weights for each of the five currencies in the SDR valuation basket are calculated by the simple summation of their individual use in global exports and global foreign exchange reserves as a proportion of their aggregate use. By aggregating a flow variable (the value of exports) with a stock variable (the value of reserve holdings), the resulting SDR basket weights are, as the report demonstrates, more heavily influenced by trade in goods and non-financial services than by financial variables. However, international financial flows and activity in foreign exchange markets are increasingly dominated by transactions in international capital markets not by transactions in goods and services, and the turnover of foreign exchange reserves by currency, rather than the stock of reserves, would reflect this more accurately. As noted in the report, data on activity in foreign exchange markets are available from the BIS.

The report did consider supplemental data, which would more accurately reflect financial flows, and concluded that it supported the basket weights derived from the export and reserves formula. However, it supported only the ordinal ranking of these weights and not the cardinal value of the individual weights. Indeed, the supplemental data suggest that the U.S. dollar could have a higher weight and the franc a lower weight. I would agree, therefore, with the staff that assigning more weight to the reserve variable and less to the export variable in calculating the basket weights for SDR valuation is unnecessary to reflect the growing importance of financial transactions only if some measure of reserve turnover were to replace reserve stocks. Otherwise, some reweighing does seem warranted at some point to reflect the growing importance of capital transactions relative to trade in goods.

With regard to the reserve role of the SDR, which is only briefly mentioned in the report, I was struck by the statement that the SDR has retained its competitiveness as a reserve asset. Although this assessment may be accurate, the fact that the SDR has virtually no private value and is used exclusively for official transactions, and particularly with the Fund, makes an assessment difficult. The comment that the SDR enjoys a high turnover despite a low share in total reserves is not necessarily a positive indicator of its worth as a reserve asset; Gresham's Law indicates that the same property would hold for an inferior asset. Indeed, the SDR as a composite asset of reserve currencies represents a fixed portfolio of these currency amounts over the medium term. In order to adjust their portfolios of reserve currencies over the short term in line with exchange rate changes to a more desirable allocation, members must hold individual amounts of these reserve currencies in their portfolios. Therefore, the inflexibility of the currency amounts in the SDR composite related to the infrequent change in basket weights may actually detract from the attractiveness of the SDR as a reserve asset.

Also, in this context, the analysis of the stability of the SDR value over time in relation to its individual components is less instructive than a comparison of stability with regard to other weighting schemes or other portfolio combinations. The properties of portfolio diversification indicate that any combination of multiple reserve currencies will have lower volatility than the individual components. However, in light of the strong correlation between the franc and the deutsche mark in the exchange rate mechanism of the European Monetary Union (ERM), a comparison of the four-currency with the five-currency combination, or for that matter the sixteen currency with the five currency combination, may have been more useful. Similarly, alternative methods of obtaining basket weights could be examined for their stability properties to address the issue of alternatives to the simple summation of exports and reserve holdings. I would urge the staff to consider such simulations since they would provide a stronger foundation for preserving the current procedures.

I recognize, however, the need for continuity and stability in the valuation of the SDR and, therefore, support the proposal to simply update the weights. Nevertheless, in the event of a re-examination of the structure of the valuation procedures related to some fundamental change in the international financial system such as the European Monetary Union, the opportunity to revise the SDR valuation procedures more substantively to take account of other structural changes in the system--most notably the growing importance of international financial flows--should not be wasted.

Mr. Ismael said that he agreed with the staff that the method of valuation for the SDR set out in 1980 remained appropriate. Therefore, he could support the proposed decisions.

Mr. Esdar stated that, in contrast to the usually reluctant attitude taken by his chair toward proposals involving the SDR, he could fully support the proposals contained in the excellent and convincing staff papers, which paid due regard to the situations of individual countries.

Mr. Zoccali made the following statement:

As other speakers, I welcome the comprehensive paper and its supplement prepared for the quinquennial review of the SDR valuation basket and note its intention of not raising issues regarding the possible future role of the SDR or possible different functions or forms of valuing the SDR, be considered in the seminar scheduled for early 1996.

It is to be hoped that the discussion on the future role of the SDR will not be approached solely from the angle of the past lack of growth in private demand for SDR denominated assets or as a means of covering exchange risk, but also to potential demand considerations arising from the SDR's financial attractiveness relative to major reserve currencies and the largely smooth experience of official institutions with transactions and operations in SDRs, also noted in the papers before us.

