February 27, 1996

Approval: 3/5/96

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/83

10:00 a.m., September 12, 1994

Contents

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman
P. R. Narvekar, Deputy Managing Director
A. D. Ouattara, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
M.-A. Autheman	M. Sirat
	P. Cailleteau, Temporary
	D. Desruelle, Temporary
J. Bergo	
H. Evans	J. Dorrington
K. P. Geethakrishnan	L. E. N. Fernando
J. E. Ismael	
D. Kaeser	K. Link
A. Kafka	
	A. V. Mozhin
	B. M. Lvin, Temporary
	E. Kouprianova, Temporary
W. Kiekens	J. Jonáš, Temporary
	N. Coumbis
	R. D. Bessone Basto, Temporary
K. Lissakers	B. S. Newman
R. Marino	G. Torres
H. Mesaki	S. Ishida, Temporary
A. Mirakhor	M. Daïri
	M. J. Mojarrad, Temporary
	H. Golriz, Temporary
	B. S. Dlamini
G. A. Posthumus	
	Y.-M. T. Koissy
S. Schoenberg	E. Wagenhoefer
	G. M. Blome, Temporary
A. S. Shaalan	Y. Y. Mohammed
D. E. Smee	G. F. Murphy
E. L. Waterman	Y.-H. Lee, Temporary
	Wei B.
	Wu H., Temporary
A. G. Zoccali	N. Mancebo, Temporary

L. Van Houtven, Secretary and Counsellor
J. W. Lang, Acting Secretary
C. P. Clarke, Assistant
M. A. Khan, Assistant

Also Present

IBRD: F. D. Levy, Europe and Central Asia Regional Office; S. Shetty, East Asia and Pacific Regional Office. Central Asia Department: H. Neiss, Director; J. M. Barrionuevo, O. J. Evans, K. Okamura, M. Schulze-Ghattas, S. B. Schwartz, W. S. Tseng. European I Department: G. Bélanger, S. B. Brown, D. P. Hewitt, S. Kalra, G. R. Kincaid, A. Lonnberg. European II Department: J. Odling-Smee, Director; L. Hansen. External Relations Department: S. J. Anjaria, Director; G. Hacche, D. R. Hawley. IMF Institute: A. Ouanes, D. Karakasheca, Participant. Legal Department: F. P. Gianviti, General Counsel; R. H. Munzberg, Deputy General Counsel; P. de Boeck, J. L. Hagan. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; B. Christensen, S. B. Creane, A. K. McGuirk, J. Santos, A. Singh, M. A. Tareen, J. van Houten. Research Department: M. Goldstein, Deputy Director; P. Isard, S.-J. Kim, D. J. Mathieson, G. M. Milesi-Ferretti. Secretary's Department: A. Mountford. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; J. E. Blalock, J. C. Corr, H. Flinch, R. H. Floyd, H. G. Jepsen, D. K. Kar, A. Muttardy, O. Roncesvalles, T. M. Tran. Western Hemisphere Department: S. T. Beza, Counsellor and Director. Advisors to Executive Directors: J. M. Abbott, R. F. Cippa, S. K. Fayyad, R. Kannan, P. A. Merino, M. J. Mojarrad, B. A. Sarr. Assistants to Executive Directors: S. E. Al-Huseini, J. M. Burdiel, A. G. Cathcart, J. A. Costa, G. Z. El-Masry, J. C. Estrella, S. S. Farid, A. Galicia, M. A. Hammoudi, O. A. Himani, G. H. Huisman, P. J. Jilek, K. Kpetigo, V. Kural, N. L. Laframboise, K. J. Langdon, F. Moss, S. Narube, S. Rouai, A. Sighvatsson, V. Verjbitski, R. von Kleist, S. Vori, Wang Y.

1. ACCESS TO FUND RESOURCES AND ALLOCATION OF SDRS - DRAFT REPORT TO INTERIM COMMITTEE; AND RELATED ISSUES

The Executive Directors considered a draft report of the Executive Directors to the Interim Committee on access to Fund resources and an allocation of SDRs (SM/94/205, 8/1/94), together with a memorandum on alternative wording proposed by a group of Executive Directors (EBD/94/146, 8/25/94); a staff paper on a draft fourth amendment of the Articles of Agreement (SM/94/216, 8/10/94) and an alternative draft amendment based on a proposal by two Executive Directors (SM/94/216, Sup. 1, 9/8/94); and a staff paper on illustrative calculations of an SDR allocation (SM/94/206, 8/1/94). They also had before them statements by the Managing Director on access limits, SDRs, and cofinancing trust accounts (BUFF/94/66, 7/1/94; and BUFF/94/71, 7/25/94); and an earlier set of illustrative calculations prepared by the staff (SM/94/152, 6/17/94; and Sup. 1, 7/5/94).

Ms. Lissakers made the following statement:

> We have less than four weeks to go to the Interim Committee meeting, and the time has clearly come to reach some resolution on the key issues before the Committee and before this Board. At a minimum, we must reduce the remaining issues to a manageable few, although full resolution of all the outstanding issues would obviously be optimal. Unless we do so, I am afraid we are likely to lose an opportunity that is unlikely to recur for some time to resolve the questions that have divided us for several years. Success in this endeavor will require that pragmatism replace ideology.
>
> On the question of an SDR allocation, the U.S./U.K. proposal on SDRs reflects a pragmatic approach. It attempts to steer a compromise course that avoids the issue of opposing and, apparently, irreconcilable views on a general allocation. It deals directly with the anomalies created by the large unprecedented increase in Fund membership since the last SDR allocation, thereby strengthening the role of the SDR in the system by making it possible for these many new members to participate. It does so in a manner that provides all countries with SDRs and ensures that those members with the most acute reserve needs--the transforming economies and the poorest members--receive proportionately more than would be provided under a general allocation of comparable size. I understand the concerns of some Directors that an amendment will take time to ratify, and the uncertainties certainly of Congressional approval in this country. However, the possible delay in implementing an amendment must be compared with the time already taken on this issue, and the unlikely prospect of reaching a consensus if the issue continues to be debated on an ideological basis. I am certainly hesitant to predict how Congress will deal with an SDR amendment. However, the fact is that Congress has never failed to enact legislation dealing with the Fund. An SDR amendment designed to take account of the expansion of Fund

members and in the context of a package that includes an increased Fund role in meeting financing needs will have considerable appeal. In these circumstances, we are confident about the outcome, and we believe also that it is all the more important to be clear that what is being proposed in the amendment is a one-time special allocation to address unique circumstances, and not a fundamental change in existing SDR provisions.

Some of my colleagues have raised fears that adoption of the U.S./U.K. approach would jeopardize the possibility of future general allocations based on a finding of global need. The draft amendment prepared by the staff as narrowly drawn would not affect any of the other SDR provisions, including those Articles dealing with a general allocation based on a finding of global need. Thus, I find it a little difficult to understand the argument that adoption of the U.S./U.K. approach would somehow prejudice possible future general allocations. Rather, it seems to me that the fears expressed by these Directors reflect a more fundamental issue involving the role of the SDR in the system. They are in effect arguing that the inability to agree on a finding of global need, given current economic conditions and those of the past few years, suggests that we will never be able to reach a consensus on a general allocation. In these circumstances, they believe that use of political leverage is the only means of attaining their objective of a general allocation and an expanding role for the SDR. Let me state very clearly that we will not support a general allocation of SDRs. If our compromise proposal is adopted by the Board and by the Governors, we would certainly urge that the Interim Committee language state clearly that this is not a precedent for future allocations, and that the basic Articles pertaining to SDR allocations remain the valid and only basis for future allocations of SDRs. There would be no question about the validity of general allocations when there is agreement on the global need criterion, which is not present at the moment.

With regard to access, let me mention briefly the other issues. The draft report to the Interim Committee in large measure reflects the current status of our discussions. Consequently, I have very few comments. First, with regard to access under stand-by and extended arrangements, a number of Directors proposed raising the annual limit to 100 percent of quota. This option should be included in the report. Moreover, the purpose of increasing the annual limit is to achieve an increase in the average actual size of Fund programs. We believe that this goal should be made more explicit in the report, for example, by indicating that the objective is to raise the average size of programs to roughly 50 percent of quota.

Second, with regard to the systemic transformation facility (STF), it would be preferable to delineate more clearly than the current report does the two approaches on increased access: a third tranche of 40 percent of quota or two tranches of 20 percent each. We very strongly favor the single third tranche of 40 percent of quota. Furthermore, the relationship between expanded STF access and stand-by arrangements would also be clearer if treated in a separate sentence. It was our impression that most Directors favored an explicit link to stand-by and extended arrangements, although some were prepared to consider the possibility of stand-alone STF-supported programs in exceptional circumstances and with prior Board approval. We believe these nuances should be made explicit in the report.

Third, the report goes too far, in our view, regarding creditor country commitments on debt rescheduling and on the need for future quota increases and the expansion of the enhanced structural adjustment facility (ESAF), particularly in view of the Fund's strong liquidity position following the recent quota increase.

I think that sums up where we are. We are close to delineating a package, but clearly we have one issue to settle, and I hope we will come closer to a resolution as a result of today's discussion.

Mr. Evans made the following statement:

Our discussions on these subjects are proving somewhat protracted, which is not altogether surprising, given the history. We have not come to agreement yet on all elements of a possible package, but I think we are closer to agreement on access than on SDRs. I believe that all of us around this table are keen to see some progress. I would like to set out why I think the proposal that Ms. Lissakers and I have made is a reasonable compromise, and suggest how we might make progress from here on with a view to giving our Ministers the best chance of reaching agreement in Madrid.