More specifically on the existing standard basket method of valuation of the SDR, I share the staff's overall conclusion that, on balance, it has continued to work well as it has provided the SDR stability in terms of the major currencies as well as reasonable assurance that the existing currencies included in the basket are both representative of the currencies used in international transactions and likely to remain stable over the medium term. Moreover, the simplification of the basket in 1980 is shown to have contributed to the attractiveness of the SDR as a reserve asset by providing for competitive risk-adjusted returns for SDR denominated assets. I concur, therefore, that there would not seem to be strong operational reasons to suggest fundamental changes in the existing method of valuing the SDR.

The attempt made to quantify impact on the percentage weights of the "financial factor" by including the turnover of currencies in the leading foreign exchange markets, the role of individual currencies in international capital markets and the currency denomination of trade invoicing evidences the difficulties involved in drawing unambiguous and straightforward conclusions. I am, nonetheless, comfortable with the judgment reached from these fragmented supplementary factors, confirming that the modest decline in the role of the U.S. dollar in each of the categories of financial activity covered over the last five years would not suggest the need for a major redistribution of long-run shares among currencies or for qualifying the results of the calculations of the new weights on the basis of the economic criteria specified in the 1980 decision.

On the question of the frequency of revision of the SDR basket, more frequent revisions would not necessarily add more stability in SDR exchange rates nor by itself contribute to improving the attitude of private markets toward the SDR. Nonetheless, were the EU to introduce a unified currency earlier than 1999, the impact of the determination of a single European currency on the SDR basket would need to be reviewed before the end of the forthcoming five-year period and a more conclusive suggestion put forward to substitute for the European currencies in the SDR basket when the ECU has been accepted and implemented as the single currency of the EU.

With respect to the proposed rounding to make individual weights sum to 100 percent, the supplementary criteria indeed seem to confirm the dollar's predominance in the context of an increasing role for the deutsche mark and the Japanese yen. While I welcome the fact that the receipt of official data on international banking interest used to adjust exports of goods and services eliminates the need to adopt any further rounding of the currency weights, as proposed initially in the staff paper. I must confess that the methodology for compiling it across countries remains unclear and would warrant some more uniform compilation, particularly in view of its base in the preliminary quota calculations under the Eleventh General Review of Quotas.

I agree on the desirability of keeping the SDR interest rate basket identical with the SDR valuation basket, so that the effective yield on the SDR would correspond to that of the valuation basket and be broadly consistent with that of comparable reserve assets. I also see no reason from deviating from the original criteria for determining the financial instruments to be included in the basket, that is, that they be representative of underlying conditions of the markets from which they are drawn and meet the criterion for the holding of central bank reserves, justifying, therefore, current three-month instruments.

The proposed change in the valuation basket entails, however, an upward shift in the combined market interest rate calculations of some 26 basis points--reflecting the decline in the share of the low-yielding Japanese three-month certificate of deposit and the increase in the shares of other higher yielding instruments--and will impact both on the level of remuneration expense and the rate of charge. Perhaps this would be the right time to look into the possibility of additional administrative cost savings for fiscal year 1996 to minimize the need for a further adjustment in the rate of charge to meet the agreed net income target.

Finally, I support the proposal to make this paper and the summing up of the Board discussion available to prescribed holders of SDRs and institutions that have adopted the SDR as a unit of account in advance of the revised SDR basket coming into effect.

Mr. Galicia said that he could associate himself with the comments put forward by Mr. Zoccali. He supported the proposed decisions.

Mr. Newman made the following statement:

The staff paper for the current discussion concludes that the 1980 decision on the method of valuing the SDR is working as intended and recommends that no fundamental changes be made. We agree with this view and believe that our approach today should be based on the wise political dictum: "if it ain't broke, don't fix it." This is especially true at a time when the Fund is about to embark on a comprehensive review of the SDR and the desirability of avoiding frequent changes that could adversely affect market participants and upset the careful balance that has been achieved between the holders of SDR-denominated assets, of which the United States is the world's largest, and those with SDR-denominated liabilities.

The 1980 decision also specifies the operational procedures to be followed in determining the choice of currencies in the basket and the weight to be assigned to each. These procedures have also been operating as intended, although we share Mr. Clark's view that they do not adequately capture the role each currency plays in international financial transactions. More important, however, we are concerned about how the operational procedures were implemented and the last-minute introduction of new calculations based on more current data on international banking interest for 1994.

The staff points out that the SDR plays an important, albeit declining, role as a store of value and unit of account for official and private institutions. The usefulness of the SDR for this purpose reflects its stability and competitive yield as well as the credibility arising from its association with the Fund. A late change in the basket to take account of new data can only raise unfortunate perceptions that the system is being manipulated to achieve particular results. It is especially disappointing when the late information comes from a member that has been in the forefront of efforts by the Fund to encourage the provision of comprehensive data to the Fund on a timely basis. Moreover, the problem is heightened when small adjustments in data can produce large changes in the basket. In these circumstances, we believe a fuller explanation is warranted of the reasons for the delay in providing timely data, particularly as other countries were able to provide the necessary information. We would be interested in knowing whether other countries were invited to provide updated information and the steps that will be taken to avoid a recurrence in the future, including clearer rules on how international interest should be treated for the purposes of valuing the SDR.

With these comments, I can support the proposed decisions.

Mr. Evans commented that he did not accept Mr. Newman's characterization of the process for data provision by the United Kingdom. He looked forward to the staff's comments on that issue.

Mr. Cippa said that his chair agreed with the main conclusion in the excellent staff paper that the basket valuation of the SDR continued to work well and should continue to be applied. That method of valuation had allowed the SDR to exhibit long-run overall stability against major currencies. The same was true of the valuation procedures applied to SDR interest rates. There was no need to change the composition of the SDR basket, as the five countries whose currencies were included in that basket continued to be the largest exporters and they were likely to remain so over the medium term. The use of supplementary financial criteria confirmed those conclusions.

His chair could support updating the weights in the SDR basket as proposed in the first supplement to the staff paper, Mr. Cippa stated. The envisaged monetary union among states in the European Union (EU) might call for a review of the SDR before the end of the forthcoming five-year period. He agreed with Mr. Clark that such a review might represent a good opportunity to further revise the SDR valuation procedures to take into account the growing importance of international financial flows. The prescribed holders of SDRs and other institutions that had adopted the

SDR as a unit of account should be informed of the revision of the weights well ahead of the date on which the new SDR basket would take effect. Therefore, his chair could support the proposed decision on the release of information.

Mr. Mesaki made the following statement:

First of all, I agree with the conclusion of the staff paper that there would not seem to be any operational reasons to suggest any fundamental changes in the present method of valuing the SDR.

Let me touch upon specific points discussed in the staff paper.

The staff paper concludes that the list of currencies in the SDR basket should remain unchanged. My authorities have no problem at all with this conclusion and believe that it will contribute to the stability of the SDR.

With regard to the relative weights of the currencies, my authorities have no difficulty in supporting the conclusion presented by the staff.

As Mr. Clark's statement indicates, in view of the increasing importance of international financial transactions, it is also appropriate to take the supplementary data into consideration for the valuation of the SDR.

With regard to the SDR interest rate, as the staff has been informed, my authorities regard that the three-month interest rate of certificates of deposit represents as the representative rate in the Japanese financial market.

I would like to commend the staff's effort in terms of the broad discussion on the impact of European Monetary Union and European Currency Union. My authorities support the staff's conclusion that it is inappropriate to contemplate use of the ECU in the SDR basket at this stage. As the staff paper mentions, however, the current SDR valuation procedure should be reviewed in the event a significant structural change takes place in EMU.

For all these reasons I support the staff's proposals.

Mr. Martinez Oliva, speaking on behalf of Mr. Lanciotti, made the following statement:

I support the staff proposal to maintain unchanged the fundamental features of Decision No. 6631-(80/145) G/S concerning the SDR valuation and interest rate baskets. I would also go along with the proposal to maintain the current five-year review period, to which the market is now attuned. An higher frequency of the revisions would not contribute to a higher stability of the SDR exchange rates.

I will comment briefly on the SDR valuation basket, then on the issue of the possible use of supplementary financial information, and finally on the revision of weights.

The staff paper documents that, since the beginning of the eighties, the SDR has cumulatively appreciated against the U.S. dollar, the pound sterling and the French franc, whereas it has depreciated vis-à-vis the German mark and the Japanese yen. Chart 2, however, shows that, at least since 1986, the French franc and the German mark have moved very closely and have remained almost stable in a narrow range against the SDR. As concerns the exchange rate with the pound sterling, this has also remained stable, until the sterling's exit from the ERM in 1992. The following depreciation of the sterling, however, appears to be a once-and-for-all adjustment.