It seems to me from our earlier discussion that two inescapable propositions emerge. The first is that there will not be a general allocation of SDRs. Like Ms. Lissakers, we will not support a general allocation. Second, there will not be, on its own, an equity allocation for new members only. So, to avoid the zero option, Ms. Lissakers and I put forward our compromise proposal on SDRs, which we thought could resolve the impasse. I think that the draft report to the Interim Committee needs to spell out clearly but briefly the options for increased access and allocations of SDRs and so provide the basis for a consensus. We would be failing in our duty to the Committee if we failed to provide them with a realistic set of choices. Before Madrid, our work must be to try to narrow down the range of options. It would be quite wrong to overload the Committee with options that have no chance of being accepted.

Let me remind colleagues why I think our proposals have merit. First, it would mean that all members will have a stake in the SDR system. Second, the role of the SDR itself will be increased and strengthened. Third, new members will receive considerable amounts in proportion to their quotas. Fourth, differences among members' allocations as a ratio of quota will be substantially reduced. Fifth, distribution effects among members are favorable.

Finally, I am grateful to the Legal Department. We have now legal language that demonstrates the feasibility in practice of our proposal. Some Directors believe that a general allocation as a mechanism for making future additions to global reserves will be seriously weakened if we were to adopt the proposal that Ms. Lissakers and I have put forward. That is not my understanding, because our proposal leaves entirely open the question of future general allocations. But to make this clearer, I support Ms. Lissakers' suggestion that we ask the Interim Committee to make a clear and unequivocal statement that a general allocation remains available as a mechanism and is unaffected by this proposal that we have made for a one-off SDR allocation. We could do that in the communiqué of the Interim Committee.

We have discussed here and in informal sessions a number of alternative formulations. I would repeat what I said earlier that there will be no general allocation of SDRs. It seems to me that the options that are available are as follows: first, a selective allocation benefiting all or nearly all members; second, an allocation along the lines that Ms. Lissakers and I have proposed; and third, no SDR allocation, for reasons that we have gone into in the past and today. The second option is the one that we favor.

On the question of access, we are closer to agreement. I think we could help the process of reaching an agreement over the coming weeks by tidying up the relevant sections in the draft report. I think there is merit in emphasizing that what we are doing on access needs to be carried through from the maximum access levels to actual access levels, and we can do so in terms that suggest that there would be an expectation of a substantial increase in the actual average level of access. In the reference on page 5 to access under the ESAF, I believe we should spell out what the high access there should be.

In conclusion, let us remind ourselves what the Interim Committee's mandate to us was. There were two relevant aspects. The first was that the Committee encouraged the Fund to play a central role in this process, namely, the transition to market economies by a large group of countries, including, if needed, through increased access to its own resources, commensurate with the strength of programs. The second aspect was for the Committee to request the Executive Board to continue to work on SDR issues.

Thus, we have a clear mandate to propose changes in access, including for economies in transition. Our Ministers were very clear in April 1994 that an increase in STF access was a key element of that strategy. I think there would be some incomprehension, both inside and outside the Interim Committee, if we fail to fulfill that mandate.

On our next steps, I think we need a revised report rather quickly. I think the more difficult section on SDRs should be much shorter, and I will be happy to expand on these procedural steps after I have heard from a few colleagues.

Mr. Al-Jasser commented that it was to be hoped that the Board would be able to come to closer agreement on the draft report over time, encompassing the elements of a package. The Board's consideration of the issues in the report had already taken some time and had created some division within the Board that, although not new to its operations, were a little sharper than on some other occasions. He agreed with Ms. Lissakers and Mr. Evans that the most contentious element of the package remained the SDR. Those, like himself, who favored a general allocation had based their findings on the fact that the authors of the Articles relevant to the SDR had seen only one way of effecting an allocation of SDRs, namely, a general allocation. He and others had yet to be convinced that there had been dramatic changes in the operations and institutional character of the Fund that would require a deviation from that original vision. Of course, anomalies had developed over time as to the allocation of SDRs among members following the large increase in the membership of the institution. The authors of the Articles had also envisaged that those anomalies would be corrected through consecutive allocations of SDRs over time, although such an approach might not in fact eliminate all anomalies.

The general allocation approach was in keeping with the tradition and culture of the institution, Mr. Al-Jasser remarked. It was going too far to propose a deviation from that approach to correct for one anomaly at the expense of well-established tradition. Indeed, correcting for an anomaly without a general allocation would, in effect, be the kiss of death for the SDR. In that respect, he disagreed with Ms. Lissakers and Mr. Evans that a positive reference in the Interim Committee communiqué would alter that interpretation. In the future, Board, management, and Governors would inevitably refer to a decision, taken after 15 years with no allocations, to the effect that the Board had not found it advisable to have a general allocation, even though inflation had been at its lowest; the precedent would have been established that there was no need to have a general allocation as long as the finding of long-term global need for a general allocation was not unambiguous.

Reasonable people could differ on the definition of "global need," Mr. Al-Jasser noted, but it was important not to take an absolute position on that issue; indeed, there were a number of other issues that, under an absolute interpretation of the Articles, would raise awkward questions, such as the lack of progress on the objective, also set out in the Articles, of making the SDR the principal reserve asset of the system. Some flexibility on the definition of "global need" was, therefore, in order. It was to be hoped that those Directors who were not yet convinced of the need for a general allocation would reconsider their position, for the simple reason of protecting the integrity of the system.

As he had said on previous occasions, Mr. Al-Jasser said, if agreement could be reached on a general allocation to protect the integrity of the Articles, especially those relevant to the SDR, the other elements of the package should be easy to resolve, including, if need be, a special allocation to correct for an anomaly that had developed over time in a dramatic way owing to the large increase in the membership. He had an open mind on a special allocation, as long as it followed a general allocation, as a corrective step. Agreement on the issues related to access was not likely to be difficult, and he could be flexible on those issues. However, the SDR issue had to be resolved before moving much further on other issues. As current Chairman of the group of Directors traditionally referred to as the G-9, he had discussed those matters with his colleagues in the group. While there were differences in wording and nuance, he was confident that his colleagues would confirm during the present discussion their general agreement with his position on the main issues.

Mr. Kafka made the following statement:

My constituency is sensitive to the desire to make SDRs available to all members. It is also sensitive to the desire to increase access to Fund resources for all members, including of course those that qualify for the STF.

The proposal made by Mr. Evans and Ms. Lissakers is attractive from the first point of view. But it has a basic flaw. It threatens the survival of the SDR allocation mechanism enshrined in the Articles. In its stead, it proposes, for this time, allocations by amendment. I am aware that this does not condemn, forever, the allocation mechanism of the Articles. I am also aware that the proponents would be prepared to include a statement to that effect in the Interim Committee communiqué. But after 15 years without an allocation, to make the first allocation by amendment is the equivalent of declaring the traditional mechanism dead. No soothing declarations can change this. To declare the enshrined mechanism dead would be a basic mistake. It would mean abandoning the injunction of the Articles to make the SDR the basic international reserve asset. Some may regard this as theoretical. To my mind, it is a very practical matter. We would, in practice, abandon a mechanism that would enable us to face up to a major liquidity need quickly and in a truly international manner. In a word, we cannot risk abandoning the enshrined SDR mechanism. The moment fully justifies a general allocation in the absence of inflationary pressures.

I would support a special allocation for certain members below a certain proportion and the re-establishment of a reconstitution requirement. Our concerns would not be met if a general allocation was made, subject to agreement of participants, to hand over their SDRs to a Fund-administered pool; this would be just as much of a subversion of the nature of the SDR as its allocation by amendment.

The STF was a special method designed to meet quickly the immediate access needs of economies in transition at an early stage. It is not at all clear that such a facility is still needed for those countries today, and it was for this reason that the STF was born with a time limit. We believe that the needs of the economies in transition can be met by our tranche policy, including exceptional access, which has always been handled flexibly. We would have no objection to extending the time limit, but without an increase in the amount available, for another year. The increase in amount of the STF reflects a diminution of conditionality, because its subjection to existence of a Fund arrangement is not absolute, despite the requirement of prior consultation with the Executive Board. We would, therefore, support an increase and extension of the STF only as a compromise, including a substantial general allocation.

Therefore, I can agree only partly with Mr. Evans's definition of the options before us. He has not mentioned the option of an SDR allocation with no STF extension or increase.

Obviously, I do not favor this option. But I cannot risk any threat to the traditional SDR mechanism. Hence, I must insist on a general allocation on traditional principles as part of our package.

Mr. Autheman made the following statement:

I would like to focus my statement on the questions raised by what Ms. Lissakers and Mr. Evans initially called a possible compromise and what they now tend to call the compromise. I am among those who consider that it cannot yet be the compromise, but I think that it could be a good basis for our discussion if significant improvements were considered, although the strong words used this morning are, I suppose, meant to signal that no significant change could be made; but I expect that a more positive approach can be achieved.

The major problem raised by this so-called compromise is the expectation that it implies that there would never be any general allocation in the future. Ms. Lissakers and Mr. Evans have tried to address this concern, but they have not done it convincingly. I think we need to analyze the reason for this expectation in more depth. There are elements in this proposal that imply that such an amendment would preclude any general allocation in the future.

The first element is its very existence, as Mr. Al-Jasser told us. The proposal offers a solution to a problem that it does not want to address. The origin of the problem is the lack of a general allocation. This problem is maintained and a substitute is offered. So, from the very beginning, there is a good case for the concern described by Mr. Al-Jasser.

I will now turn to the elements of the proposal that give some further ground for such concern; one is explicit and one is implicit. The explicit element is the amount. The proposal aims to signal an agreement on a small allocation--a small allocation in order to probably reassure those who consider that the SDR should not play any significant role in the future. Considering the credibility gap of the proposal, only a significant amount, while reasonably moderate, can alleviate this concern. But I understand that this part of the proposal is probably the easiest to modify, and I want to say that, in order to consider such an approach, we would need to agree on a higher amount, somewhere between SDR 16 billion and SDR 36 billion.