I would note, then, that the value of the SDR in the last decade has been remarkably stable against the European currencies included in the basket, while its value has changed substantially against the dollar and the Japanese yen. The exchange rates of the SDR vis-à-vis these two currencies appear clearly dominated by the long-run tendency of the dollar to depreciate and that of the Japanese yen to appreciate.

Overall, the long-run stability of the SDR value has been preserved and the SDR has retained its competitiveness as a reserve asset. Moreover, the share in world exports of goods and services of the five countries represented in the basket has increased in the 1990-94 period compared to previous periods. The gap with the countries not included in the list has obviously diminished, but it appears that it will remain substantial for a number of years. Against this background, I agree with the staff that there is no reason to modify the current currency basket.

It is certainly regrettable, however, that notwithstanding these apparently positive features of the SDR its use both in the private market and as an official reserve asset remains very limited. There is no need to say that we should examine this issue very carefully. I look forward to the discussion on the role of the SDR scheduled for early 1996.

I fully support the idea that we should consider the possibility of using other financial variables, in addition to reserve holdings, in order to determine the weights of the component currencies in the basket. This in light of the importance assumed by capital markets in recent years in influencing world exchange rates and the limited usefulness of official reserves as a measure of a currency's financial role.

Unfortunately, as the staff notes, the information on other criteria is still fragmentary and incomplete, and in any case the available data seem to confirm the ranking of the currencies in the SDR basket without any significant redistribution of shares. However, I believe that we should reconsider very carefully this issue in a next review. Indeed, the existing data already appear sufficiently good and detailed, in my opinion, for some of the suggested criteria. This is the case, for instance, of the data on the turnover in exchange markets and on the relative importance of different currencies in international capital markets. The quality and reliability of these data will certainly improve further in future years.

Let me touch upon a more technical aspect of the construction of the new basket, the rounding procedure currently adopted seems to leave too much room for arbitrariness. In fact, after rounding all the share to the nearest percentage point, we may be left, if the shares do not sum up to 100, with the need to allocate an entire percentage point to one of the five currencies. This is what happened in the last review and would have also occurred in the current occasion, had the calculations not be revised for the release of new U.K. data.

I wonder whether we should not consider an alternative rounding procedure to reduce the degree of arbitrariness. I am personally sympathetic with the proposal which was put forward by the Belgian chair during the last review, consisting in allowing a rounding up to the first decimal point. In this case, one would be left with the problem, if any, of allocating only a tenth of a percentage point instead of a full percentage point. However, I understand that there are also good reasons in favor of the current rounding procedure. Thus, I will not object to leave it unchanged for the time being.

As concerns the procedure to assign the eventual "missing" percentage point, I favor the use a "mechanical" criterion, as the one which is based on the smallest impact in relative terms, which helps reducing arbitrariness.

Mr. Evans said that he had no difficulty in supporting the staff proposals. The United Kingdom would continue to provide data both to the Fund and to the public on a timely basis. Although he did not agree with Mr. Clark's comments on the larger role played by capital markets and the smaller role played by trade and goods and services, he hoped that that issue could be taken up in the context of the seminar on the role of SDR to be held in 1996.

Mr. Ramdas made the following statement:

We share the staff view that the SDR has continued to work well on balance. We note that the SDR continues to show stability against major currencies, its effective yield is competitive, official acceptance as a reserve asset remains largely unchanged, and no operational difficulty has arisen with respect to transaction valuation.

We support the proposed decision to update the percentage weights for the five currencies and the currency amounts according to the revised staff supplement.

Mr. Mohammed stated that he could agree with the main conclusion of the staff paper, namely, that the method of valuation for the SDR agreed in 1980 continued to work reasonably well and should continue to be applied. He could also agree with the main operational conclusions contained in the staff paper and with the modification indicated in the first supplement to the staff paper. Although the upward shift in the SDR interest rate entailed in adopting the new SDR basket was not insignificant, especially for those countries that used Fund resources, it was a product of the same exercise that had led to a downward shift under the previous review of the valuation of the SDR. It was to be hoped that the expected upward adjustment in the SDR interest rate would make the Fund think long and hard before accepting any proposals that would lead to a higher rate of charge on the use of Fund resources.