The second element, which is the one I will concentrate on, is the motivation for an amendment. Presently, there is no motivation for an amendment. I note that the authors of the proposal are satisfied with the paper circulated by the staff, but this paper proposes a decision without motivation: "The Fund shall allocate SDRs in accordance with Schedule M." Why? Nobody knows. For what? No one says.

When we analyzed the details of the proposal, I found three components in it. One is the catch-up allocation for new members or for members holding SDRs under a benchmark. The equity dimension of this component is obvious. Another is the narrowing of the disparity of the ratio of SDR allocations to quota, which means that the equity component of the proposal goes further than the initial purpose, which was to offer to new members access to the SDR Department. It goes further; it looks to narrowing the disparity among members. But one should note that the second aspect of the proposal is only a consequence of its first component, namely, the catch-up allocation.

The third component of the proposal is a general increase for all members that hold SDRs above the benchmark. This general increase reduces the second achievement, as it re-establishes some limited disparity. Its consequence is that all countries not concerned by the equity issue receive SDRs. I am still looking for the motivation of this third component. One cannot be satisfied with a motivation that would refer to a parliamentary character of the Fund, which would satisfy members of UNESCO or the United Nations, or members of a union of parliaments: "We need that general component because we need to get parliamentary approval." I am not aware that, at any time in the past, members of institutions have considered decisions outside their monetary character only in order to accommodate parliamentary requirements.

Such language would be inadequate, and consequently it is proposed that there be no language at all.

A justification that would only refer to equity would not describe the proposal. What is the meaning of a general allocation that its proponents do not want to recognize? I understand that the proponents think that there is a good case for increasing the amount of SDRs in circulation, in order to maintain the role of the SDR within the monetary system or within the Fund.

On this basis, there is a good case for a general allocation of 8 percent to quota, but this should be said in the amendment. So, I am looking forward for more than a communiqué paying lip service to principles, such as "availability of a general allocation in the future," or restating that a general allocation according to global need would be the only valid basis for the future. I am looking for a motivation in the amendment itself of the content of the amendment.

Whether the final decision is a general allocation or an amendment, there must be an unambiguous reference to the monetary character of the decision, namely, a monetary motivation. This will be obvious through a general allocation. This has to be introduced in any amendment, for such an amendment to be worth consideration.

The Chairman said that he was interested in Mr. Autheman's remarks but had difficulty with one aspect. In asking implicitly the authors of the compromise proposal to find appropriate language to motivate a general allocation on monetary grounds, he wondered whether Mr. Autheman was not merely asking for justification in the language of an amendment for a general allocation that was already available under the present Articles.

Mr. Autheman replied that, although the compromise proposal was not his own, he could understand that, in a situation in which agreement on the assessment of long-term global need could not be reached, an agreement might be reached on the need to maintain the role of the SDR in the international monetary system, to maintain the role of the SDR in the operations of the Fund, and, accordingly, to maintain the amount of SDRs at an appropriate level, considering also that the credibility of the SDR might have been affected by the absence of an allocation during the previous 15 years.

Mr. Mesaki made the following statement:

I believe that the Board should focus its discussion today on an SDR allocation, in light of the current significant difference of view on this issue.

We have little time left before the Madrid Interim Committee meeting, and it is urgent to intensify our effort to reach a compromise on an SDR allocation. To this end, I appreciate the creative proposal made by Mr. Evans and Ms. Lissakers as being in the right direction, and I strongly support their proposal.

My authorities' firm position is that the Fund should make an equity allocation of SDRs as soon as possible, as this will enable all members to fully participate in the SDR system and will help revitalize the role of the SDR as the principal reserve asset in the international monetary system. Also, I would point out the fact that consideration of the equity issue has been a main motivation for discussing an SDR allocation.

The Managing Director argues that a general allocation should be made promptly while ratification of the amendment providing for a special allocation is in process. I am concerned, however, that this might discourage incentives to accelerate domestic procedures for ratification in those countries that have participated in all the previous SDR allocations, and that, consequently, the special allocation for equity will be delayed.

In sum, I believe that it is crucial to address the equity problem first. In this respect, I believe that the U.K./U.S. proposal would be a good solution.

Mr. Coumbis made the following statement:

The difficult issue we are discussing today, for its importance and for the apparent difficulty to reconcile different views in the Board, has become the most crucial on our agenda. I would like to state, with the utmost clarity, that we could not be more sensitive to the need to respond in the most appropriate way to the serious and pressing needs for financial assistance to developing countries and economies in transition.

I will express the position of this chair by following the suggestions of the Managing Director, namely, concentrating on the two basic aspects of the amount and the method.

As far the issue of the amount is concerned, this chair has in the past expressed agreement with a "moderate" allocation. I maintain this position today. It corresponds to an allocation close to SDR 20 billion that this chair has always deemed to be in line with the definition of a "moderate" allocation.

The issue concerning the method is, apparently, the most important source of disagreement. Let me start by saying that, on the occasion of previous Board discussions, this chair expressed a clear interest in a favorable conclusion of this difficult issue, in a spirit of compromise.

For this reason, we have always considered a combined allocation, which included an "equity" amendment as well as a general allocation, as the best compromise between different views, and the most equitable solution, provided the sum of the two remained within the limit of SDR 20 billion.

The proposal made by Mr. Evans and Ms. Lissakers in their memorandum of July 28, 1994 seems to me to be a reasonable starting point for an agreement between those who favor a general allocation and those who would prefer an equity amendment. It appears to be an efficient and pragmatic compromise between opposite views.

I do not claim that such a proposal is the most efficient, as it requires an amendment of the Articles, which means engaging in a process that would certainly involve a longer period of time than a straightforward, general allocation. I am, nonetheless, convinced that it could turn out to be the most efficient solution ex post, should it reveal itself as a suitable device for the achievement of the necessary majority.

Let me add that I do not necessarily consider pragmatism as a virtue, unless it is wisely utilized. This means that I would not approve a pragmatic view should it overlook the important institutional issue of the future role of the SDR, and its enhancement, to which this chair feels committed by the spirit and the wording of the Articles; prevent the future possibility of an SDR allocation aimed at coping with a future long-term global need; or involve that which has been forcefully defined as "collateral damage."

I am nonetheless not convinced today that the proposal necessarily conceals such dangers. The excellent draft amendment to the Articles prepared by the Legal Department appears to me to leave open also the possibility of future allocations of SDRs to meet the need for a supplement to existing reserve assets. In this context, I have the impression that the proposal put forward by Mr. Evans and Ms. Lissakers still offers the closest approximation to the spirit of compromise that is a necessary condition to complete the difficult mandate of the Board to make a recommendation to the next Interim Committee meeting.

Mr. Wei made the following statement:

At the outset, let me say that I fully share the views and comments made by Mr. Al-Jasser and Mr. Kafka.

As is known to this Board, our position on the issues related to SDR allocations remains unchanged. In our view, a substantial general SDR allocation is fully justified for the following reasons.

First, we are fully convinced that many countries continue to need to increase their reserves in order to support their adjustment efforts. It is correctly pointed out by the staff that the necessity of increasing reserves arises in these countries as their international trade and services transactions are rising, as well as taking into account the volatility of their nontrade transactions.

Second, in the absence of SDR allocations, many countries have to meet their reserve needs through borrowing from private credit markets at a much higher cost, which they cannot afford, or through compression of domestic demand and net imports, which will adversely affect the adjustment process.

Third, and most important, we must make efforts in moving toward the objective of making the SDR the principal reserve asset of the international monetary system, as stipulated in the Fund's Articles of Agreement.

Fourth, a general SDR allocation of substantial size will address the "equity" issue to new members in the most expedient way.

This being said, we continue to support a general SDR allocation in an amount of SDR 36 billion, as proposed by the Managing Director. However, as a compromise, we could go along with the combined approach, namely, a general allocation and a special allocation in which, through the latter, the ratio of net cumulative allocations to quota could be brought up to the same level for all Fund members.

Our support of the package, as presented in the report, is contingent on the approval of a general SDR allocation. Without a general SDR allocation of a substantial size, we cannot support the package in the draft report.

Mr. Koissy made the following statement:

Let me first acknowledge the efforts that the Managing Director and various chairs have continued to make to secure a consensus on this delicate issue. We hope very much that our discussions today will bring the Board much closer to an agreement that would meet the call made by the Interim Committee to respond to the enormous challenges that will continue to face this institution. We also believe that decisions on this package should be taken in a pragmatic and cooperative spirit, with each member recognizing the needs and concerns of other members.

I subscribe to everything Mr. Al-Jasser has said. This being said, let me make two general remarks. Although the staff made a commendable effort to reflect their understanding of the status of the discussion on the package, like previous speakers, we strongly believe that the report would need to bring out more clearly at the outset the strong linkage that many Executive Directors have established between the various elements of the package, as well as the conditional nature of the understandings reached so far. The drafting suggestion proposed by the Chairman of the G-9 should be helpful in clarifying this issue.

Also, as indicated by Ms. Lissakers and Mr. Evans, we hope that the report that will emerge from the discussion today will be more streamlined and oriented toward a limited range of issues on which the Interim Committee could provide the necessary guidance to conclude our work.

Turning now to more specific observations in the report, Part I of the report on access to Fund resources reflects broadly the understandings reached. I would also support more explicit language on the need and the expectation that the new access limits will be applied evenhandedly and will result in effectively raising access.

We keep an open mind with regard to the STF and the phasing of additional purchases. Given the potential implications for the liquidity of the Fund, we agree to reflect in this section, the need for a timely consideration of an equitable mechanism for distributing the cost of operating the Fund.

On the date of effectiveness of the new access limits and of the enlargement of the STF part of the package, we believe that the date of effectiveness will need to take into account the timetable of legislative actions in different member countries, which would guarantee that all the elements of the package are put on the same schedule.

On Part II of the report, we believe that the proposal for an upfront and substantial general allocation of SDRs, combined with a special allocation, remains the best option and will preserve the SDR as the principal instrument in the international monetary system. We believe that the acute reserve need in the transition economies and in the low-income countries, and the budgetary situation in industrial countries, provide the opportunity to enact the package of allocations.

The U.S./U.K. proposal, using the fixed benchmark method, is a step in the right direction, but, unfortunately, the allocation resulting from this proposal will only weaken further the objective of revitalizing the role of the SDR and making the SDR the principal reserve asset of the international monetary system. Despite the guarantees proposed in the language for the Interim Committee communiqué, we would prefer to leave the method of determination and activation of the SDR, as provided in the Articles of Agreement, unchanged. In this regard, like Mr. Autheman, we believe that the suggestion that the finding of global need for an SDR allocation should be removed, even for one time only, is counter to the Articles of Agreement, and is not in line with the views held by an overwhelming number of Governors on this issue.

In conclusion, although we welcome the U.S./U.K. initiative in presenting this proposal to the Board, we sincerely hope that the small steps required to achieve a broad-based consensus on this issue will finally be made in time to allow the Committee to have a fruitful meeting, and allow the meeting in Madrid to represent a true landmark in the Fund's evolution and its future.

Mr. Waterman made the following statement:

Coming from what might be described as a "Group of One," this constituency obviously will not have much influence on the final shape of the package, so I can be both brief and direct.

We all know about that Cambridge wit who said, "We have time so that everything does not happen at once," but we have been going around this issue for a few years now, and there has to be more to life than the SDR, even for the Managing Director. So it seems to me that the Board needs to make progress on the matter now. It is unlikely to be any easier in Madrid, and there is a risk that the moment for reaching agreement could pass. As a salesman would say, "It is the time for closure."

We would all like to see where we will end up before showing our hands, but clearly that is not possible, and I think we need to be frank about where we stand. This constituency has moved a good way in recent times in order to join a consensus, although I suspect some would probably characterize that move as being from the right of the Bundesbank to a regular conservative position. Like others, we would want to see the final package before signing off completely, but let me say what I believe we could accept.

First, we could accept an extension of the STF for a year, with an additional tranche or two, with a strong preference for that involving stand-by-type conditionality. Second, we could accept an increase in access limits to, say, 80 percent or 90 percent of quota. On SDRs, we could, I think, go along with a total allocation in the range of SDR 10 billion to SDR 20 billion, and the approach suggested for that allocation by Mr. Evans and Ms. Lissakers, or some variant of it, is a long way ahead of whatever is running second, in our book. But in all of this I know we are likely to show some flexibility in terms of the detail in order to reach a general agreement.

It should be recognized that there has been a considerable movement on the part of the larger industrial countries. For my part, I do not see the Evans/Lissakers proposal as killing off the SDR, for reasons that they have both touched on already. Moreover, it would result in the first allocation of SDRs in some 15 years and, combined with the other elements of the package, would benefit many members of the Fund, particularly the newer members.

In short, it seems to me that we are at a time to bring an end to the brinkmanship and bring to Madrid as detailed a set of proposals as possible. Otherwise, as others have noted, we would have failed our ministers. So we need to draw on whatever negotiating powers we might have, rather than acting like people with only the authority of telegraph messengers.

Mr. Zoccali made the following statement:

The members of this constituency welcome the good faith efforts being made to reach a wide consensus on a strategy aimed at ensuring that the Fund continues to play a central role in the adjustment process, while safeguarding its monetary character and catalytic role. In this light, the large financing requirements of transition and other members in the period ahead, including their need to build reserves to more appropriate levels, call for agreement on a comprehensive package that is perceived to be both consistent with the spirit of our Articles of Agreement and effective in addressing those needs. We remain convinced, therefore, that an appropriate mix of conditional resources in support of strong adjustment and reform policies and a substantial general allocation of SDRs to meet part of the demand for international reserves to hold, constitutes the most cost-effective and equitable response to the historic challenge and to preserve the credibility of the Fund.

More specifically on the draft report, while we find its text to be generally representative of our discussions, the alternative wording on page 2 of EBD/94/146 is viewed as being more consistent with the intention expressed on page 6 of the report, namely, to give effect to those understandings, subject to a satisfactory resolution of the issue of a general SDR allocation. Similarly, the last sentence of the first paragraph on page 6 should also reflect, among the potential implications of the proposed actions regarding access to Fund resources, their possible impact on the distribution of the costs of financing the Fund's future operations and the need for a more equitable mechanism, as was noted by some chairs.

In agreeing with the proposed temporary increase in the annual access limit to 90 percent of quota and in average access in the presence of strong stand-by and extended arrangements, we consider it essential to stress the need to maintain an evenhanded approach, and that somewhat higher access under ESAF arrangements would also be considered, where warranted by the strength of policies and financing needs.

Even though we remain unconvinced regarding the efficacy of the proposed modifications to the STF, in the spirit of facilitating an overall agreement, we could join a consensus with respect to the upper limit or the number of purchases being proposed. Our preference, however, lies with an increase to 80 percent or perhaps 90 percent in one or at most two purchases, on approval of an upper credit tranche arrangement, on completion of a review under such an arrangement, and with the maintenance of the requirement that the second purchase be made within 12 months of the first purchase. Such an approach would preserve sufficient flexibility to frontload resources when policies warrant, while maintaining strong incentives to move to more comprehensive programs.

As to Part II of the report on an allocation of SDRs, my constituency fully subscribes to what has been mentioned by Mr. Al-Jasser. The proposed text is an adequate reflection of the discussions, thus far. Yet, by leaving open so many outstanding issues, it contributes little to making the SDR the principal reserve asset in the international monetary system, as is our obligation under the Articles, or to fulfilling the mandate of the Interim Committee. Moreover, it serves to put into doubt the viability of the SDR as a monetary or reserve asset, which has not been questioned even by its largest holders. The considerations and conclusions in the draft that a substantial general allocation pursuant to Article XVIII, Section 1(a) and Article VIII, Section 7 is warranted and would go a long way toward reducing the degree of inequality in the ratios of net cumulative allocations to quota that at present exist, particularly with respect to the new members, are for us self-evident.

The recent U.S./U.K. proposal represents a departure from that established mechanism for SDR creation, based on monetary considerations. Even if it includes a shadow general allocation, it is not recognized explicitly. Moreover, after 15 years of no allocations and a generally low global inflationary environment, the proposal entails substantial risk for the integrity of the SDR system, a lengthy and uncertain process of ratification of the required amendment, and, more important, risks a negative shift in the demand for SDRs to hold, affecting not only those in particular need for reserve supplementation, but also the largest holders. Without in any way questioning the ability of the Legal Department to accommodate imaginative solutions, draft Schedule M of the proposed amendment exemplifies the technical difficulty of presenting the scheme and of giving it effect, without fully explaining the rationale for a special allocation of SDRs or resolving the potential for inequality that could arise over time.

In conclusion, we remain committed to an integral agreement governing conditional and unconditional resources, provided that a sizable general allocation based on global need, remains one of its components. We would also be prepared to explore further the possible features of a general allocation with "staggering" and "reconstitution," noted by Mr. Kafka, if they preserve a future role for the SDR.

Mr. Shaalan said that the position of his chair was well known, and had not changed following the imaginative proposal by Ms. Lissakers and Mr. Evans. At a meeting in Tunis the previous week, the strong consensus of his constituency had been that a general allocation was the priority. The issues of access and the extension and other modifications of the STF would not be difficult to resolve, and his chair had a flexible position on those issues. In short, he could fully support the views expressed by Mr. Al-Jasser and Mr. Kafka, particularly with regard to the package. A general SDR allocation had to be agreed first.

Mr. Geethakrishnan stated that he fully endorsed the statement of Mr. Al-Jasser.

In the present discussion, Mr. Geethakrishnan observed, the Board was being asked to consider a number of proposals, including a general allocation of SDRs, a special allocation of SDRs to address the equity issue, an extension of the STF, and an increase in access under the STF and other instruments. In his view, those proposals should be considered as a package, the linchpin of which was the proposal for a general allocation. He could endorse the proposal for a general allocation, and the need to agree on that proposal before pursuing other proposals, but he and other Directors had reservations on the other proposals. On a special allocation, for example, it was interesting to note that the Board had not concerned itself with the distributional aspects of the SDR system in 1978, when it had agreed to a series of general allocations. In fact, the distributional problem that had arisen had been created by not agreeing to a general allocation every few years, as envisaged by the founding fathers of the system; by the same token, its resolution lay in agreeing to a new general allocation. Thus, he found it difficult to understand the equity arguments that had been raised. Moreover, if, as Mr. Kafka had suggested, a residual problem would remain following a general allocation, he could see the scope for a limited special allocation, but a special allocation should not be the tail that wags the dog.

Similarly, the proposal on extending the STF gave some cause for concern, Mr. Geethakrishnan considered. Clearly, the creation of the STF had served a useful and urgent function for several countries in transition that were not familiar with the concepts and language of the Fund. At present, however, essentially all of those countries understood the underlying economic philosophy of the Fund and had a clear idea of the requirements for the transition to a market economy. It could be argued that sufficient, well-established instruments existed in the Fund to which those countries had recourse. From that perspective, the need for an extension of the STF was not clear. On the proposed increase in access limits, he would note only that some Directors, even among the G-7, were opposed to an increase on the grounds that it would ultimately dilute conditionality.

He had mentioned some of his reservations, not so much as to contribute to the debate on the relative merits of the other proposals, but to indicate that, in the spirit of compromise, it should be possible to reach a consensus on all elements of the package, Mr. Geethakrishnan commented, provided there was agreement on the essential element--a general allocation of SDRs. With that in mind, it might be useful to look again at the proposal for a general allocation.