Mr. Akatu made the following statement:

I wish to commend the staff for a comprehensive, lucid and balanced paper on the issues pertaining to the quinquennial review of the valuation of the SDR. I am in broad agreement with the proposals that have been put forward in the paper for up-dating the valuation method for SDR. I note that the new procedure is due to go into effect from January 1996. I consider them generally adequate for the time being for the purpose of maintaining the effective operation of the SDR scheme as currently conceived. I note that a seminar on the future of the SDR is planned for early next year. However, I believe it would be impossible at this point in time to meaningfully anticipate what the outcome of that seminar is likely to be and to attempt to take account of that in the current review.

On the number of currencies that should comprise the SDR basket, we agree with the proposal to retain the status quo in line with the Fund Decision of 1980. In our view, the five-currency valuation basket has worked satisfactorily in the terms of the stability of the SDR relative to the bilateral rates of exchange of the component currencies. The SDR, because of its relative stability, has also maintained a competitive edge over its component currencies. We note, however, that despite these attractive features, the SDR is far from being the principal international reserve asset as was perhaps the original vision. Perhaps the staff would like to comment.

On the proposed weights of the currencies in the basket, the two main determining factors appear to present no major problem given the data presented in Tables 3 and 4. The data and analysis presented by the staff in respect of the supplementary variables, however are less clear-cut. Nonetheless, I am in agreement with the staff view that the broad tendencies of the trends in these factors generally support the ranking of the five currencies on the basis the two basic economic and financial variables. Hence the calculated weights presented in Table 5 are in my view, adequately representative of the relative sizes of the respective issuing countries in the world economy. The staff have a point in suggesting that it would be most appropriate to round up the weight of the U.S. dollar by 1 percentage point in order to bring the total of the calculated weights to 100. This option would indeed represent the smallest relative increase in calculated weights (3.23 percent). However, if the calculated weight of the yen were similarly rounded up the resulting increase would be quite close (at 3.54 percent) while the increase in the case of the mark would not far away (at 3.72 percent). The decision here therefore, is a close call although this chair would be flexible in the interest of achieving a consensus.

The formula proposed by the staff for maintaining the transactions value of the SDR unchanged in the transition to the new basket on January 1 is acceptable to this chair. Our understanding of the character of the SDR is that movements in its exchange rate should reflect movements in the exchange rates of its component currencies.

On SDR interest rates, I would generally endorse the current practice which seeks to align SDR interest rates closely with the yield on alternative reserve assets. The difficulty, however, is to find a proper balance between the objective of making the effective yield on the instrument high enough to make it attractive to acquire and hold, and that of ensuring that they are not so high as to make countries reluctant to use them when in deficit. The view of this chair that the latter should weigh somewhat more heavily, especially as the SDR enjoys a risk-return advantage over its component currencies. The staff may wish to comment on this observation. Beyond this, I would agree with the choice of financial instruments which currently form the basis for setting and adjusting SDR interest rates, given that the selected securities are adjudged to be broadly representative of government securities in which central banks would hold their reserves. I note the expected discrete jump in SDR interest rates in the transition to the new SDR valuation basket and hope that the increase will be modest.

Finally this chair has no objections to the proposal to inform holders of SDR and other institutions which employ the SDR as a unit of account about the revision of weights ahead of time. I also agree that transparency about the mechanics of the SDR is necessary to maintain public confidence in the instrument. Hence it would appropriate to make the staff report and the summing statement of the chairman available to SDR's clientele.

Mr. Verjbitski made the following statement:

I shall join the Executive Board's collective quest for brevity.

I have sympathy for the staff's view that changes in the fundamental features of the present method are undesirable until the broader issues of the future role of the SDR and its characteristics as a reserve asset are considered at the forthcoming seminar early next year and, later on, by the Executive Board.

Therefore, at this time I can support maintaining the status quo, and I can go along with the proposed decision on updating the weights of the five currencies in the SDR basket at the beginning of 1996.

Mr. Cailleteau made the following statement:

I welcome the provision of fresh data by the United Kingdom, which allows us to complete the review with accurate data. I wonder whether the staff could comment on the comparability of data provided, or not provided, by member states on the technically delicate issue of international banking interests. I would like also to comment briefly on two very interesting points raised in Mr. Clark's opening statement.

As to the issue of stability versus accuracy, it should be noted that accuracy is a very delicate concept, perhaps more so than stability with respect to the valuation of the SDR. The current method used to calculate the value of the SDR provides an acceptable level of accuracy, given the nature and functions of the SDR. We agree with the staff that it is appropriate to emphasize stability as the first desirable property for the SDR, for at least two operational reasons. First, some member countries have pegged their currencies to the SDR. Second, the stability of the SDR as a unit of account is very appreciated by creditor central banks.