The Managing Director had proposed a general allocation of SDR 36 billion, a proposal that had been on the table for some time, Mr. Geethakrishnan noted. Some chairs opposed that proposal--indeed, a few had opposed the idea since the previous allocation in 1979-81--on the basis that, in their view, there was no long-term global need to supplement existing reserves to hold. That view was somewhat difficult to reconcile, however, with the U.K./U.S. proposal, which provided for a 6 percent or 8 percent minimum allocation to every member, very much akin to a general allocation under the present Articles, based on a finding of global need. Indeed, it was not clear what the justification was for such an allocation if there was no global need.

At present, Mr. Geethakrishnan continued, a large number of countries clearly required a supplement to their reserves to hold. He would not go so far as to suggest that all members required such a supplement; indeed, some countries had not required an allocation of SDRs in 1979-81, and the United States had not participated fully in all previous allocations. The point, therefore, was that the Board had, in similar circumstances in the past, conceded that a global need existed, notwithstanding the fact that need varied among members, and it had acted accordingly.

Another reason for the reluctance of some chairs to accept a general allocation of SDRs--again, for some, that reluctance had been consistent since 1979--was the perceived inflationary risk of an allocation, Mr. Geethakrishnan remarked. By that reasoning, it was difficult to see why the U.K./U.S. proposal for a sizable allocation would not also be perceived as inflationary. The long-held objections to a general allocation, however couched, gave a strong impression that some members were not satisfied with the SDR as an instrument, and that they would prefer to see it eliminated from the international monetary system, whether through a cancellation of SDRs or by neglect. He was, frankly, skeptical of the suggestion of some chairs that "suitable language" to allay that concern could be included in the Interim Committee communiqué; in bureaucracies, such statements often served, unsuccessfully, to disguise the fact that a precedent had in fact been set.

There was, at least in his view, Mr. Geethakrishnan stated, a large credibility gap in the dogged resistance to a general allocation over the previous 14 years. That gap was all the more apparent in the light of the assessment of the vast majority of Directors that a long-term global need existed and in view of the historically favorable inflationary environment. If opposition to a general allocation based on the present Articles was maintained while, simultaneously, a proposal to allocate SDRs in an amount equivalent to 8 percent of quota for each member through an amendment of the Articles was endorsed, the SDR itself would, for all intents and purposes, be finished. No carefully worded assurance in a communiqué would alter that fact.

He had some reservations about the allusion in the statement by Ms. Lissakers that some countries were insisting on a general allocation of SDRs as a means of gaining political leverage, Mr. Geethakrishnan remarked. He objected to that characterization, which in any event could be applied equally well to those countries, such as the United States, that were insisting that there would never be a general allocation. In order to further the debate, it would be helpful to avoid using loaded phrases such as political leverage, while agreeing that the debate itself was centered around the relative merits of both arguments.

Mr. Ismael made the following statement:

> The Managing Director has for some time advocated a general allocation of SDRs. In the meantime, an entirely new issue in the SDR discussions has emerged: the so-called issue of equity. No consensus has been reached on both proposals. It is exactly in order to break the stalemate that the Managing Director has come up with a compromise proposal. My constituency supports this proposal, which, in its view, is a real compromise in which the diverse needs of the membership are well balanced.
>
> In particular, my constituency wishes to reassert its firm support for a general allocation of SDRs to be a part of the SDR compromise. Our position is supported by four basic reasons. One, not only was the SDR created as a global liquidity instrument of this institution, but the international membership also intended it to be the principal global instrument. There has been no question, at least explicitly, challenging this central role of the SDR. Two, a general allocation retains the integrity of the Articles. The Second Amendment of the Articles envisaged that this fundamental role of the SDR would be gained over time through regular general allocations, a process which is clear, smooth, transparent, and equitable. Three, the global need for supplementation of global liquidity has been convincingly demonstrated. Four, there is no uncertainty in such a general allocation, which can be made immediately after Board approval to meet the urgent demand of the membership.
>
> It is precisely the absence of such a general allocation from the Lissakers/Evans proposal, and the uncertain and lengthy timing of the process of ratification of an amendment of the Articles of Agreement, and not the amount or its relative distribution, that have prevented us from going along with their proposal.
>
> Let me summarize my constituency's position on the Managing Director's package. First, this chair supports a compromise combination of a general allocation supplemented by a special allocation along the lines of the Managing Director's package. This supplementary special allocation should logically be lower

than a general allocation. Second, my constituency regards the general allocation of SDRs as the linchpin of the Managing Director's package, and its resolution is critical to our support for all the other ingredients of that package. Third, my constituency specifically feels that, if there is no explicit general allocation, then it could not support any other mode of SDR allocation. Finally, these sentiments need to be spelled out clearly in our draft report to the Interim Committee. Therefore, I fully endorse the revisions to the draft report that have been submitted by Mr. Zoccali on behalf of the Group of Nine, which have been circulated by the Secretary as EBD/94/146.

Mr. Schoenberg made the following statement:

Many Directors have referred to the need to agree on a package whose shape has not become completely clear to me in all circumstances. So let me comment on the proposals contained in the draft report to the Interim Committee.

We have problems with both the format and the substance of the draft report. On the format, I have two principal observations. First, the sequence of the presentation of the issues creates the impression that the core objective of the whole exercise is the enlargement of the financing made available by the Fund, whereas the issue of higher access to Fund resources has come up, in fact, as proposals to compensate for abandoning a general SDR allocation. At least, we see here a close link. The Interim Committee has also asked the Board for one report only--namely, on the SDR issue. The first paragraph of page 2 of the draft report is merely a general passage taken from the communiqué, not comprising any specific assignment to the Executive Board, but rather stressing the need to continue policies vis-à-vis the transformation countries, on the basis of certain principles highlighted by the Interim Committee.

My second more general observation is that the SDR discussions of the Board are being presented in a somewhat one-sided fashion, with ample room given to all arguments of the proponents of a general SDR allocation, whereas the considerations of the opponents have been taken up in a very compressed and succinct manner. Given the experience that passages contained in such reports that were not expressly rejected were interpreted at a later stage, if the need arises, as having been expressly approved, I would like to insist that the views of the minority of Directors also be fully included in the draft report. I suggest that I do not spell out all of our suggestions for amendments now, but I would like to submit them in written form, if this would be agreeable to the Chairman.

On substance, as we have made clear already at various times, we do not see a global need and we remain opposed, therefore, to any general SDR allocation. However, we see the need for an equity amendment. Although we would prefer a clean equity amendment, we can also support, as a compromise, an equity allocation along the lines proposed by Ms. Lissakers and Mr. Evans, recognizing that it takes account of many of the concerns of those who want a general allocation. Listening to Mr. Geethakrishnan, I thought that the U.S./U.K. proposal was specifically also taking into account the position of those countries that are already at a relatively high ratio of allocated SDRs to quotas.

On access, we favor an increase in the annual access limits for the regular arrangements of the Fund to 90 percent of quota, but we are not inflexible on that issue.

Regarding the STF, we would prefer one additional tranche of 35 percent of quota, to be made available, in principle, only if a regular Fund-supported program is in place. In truly exceptional circumstances, we could agree also to a stand-alone third STF tranche.

On some other issues, like Ms. Lissakers, I have the impression that the report, at least at this stage, goes too far with respect to a further ESAF extension and debt rescheduling.

The Chairman welcomed Mr. Schoenberg's offer to submit his drafting suggestions in writing, which would help to prevent the present discussion from becoming merely a drafting session. Nevertheless, the Board would need to agree at some point on a precise text, with as few brackets as possible.

Mr. Kaeser made the following statement:

Like my colleagues, I welcome this opportunity to discuss the content of our package deal; the more so as the views of Directors remain divided on the crucial issues. It will be possible to review the wording of the report only after an understanding on these issues is reached. I refrain, therefore, from commenting on the report in spite of the fact that I do not agree with some parts of it.

Before embarking on this discussion, I would like to express my gratitude to the staff, which has provided an impressive amount of material to alleviate and back our work.

As a general remark, let me also say that I perceive signs of discussion fatigue among our authorities. This may become an incentive to find a broadly acceptable compromise, but could also lead to a "take it or leave it" attitude, if the necessary concessions appear to be too one-sided.

Let me now turn to the main topics of the report.

Concerning the annual access limits under stand-by and extended arrangements, I can support an increase from 68 percent to 85 percent of quota, provided that this increase would be in effect for a period of three years and be reviewed annually, and that only very strong programs will benefit from the increased access. Therefore, I expect that the actual average level will increase only marginally and should not substantially worsen the Fund's liquidity position. I do not understand why the average access level to the Fund resources should be raised when the major developing countries have to deal with large welcome or unwelcome inflows of capital.

Concerning the access under the STF, this chair is ready to accept an extension of the availability of the first purchase through end-1995 and to add a third tranche of 30 percent of quota to the existing ones. As other Fund facilities are open to the countries in transition--and this probably with increased access limits--I think that it would be too much of a good thing to go over 80 percent of quota for a facility that should merely be a bridge to upper credit tranche arrangements. This 30 percent tranche represents in my view the best reward for accepting the high conditionality of the Fund.

I have still strong reservations against a stand-alone third tranche, because I fear that it would send a wrong signal to the users of the STF and delay the necessary adjustment process. In a spirit of compromise, however, I could accept the Managing Director's proposal, according to which the Board would have to be consulted prior to any discussion on a stand-alone purchase, which should only be possible in exceptional circumstances.

Concerning access to the ESAF, it has proved rather difficult to mobilize the resources for the extension and enlargement of the ESAF. As parliamentary ratification of ESAF contributions is still under way in a number of countries, this chair has reservations about increasing the ESAF access limits for the time being. For the same reason, it seems at least premature to announce a further extension and enlargement of the ESAF.

Finally, concerning the allocation of SDRs, this chair originally supported the general allocation of SDR 36 billion proposed by the Managing Director, notably because this proposal seemed well suited to address the "equity" issue. Later on, I supported the combination of a general and a special allocation, provided that both allocations together would not surpass SDR 36 billion. In my opinion, in both cases, the general allocation should be linked with some sort of reconstitution requirement.