Two of the arguments presented in the staff paper seem difficult to reconcile. In the first instance, the staff indicates that some measure of reserve turnover should be taken into account. However, in the second instance, the staff states that the high turnover of the SDR does not constitute in itself a positive indicator of its worth as a reserve asset. I wonder whether the staff considers reserve turnover to be as an asset or a drawback for currencies.

Mr. Clark said that his opening statement was intended to emphasize the need to make the weighting of currencies in the SDR basket better reflect developments in the financial markets. He was not sure whether the turnover of reserves was the best indicator to use for that purpose In addition, he was not convinced that the rapid turnover in the use of SDRs should be taken as an indication that the SDR was a valued reserve asset.

Mr. Saha stated that he agreed with previous speakers that the currencies included in the SDR basket should represent the major currencies used in international transactions. He also agreed that the current method of valuation for the SDR had continued to perform well. However, it should be noted that private transactions in SDRs were not widespread, as developments in the private market in SDR-denominated assets showed. That was an area for improvement. He could support the proposed decisions.

Mr. Al-Tuwaijri said that he could support the proposed decisions.

Mr. Hamilius made the following statement:

Let me begin by commenting on the selection of the basket currencies and the technicalities of constructing the new basket, and then turn briefly to the SDR interest rate.

First, I agree that the principles governing the standard basket valuation method are still valid. Although basket currencies have decreased their relative shares in terms of world holdings, there is no striking need to modify the basket, through the inclusion of a new currency. Moreover the basket currencies have increased their relative share in terms of total world goods and services.

By the same token, the reasons which have led the Executive Board to confirm these valuation methods ever since 1980 are likewise still valid. The present SDR valuation basket should remain as it is and its attractiveness as a reserve asset should be upheld. It has already been observed that, for various reasons, SDR denominated assets have lost ground on both the demand and supply sides. For one thing, the decline in the stock of officially created SDR-denominated assets during recent years has raised questions about the SDR's role as a reserve asset. For another, for obvious political reasons, the SDR has not received the same kind of promotion efforts as the ECU. And its high overhead costs have deprived the SDR of some of its attractiveness. A more thorough analysis of the SDR's relative "unattractiveness" would have been useful.

It would also certainly be interesting if we could assess more precisely the weight of each basket currency with the aid of supplementary financial criteria such as its turnover in foreign exchange markets and its relative importance in the international capital markets and the invoicing of international trade. But addition of these new criteria would probably only have marginal effects on the final result, while introducing a certain degree of imprecision: for example, the staff notes that data on the invoicing of international trade are incomplete and in many cases outdated. Given these drawbacks and for the sake of simplicity, always important for the international markets, we believe the present elements, that is, exports of goods and services and the official holdings of currencies, are appropriate for assessing the SDR basket currencies and determining their relative weights.

On the issue of the SDR interest rate, we concur with the view that the SDR interest rate basket should match the SDR valuation basket. We therefore see no compelling reasons to change the method of setting the SDR interest rate. However, as suggested by the staff, it is certainly useful and even necessary to periodically review the financial instruments to be included into the SDR interest rate basket.

The Treasurer said that the staff had issued a supplement to update the information contained in the original staff paper, which had been circulated on August 14, 1995. As official data on international banking interest for the United Kingdom used in calculating the valuation of the SDR basket had not been available at the time the original staff paper was circulated, that data had been estimated by the staff on the basis of the data that had been used in making preliminary quota calculations in the context of the Eleventh General Review of Quotas. As that data--which had become available only after the original staff paper had been circulated--showed that the amount of net international banking interest used to adjust the data on exports of goods, services, and income for the United Kingdom had declined from 20.1 percent to 18.3 percent, the staff had considered it important to bring that change to the attention of the Board.

It should be noted that the United Kingdom had the world's largest amount of international banking interest, owing to the role of London as an international banking center, the Treasurer stated. However, because a large portion of foreign transactions in the United Kingdom were undertaken by foreign banks on behalf of foreign customers, those transactions did not impact on the United Kingdom's gross domestic product or on its balance of payments position.

The staff was not in a position to comment on the extent to which the methodology used to define international banking interest was consistent across countries, the Treasurer commented. The data on international banking interest for 1990-94 for France, the United Kingdom, and the United States had been taken from official data provided by the authorities. The staff assumed that those data had been compiled on a comparable basis in accordance with the Balance of Payments Manual. The data for Japan had been estimated by the staff in consultation with the Japanese authorities, and the official data on exports of goods and services for Germany had been compiled net of international banking or offshore interest receipts or payments.

The actual amount of the upward adjustment in the SDR interest rate that would result from a change in the weighting of the currencies in the SDR basket would depend on the configuration of interest rates and currency movements when that change came into effect, the Treasurer continued. Based on the current configuration of interest and exchange rates, the adjustment of the SDR interest rate could be expected to amount to about 23 basis points. However, if the interest rates on the currencies that held relatively large weights in the SDR basket turned out to be lower than currently envisaged when the change in the weights came into effect, the adjustment in the SDR interest rate would be lower.

As the rate of charge on the use of Fund resources was currently 106 percent, some upward adjustment in the SDR interest rate would help to increase the Fund's net income position, the Treasurer added. If a surplus emerged, that surplus would be returned to members.

The staff would examine the issues raised by Mr. Clark in the context of the forthcoming seminar on the role of the SDR, the Treasurer stated. It was to be hoped, also in the contest of that seminar, that members might agree to allow the valuation of the SDR to be freely determined by market forces. Although the valuation of the SDR derived under the current methodology would likely hold its present position in the market, it might be desirable to eliminate the official constraints on it.

The reference to the summing up of the Executive Board meeting contained in the first sentence of the proposed decision on the release of information to prescribed holders of SDRs should be deleted to better reflect the record of the current discussion, the Treasurer said.

The Chairman noted that Directors had agreed to amend the decision on the release of information to prescribed holders of SDRs as suggested by the Treasurer.

The Executive Board took the following decisions:

SDR Valuation Basket

The Executive Board, having reviewed the list of the currencies, and the weights of these currencies, that determine the value of the special drawing right, in accordance with Decision No. 6631-(80/145) G/S, adopted September 17, 1980, decides that, with effect from January 1, 1996, the list of the currencies in the SDR valuation basket shall remain the same, and the weight of each of these currencies to be used to calculate the amount of each of these currencies in the basket will be as follows:

Currency	Weight (In percent)
U.S. dollar	39
Deutsche mark	21
Japanese yen	18
French franc	11
Pound sterling	11

Decision No. 11073-(95/92) G/S, adopted September 25, 1995

SDR Valuation - Release of Information

The Executive Board approves the proposal to release the staff papers on the review of the method of valuation of the SDR (SM/95/201, 8/14/95; and Sup. 1, 9/13/95) to the prescribed holders of SDRs and to the institutions that have adopted the SDR as a unit of account, as shown in the annex to this decision.

Adopted September 25, 1995

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/91 (9/22/95) and EBM/95/92 (9/25/95).

3. PHILIPPINES - ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, and 4

The Fund notes with satisfaction that, with effect from September 8, 1995, the Philippines has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement. (EBD/95/128, 9/19/95)

Decision No. 11074-(95/92), adopted
September 22, 1995

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAM/95/153 (9/21/95) is approved.

APPROVAL: April 1, 1997

REINHARD H. MUNZBERG
Secretary

Prescribed Holders and International and Regional
Organizations that Use the SDR as a Unit of Account

A. The following institutions are the prescribed holders of SDRs:

1. African Development Bank
2. African Development Fund
3. Andean Reserve Fund
4. Arab Monetary Fund
5. Asian Development Bank
6. Bank for International Settlements
7. Bank of Central African States
8. Central Bank of West African States
9. East African Development Bank
10. Eastern Caribbean Central Bank
11. International Bank for Reconstruction and Development
12. International Development Association
13. International Fund for Agricultural Development
14. Islamic Development Bank
15. Nordic Investment Bank

B. The following international and regional organizations use the SDR as a unit of account, or as the basis for a unit of account:

1. African Development Bank
2. African Development Fund
3. Arab Monetary Fund
4. Asian Clearing Union
5. Asian Development Bank
6. East African Development Bank
7. Economic Community of West African States
8. European Conference of Postal and Telecommunications Administrations
9. Great Lakes States Development Bank
10. International Center for Settlement of Investment Disputes
11. International Development Association
12. International Fund for Agricultural Development
13. International Telecommunications Union
14. Islamic Development Bank
15. Universal Postal Union