Now this chair finds that the so-called U.K./U.S. proposal, which would combine a special and an equiproportional allocation under an amendment of the Articles of Agreement, is very ingenious. But it raises also serious legal concerns in my view.

This amendment would necessarily appear as a means to circumvent Article XVIII, which exhaustively regulates general allocations and the cancellation of SDRs. This merely political solution would do more harm than good to the reputation of this organization.

Furthermore, the necessity to resort to an amendment of the Articles for an equiproportional allocation of SDRs, demonstrates a false scenario that a general allocation based on Article XVIII would only be possible under special circumstances, say, if the international financial system was on the verge of breaking down. The introduction of the U.K./U.S. amendment would call for a further revision of the provisions concerning the SDR. In my chair's view it would, for example, be very difficult to retain in Article VIII, Section 7 the objective of making the SDR the principal reserve asset in the international monetary system if we accept the U.K./U.S. amendment.

Mr. Marino made the following statement:

Our views are similar to those of Mr. Al-Jasser, Mr. Kafka, and Mr. Autheman, who have eloquently made the case for a general allocation of SDRs and have pointed to the difficulties that we have with the Evans/Lissakers proposal. Let me try to elaborate briefly on this.

In the Evans-Lissakers proposal, the starting points are: no general allocation of SDRs; a desire for a specific allocation to those member countries that have never received an allocation of SDRs; and assurance that only a modest amount of SDRs are allocated.

Within these constraints, they try to put together the elements of a compromise.

To address the first point on a general allocation, they propose that all member countries have the option to receive an allocation of at least 8 percent of quotas. However, this element cannot be called by its name, a general allocation, in order to satisfy those that oppose a general allocation under any circumstances.

To address the second point on "equity," their proposal draws a threshold of 24 percent of quota. However, by their own equity criteria, they still fail to meet what is implicitly recognized as the most equitable solution, an option starting from scratch: an equalization of the SDR to quota ratio among all members--something that was behind the U.S. chair's original idea of a simultaneous cancellation and reallocation. My understanding is that the 24 percent threshold is set in order to ensure the third point, that only a modest amount of SDRs be allocated, sacrificing the opportunity to fully resolve the equity issue.

We understand that, in conjunction with this proposal, to make it more palatable, a phrase would be included in the Interim Committee communiqué to assure the membership that, under some unspecified set of circumstances, an SDR allocation still remains an open possibility.

I would ask why not follow the converse route, to have now a general allocation and include in the Interim Committee communiqué our assurance that this does not prejudge the requirements for any future SDR allocation. After all, a small group of countries have been very successful at blocking an SDR allocation for the past 15 years. This small group of countries has more leverage to assure that this commitment will be fulfilled than the rest of the membership to ensure that the other one will be. Moreover, we are at a point where the upside potential of a general allocation of SDRs is substantial, while the downside "inflationary risk" is at an all-time low.

Why follow the more complicated route, when we could have a modest allocation that could give some upfront, speedy relief to the reserve needs of an important group of countries? Moreover, we have to recognize that at current levels of world liquidity, SDRs have become the small change of the system, instead of the principal reserve asset, contrary to the mandate of the Articles of Agreement.

Why not go the full way in solving the equity issue and, through an amendment, agree to equalize the ratio of SDRs to quota for all members?

Mr. Smee said that he welcomed and supported the U.S./U.K. proposal. In Mr. Kaeser's words, the proposal was "ingenious" in bringing together in a very good compromise many of the issues that were still before the Board. He also welcomed Ms. Lissakers's statement as a very positive contribution, in both its substance and in the clarity with which it presented the issues in a forward-looking way. While Mr. Marino had belittled the need for a statement of some sort in the communiqué to reassert the precedence of the current Articles, the suggestion was a useful one.

The U.S./U.K. proposal was not merely another way of presenting a general allocation without calling it a general allocation, Mr. Smee considered. The proposal addressed the issue of equity. As had become clear with time, that issue was not as straightforward as had been thought at the outset of the debate; relativities were clearly important in making judgments about fairness and equity. Within his constituency, for example, there were countries that had joined the Fund sometime between the first and second allocations of SDRs, and had thus not participated in all allocations. It would be difficult to explain why those members should be placed in an inequitable position in relation to newer members. The ingenuity of the U.S./U.K. proposal was that it attempted to address those issues by offering an allocation to all members, but in such a way that poorer countries and countries that had never received SDRs would receive a greater share proportionately of the overall allocation. He agreed with Mr. Waterman that it would be a shame if progress could not be made on the compromise proposal, because the cost would be borne most by newer members and the poorest countries--in effect, the countries that most needed the support of an SDR allocation.

With respect to access, Mr. Smee remarked, he agreed that the access limit should be increased to 100 percent of quota and that there should be an increase in average access to 50 percent. On the systemic transformation facility, he would like to see the facility extended for one year and an increase in STF access to 85 percent of quota, with a third tranche in conjunction with a regular Fund arrangement.

Mr. Kiekens made the following statement:

I will first discuss the core question of whether or not there should be a general allocation of SDRs, and then make some comments on increased access and the STF.

We all fear precedents. Those who do not favor general allocations fear that if we accept such an allocation today, it will create expectations in the world financial markets that there will be additional general allocations in the future; therefore, they cannot agree today that there is a case for a general allocation based on global need. However, they could accept an allocation of a certain size under another legal instrument that we will create. Other countries, including those of my constituency, believe that if we go along with the proposal of Ms. Lissakers and Mr. Evans we will set an unacceptable precedent by agreeing that there is no general need under present circumstances.

In order to get around this fear of precedents, Ms. Lissakers has proposed wording the proposal so as to state explicitly that this special allocation does not set a precedent, and that the present Articles will be the basis of all future allocations. Of course, she is right to stress that the present Articles will remain in force, but whether or not we want to, we will still create a precedent. What is the precedent? It would consist of a determination that, under prevailing economic circumstances, there is no global need and thus no general allocation. We should also be aware that, even if there is no agreement at all and no package is accepted, we will create the precedent that, under present circumstances, there is no global need, or at least that there is no agreement around this table to find a global need.

How can we solve this problem? We have very little time to reach an agreement, so we have to take all statements seriously.

Ms. Lissakers, Mr. Evans, and Mr. Schoenberg have very clearly stated that, as there is no global need, there can be no general allocation. After what Mr. Al-Jasser has said, many colleagues have confirmed that, if there is no general allocation, then no package will be agreed. Mr. Autheman has made a useful approach to solving this problem by suggesting that the monetary character of the allocation under the Lissakers/Evans proposal be recognized and confirmed. I suggest that we adopt an evolving interpretation of the notion of global need.

Our Articles of Agreement contain a mandate to make the SDR the principal reserve asset in the international monetary system. At the core of the international monetary system is the Fund. We all accept that there is presently a need for the Fund to provide more liquidity. We accept increased access, and we accept making larger amounts available under the STF. Given these present circumstances, we must also accept that there is a case for creating additional liquidity, which, in line with our mandate to make the SDR the principal reserve asset of the international monetary system, should take the form of SDRs.

But let us give good interpretations of global need and of what is meant by the principal asset of the international monetary system. I suggest that the SDRs created through a general allocation be put at the disposal of the Fund to then lend under appropriate conditionality; probably not high conditionality but conditionality sufficient to overcome the resistance of those who fear that, otherwise, additional SDRs risk being inflationary. The amount can be limited, if we make it available to the Fund, so that each member with a balance of payments need can draw a larger amount on the Fund's SDRs than the amount it has received under a general allocation. Putting the SDRs at the disposal of the Fund thus increases their potential impact.

Some may object that it is too late to evaluate these proposals. I am not sure. If this avenue seems to promise a solution, it is only necessary to have in Madrid an Interim Committee resolution recommending to the Board of Governors, and also to our Executive Board, that all elements of the package be put in place by the end of the year, on condition, of course, that at that time the mechanism for the reallocation of the newly created SDRs has been agreed by a sufficient number of member countries.

Some of my colleagues may say that putting the SDRs created by an allocation at the disposition of the Fund would require parliamentary approval. This may be so. But it may depend on the conditions under which the SDRs are made available to the Fund. If this is done against the security of all the assets of the Fund and if the conditionality is rather low, so that the SDRs remain available in case of balance of payments need, I believe there is a strong similarity to the present possibility for the U.S.

authorities to make foreign reserves available to the Fund without specific approval by Congress.

Let me now comment on the other aspects of the package.

With respect to increased access, we could accept access of 90 percent of quota or even, if necessary, 100 percent of quota.

As to the systemic transformation facility, we favor two additional tranches of 20 percent each rather than one additional tranche of 30 percent. Most of my colleagues favor only one additional tranche of 30 percent as an incentive for countries to move to the high conditionality of a stand-by arrangement. But it is not only important for countries to have an incentive to accept and agree to a stand-by arrangement; they must also have an incentive to implement their arrangement or program. Here, too, a fourth tranche of 20 percent would be very useful.

We also strongly favor that the third and fourth STF tranches be in conjunction with a stand-by arrangement. It has been proposed that, in exceptional circumstances, stand-alone tranches should be accepted. I can agree with this idea, but with amendments to the proposal. First, prior to the opening of discussions on a stand-alone purchase, the Board should accept this approach by adopting a formal decision, rather than by mere consultation, as proposed by the Managing Director. Second, the exceptional circumstances required for a stand-alone drawing should be confirmed, at the time the Board approves the drawing, by a qualified majority of more than 50 percent.

Mr. Mozhin observed that there were essentially two sides in the debate, with each side liking some elements of the package and disliking other elements. His chair liked all elements of the package, namely, a general allocation and a special allocation, higher access limits, and an extension of the STF. His chair was especially concerned to avoid a stalemate, in which the Board would be unable to reach the necessary decision prior to the Annual Meetings in Madrid. Therefore, his chair was very much on the side of compromise.

With that in mind, Mr. Mozhin continued, it seemed that the suggestion made by Mr. Autheman held out some promise for a possible compromise. While it would no doubt be difficult to find the appropriate language to express the idea that the U.K./U.S. proposal contained an element of a general allocation, that suggestion could usefully be pursued, along the lines of the language proposed by Mr. Kiekens. The point had also been made that, to the extent that the U.K./U.S. proposal did indeed include a general element, a procedure already existed under the present Articles to effect a general allocation. The answer to that dilemma lay in the issue of timing and the linkages among the elements of the package, as had been discussed informally by Directors in recent days. In particular, it would be difficult to accept a situation in which a general allocation was made quickly, while a special allocation was delayed and subject to great uncertainty.

Mr. Dlamini stated that his chair's position on the SDR issues under discussion remained the same. Therefore, he supported the statements by Mr. Al-Jasser and Mr. Kafka.

Mr. Posthumus remarked that the tone of the present debate was rather different from previous discussions on SDR issues. The statements by a number of Directors--including notably some chairs representing smaller members--appeared to have a "take it or leave it" character, which was somewhat unusual but not unprecedented in the Board. Somewhat novel, however, was the fact that the number and force of those statements was polarizing the debate, which was not very constructive. Nevertheless, the strength and conviction of the message that was being conveyed by each side might have the effect of forcing both sides to renew their search for a compromise.

On the access proposal, Mr. Posthumus continued, previous calls for an increase in access had always been couched in terms of raising maximum access, namely, the access limits themselves. From some statements, however, it appeared that the current proposal on access was aimed more at treating average access as a target, which had as its counterpart neglect of the strength of programs, traditionally the second element of access policy. In his view, a move in that direction would be deplorable.

With respect to the SDR issue, it was clear from the statements by Ms. Lissakers and Mr. Evans that there would be no general allocation, Mr. Posthumus stated. It was surprising, therefore, that the U.K./U.S. proposal included a floor that was tantamount to a general allocation, even if it was referred to differently in the text of the proposal. Mr. Evans had gone one step further: he had also insisted that there would be no specific allocation, although the U.K./U.S. proposal also contained a specific element.

Mr. Evans commented that he had noted in his statement only that there would be no specific allocation for new members only. In view of the initial position of his chair on that issue, he considered that statement to be a good measure of the extent to which his chair was prepared to compromise.

Mr. Posthumus remarked that he would much prefer a proposal along the lines of the U.K. chair's initial position, namely, a clean equity amendment. Unfortunately, such a proposal was not on the table. In fact, there was only one active proposal, namely, the U.K./U.S. proposal, which, for lack of a better alternative, he could support. On the size of an allocation of SDRs, he continued to believe that an allocation of about SDR 16 billion would be appropriate.

On access to Fund resources, he could support a temporary increase in access to 90 percent of quota, Mr. Posthumus noted. A definition of "temporary" should be included in the final decision, however, and he would suggest that three years should be sufficient. He also supported the existing text in the staff paper to the effect that there would be no target for average access.

On the systemic transformation facility, Mr. Posthumus commented, he supported an increase in access to 80 percent of quota, and perhaps even 90 percent of quota. He would prefer one additional purchase, in which case total STF access should be set at 80 percent; if access were set at 90 percent, there should be two additional purchases, linked to a stand-by arrangement. He remained extremely reluctant to accept the possibility of further stand-alone purchases under the STF. He supported the extension of the STF for one year. He would prefer to return to the original requirements of STF purchases, namely, that the second purchase be made within 12 months of the first purchase; it was his understanding that the decision to extend that period to 18 months had been taken on an exceptional basis only.

The proposals on access and the extension of the STF had the effect of increasing the risk to the Fund, Mr. Posthumus remarked. That point only underscored the need to continue to build up the Fund's precautionary balances. Therefore, the Board should continue to work toward a reform of the financial structure of the Fund that would enable a better distribution of the cost of building up precautionary balances.

Mr. Ismael observed that Mr. Posthumus had stated that there was only one proposal on the table. Actually, there were two proposals: the Managing Director's proposal, and the Lissakers/Evans proposal.

The Chairman commented that Mr. Autheman's suggestion should also be taken into account.

Mr. Bergo made the following statement:

> The current draft report does not make me very happy. It is not that the staff has not done a nice job in summarizing our discussions and phrasing our arguments more elegantly and persuasively than we did ourselves. My unhappiness stems from seemingly not being able to deliver what I believe the Interim Committee expected of us.
>
> Unfortunately, with regard to the discussion on the SDR issue, I have little to contribute, except signaling a willingness to continue discussions in the interest of reaching a broad agreement on all the elements covered by the report. In these discussions, we will not be dogmatic and we will enter them with a certain flexibility.
>
> However, my conclusion from the discussion is that, until the opposite parties of the discussion are willing to come out of the trenches from where they defend their principles, coming forward with new proposals without directly addressing those matters of principles will be neither very meaningful nor fruitful.

There are two dimensions to our debate: one dimension concerns actual outcomes; the other, principles. If finding a solution would only be a matter of the actual outcome, we would probably have reached a compromise already. The problems are not at a quantitative level, but rather at a logical one.

To go further, it seems one side or the other must change or reinterpret some fundamental, not to say fundamentalist, positions. Hence, further deliberation of numbers, with different combinations of general and special allocations, seems fruitless unless we first address and reach some common understanding of the logic and motivation behind an SDR allocation, be it a general one or a special one. We need a meeting of minds here, so maybe, as also pointed to by Mr. Kiekens, we who favor a general SDR allocation, could consider whether the interpretation of long-term global need can be modified so as to alleviate the fear on the other side.

Maybe those favoring a solution along the lines proposed by Mr. Evans and Ms. Lissakers can come up with a sufficiently convincing logic and a set of principles that could justify a special allocation with a character of a general allocation to all members. I have to admit that I find it difficult to envisage a convincing logic, but Mr. Autheman made a start. As I agreed with almost all that he said and have little to add, I will leave the SDR issue and make some brief comments on the other elements of the report.

With regard to access limits, in the spirit of compromise we could agree to go up to 90 percent of quota for stand-by and extended arrangements. If any language on "expectations of increases in average access" is contemplated to be included, I would strongly urge that reference be made to the commensurate strength of the programs. With regard to the STF, we would prefer only one additional tranche in conjunction with a Fund arrangement. We could go up to 80 percent in access altogether. We remain very reluctant to accept a stand-alone purchase, and would hope this will not be part of the proposed arrangement.

Like Mr. Posthumus, I am not sure if we should eliminate the requirement to make the second purchase within a certain period. I would think such a requirement would give important incentives to rapid reform.

With regard to the ESAF, I presume that when the report speaks of increased access, it is referring to increases in actual access and not in access limits. I hope this could be made more clear in the report.

Mr. Mirakhor said that he supported the views expressed by Mr. Kafka, Mr. Al-Jasser, and Mr. Ismael. On the U.K./U.S. proposal, he shared the assessment of Mr. Autheman and Mr. Kaeser. He would be grateful for some staff comment on the assertions by Ms. Lissakers and Mr. Evans that their proposal was the best of all available alternatives, including those that included general and special allocations of equal size. Like other Directors, he also supported the change in the language of the draft report suggested by Mr. Zoccali in his note of August 24, 1994 (EBD/94/146).

Mr. Evans remarked that his colleagues would have to decide and advise their authorities on the adequacy of the arguments put forward in the U.K./U.S. proposal. His own rationale for the proposal was similar to that advanced by Mr. Smee. The proposal was essentially an equity amendment with two elements. It took account of two different concepts of equity: one was related to the stock of SDRs, by giving all members, especially new members, enough SDRs to bring them up to a certain minimum level; and the other was related to the flow of SDRs, providing something for everybody. Mr. Marino was correct that the proposal did not provide a perfect solution to the equity issue, but it went a long way in that direction.

Some Directors had expressed concern about the perceived precedent that would be set if the proposal he and Ms. Lissakers had made were adopted, Mr. Evans recalled. Indeed, some Directors had said that the U.K./U.S. proposal would effectively kill the SDR in terms of possible future general allocations. To allay those concerns, both he and Ms. Lissakers had suggested the inclusion of an unequivocal statement by the Interim Committee; such statements carried some weight, despite Mr. Autheman's skepticism. Moreover, it was useful to ask whether a failure to agree on any SDR allocation would in fact send an even clearer signal that the SDR was falling into disuse.

Ms. Lissakers noted that Mr. Geethakrishnan had alluded to the fact that her chair had sufficient votes to block an SDR allocation. Indeed, if the intention of her chair were to eliminate the SDR, weaken it, or prevent its use as a reserve asset, her chair could use its voting power to block any SDR allocation. However, that was not the intention of her chair. The proposal on an amendment to provide a meaningful SDR allocation to new members was an affirmation of the SDR as an important part of the international monetary system, and a recognition that participation in the SDR system was an essential part of full participation in the Fund. She had made the point repeatedly that her intention was to address the anomaly that more than 35 members of the central institution in that system had no SDRs. She had tried to construct a so-called equity amendment in a way that would meet the objectives of other members and that would both provide for full participation by new members in the SDR system and smooth out some of the anomalies in distribution under previous SDR allocations. That effort had been made without requiring a recognition or acceptance of a long-term global need to supplement existing reserve assets because there was no consensus in the Board on that point. The U.K./U.S. approach was, therefore, both reasonable and consistent with the Articles of Agreement.

It was true, as pointed out by Mr. Autheman, that the draft language prepared by the staff did not elaborate on the rationale for the amendment, Ms. Lissakers commented. In practice, however, most of the Articles were operational in nature and did not elaborate on the background; the Articles concerning quotas, for example, provided for both general and selective increases without offering the underlying rationale. She certainly would not oppose some broadening of the language in the draft amendment, and such an approach might well provide the basis for a compromise that all members could support, along the lines that Mr. Autheman had explored. If it were felt that such a compromise would violate some basic principles, however, there might be no alternative but to return to consideration of a narrow equity amendment, which her chair would be prepared to support.

With regard to the size of any allocation of SDRs, Ms. Lissakers continued, her chair had consistently advocated a modest allocation. By contrast, she found somewhat inconsistent the fact that chairs that had consistently admonished individual members to maintain a tight monetary stance, to consolidate their fiscal positions in order to stem inflationary pressures, and that had warned in recent Article IV consultation discussions about the impending resurgence of inflation would then insist that the world economy needed $50 billion in additional liquidity.

Mr. Mirakhor remarked that the assertion made by Mr. Evans that no allocation would be more damaging to the SDR as an instrument than a special allocation might well be correct, but it was probably incomplete. If there were no allocation, and therefore no statement of assurance were issued confirming the importance of the SDR as a reserve asset, it would be difficult to see how the SDR would be weakened. Moreover, if it were made clear that the Board had reached its decision not to allocate SDRs without questioning the role of the SDR itself, it seemed likely that the SDR would be strengthened in comparison with the impression that would be conveyed through a special allocation under an amendment of the Articles.

Mr. Posthumus said that, like Mr. Ismael, he recognized that there was another proposal on the table. The long-standing proposal by the Managing Director might have been somewhat oversold a little bit, however, inasmuch as acceptance of its arguments implied in effect that there would be a continuous need for general allocations. The more fundamental issue at present was that the floor element in the U.K./U.S. proposal resembled too much a general allocation, which could not be denied. In that context, the suggestion of Mr. Autheman was rather constructive, and, like Mr. Bergo, he would suggest that the Board examine that approach further. As he had mentioned at an informal meeting the previous week, acceptance of some variant of the U.K./U.S. proposal implied that there would be no general allocation based on long-term global need.

The Chairman, in drawing conclusions from the discussion, remarked that the Board faced three main tasks in the period leading up to the Annual Meetings in Madrid. First, a compromise must be reached on the package on access, including such elements as the appropriate language on debt rescheduling and on the ESAF. On that first point, he sensed from the statements by Mr. Evans and a few others that the Board was farther from reaching a consensus than had been thought. In particular, references to the expectation that average access would be increased substantially raised a number of concerns, especially for those responsible for negotiating strong programs with the authorities; going too far in the direction of an expectation would produce precisely the opposite result that was intended. In finding the appropriate language to convey that point in the report, therefore, it would be important to emphasize the need for good policies.

Ms. Lissakers said that, for the sake of clarification, she had not advocated a specific target for access under Fund-supported programs. Rather, she had stressed that, given that average access was currently about 35 percent of quota, it should be made clear that the purpose of raising the access limits was to raise effective average access. In any event, access limits had traditionally had the effect of tying the hands of the staff in negotiating specific programs with specific members.

The Chairman commented that he could not agree with Ms. Lissakers on the signaling aspect of raising access limits. If the Board were to agree to an annual target for average access, however presented, the negotiating strength of missions conducting program discussions would be significantly undermined. He would, therefore, caution strongly against a move in that direction. Moreover, from the perspective of reaching an overall agreement, such a move was likely to make it more difficult for others to agree on the proposals on debt rescheduling and on the ESAF.

The second task facing the Board prior to the Madrid meetings was to come to closure on the SDR issue, the Chairman considered. The third task, of course, was to agree on the language, with as few brackets as possible, of the report to the Interim Committee. For that purpose, the Board could meet again shortly to see whether some of the existing differences could be narrowed or even eliminated on the basis of the present discussion. There would appear to be some scope for optimism in that respect, owing in part to the suggestions of Mr. Kiekens, Mr. Autheman, and others.

On the substance of the discussion on SDR issues, the Chairman said, three positive developments had emerged from the present meeting, despite the occasionally somewhat abrupt tone of the discussion. First, Directors had confirmed that all chairs wanted to reach as advanced a solution as possible in the Executive Board, a sentiment he shared fully. Second, Directors had reaffirmed that the Fund was facing an exceptional situation and that it must address the issues with all of the instruments at its disposal, including exceptional instruments such as the SDR. Third, although there were some lingering concerns, it was generally accepted that the package would need to include an amendment of the Articles for the purpose of addressing the equity issue. The difficulty in the Board's work lay in the fact that, implicitly or explicitly, all chairs recognized that the success of the package depended critically on the inclusion of a general allocation of SDRs; the key issue, therefore, was how to present the idea of a general allocation in a way that would satisfy the concerns of all chairs.

The presentation issue could be approached in one of two ways, the Chairman considered. The first was based on the ingenious design of Ms. Lissakers and Mr. Evans, which he welcomed as a testament of their willingness to facilitate the process of reaching a consensus. Several Directors had either given their support to that approach or were working on improvements that could make it acceptable to a broader number of Directors.

The problem with the U.K./U.S. approach, however, was that it was aimed at allaying the concerns of those who had difficulty with the concept of global need. In doing so, the U.K./U.S. approach created major problems for many Directors: it gave the impression that the SDR system had been either abandoned or circumvented dangerously, and its success relied in part on the somewhat perilous route of parliamentary approval. With 178 member countries, each with its own legislative requirements, there was a very real risk that an amendment of the Articles, and therefore the package, would not be adopted by the necessary majority. The second approach to the presentation issue underpinned his own proposal for an allocation of SDRs. In effect, he was proposing that the Board follow the path taken by the Board in 1978 when it had decided to agree on a general allocation in the context of a package of other agreements. The current discussion on SDR issues was, therefore, limited essentially to a choice between those two approaches to the presentation of a general allocation.

In his view, the Chairman remarked, the merits of the approach offered by Ms. Lissakers and Mr. Evans were not compelling, although it must be recognized that his view was not shared by others, including the German chair. Nevertheless, it was useful to ask whether the perceived merits of that approach were sufficiently strong to justify embarking on the perilous route of ratification by national parliaments, with the delays that such an approach entailed for the countries in urgent need of additional financing.

He would urge all Directors to reflect carefully on the remaining issues, to recognize that the debate was henceforth primarily one of presentation rather than substance, and to encourage their authorities to grant them the flexibility to be able to present a package to the Ministers and Governors in Madrid that could be accepted without divisive debate, the Chairman stated. With that in mind, he would welcome further suggestions aimed at bridging the remaining gaps among Directors. The suggestion of Mr. Autheman, in particular, held out the prospect of a clearer explanation of the rationale for an amendment of the Articles to provide for a general allocation of SDRs, a step that did not normally require parliamentary approval. It was to be hoped that the Board would be able to take up simultaneously the remaining drafting issues and the substantive discussion on access, the ESAF, and debt rescheduling.

Mr. Schoenberg observed that the Chairman had referred to the approach followed by the Board in 1978 in addressing the presentation issue. In his view, however, the 1978 decision did not involve a presentation issue; it had dealt exclusively with a straightforward general allocation of SDRs.

The Chairman recalled that the 1978 decision on an SDR allocation had in fact been part of a package, as had been emphasized at the time by the German Finance Minister at the September 1978 Interim Committee meeting. On that occasion, Germany had clearly accepted a general allocation as part of a package with many important elements for the membership.

Mr. Schoenberg said that, for the record, his chair did not recognize the need for a general SDR allocation. In the view of his chair, the U.K./U.S. proposal was for an equity amendment.

The Chairman asked Mr. Schoenberg how he reconciled the stated view of his chair with the fact that the U.K./U.S. proposal contained an element that was very much akin to a general allocation of SDRs.

Mr. Schoenberg replied that, as had been argued by Mr. Smee, equity could be defined in either a broad or narrow sense.

The Chairman encouraged Mr. Schoenberg to consult closely with Mr. Evans and Ms. Lissakers on the definition of equity implied in their proposal for an SDR allocation.

Mr. Evans commented that the debate on the SDR issue was not only about presentation. Indeed, one of the major issues of substance was whether or not there was a long-term global need to supplement existing reserve assets, which was a distinguishing feature of the proposal he had made with Ms. Lissakers vis-à-vis the proposal for a general allocation of SDRs. With respect to what the Chairman had referred to as "the perilous route of parliamentary approval," it was important to recognize also the widespread agreement in the Board that some form of equity amendment, perhaps conditional on other elements, was needed. It was accepted, therefore, that parliamentary approval was inevitable. The U.K./U.S. approach did not add to the difficulty of that process; indeed, for many chairs, it should make the process easier.

The Chairman remarked that if the existence of a long-term global need was not accepted under the present circumstances, then there had never been a global need and the Fund should never have allocated SDRs. On previous occasions, the Board had considered that a sufficient need existed for allocating SDRs, a consideration that was made significantly easier under present circumstances. On the ratification of an equity amendment, views differed on that essentially political issue, but his impression was that it would be difficult to convince parliaments to vote for an amendment that provided for anything other than a straightforward equity allocation.

Mr. Al-Jasser asked Mr. Evans whether he could allay the concerns of those Directors who remained concerned about the SDR and its status in the Fund by outlining the circumstances, short of a global recession, in which he could envision a long-term global need to supplement existing reserve assets to hold. Like others, he remained convinced that an allocation of SDRs that did not include a general allocation, would signal the end of the SDR and the principle of general allocations.

Mr. Evans observed that the prospects for the world economy over the coming few years included substantial growth in both industrial and developing countries, continued large-scale capital flows among industrial countries and from industrial countries to many developing countries, and consequently, a substantial buildup in reserves in many countries. If those factors were to change, he could see that a case might be developed for an SDR allocation based on global need; indeed, his chair did not rule out that possibility as a matter of principle. Looking at the present state of, and prospects for, the world economy, however, such a case could not be made.

Ms. Lissakers said that she could not specify the circumstances in which she could see a global need for a large SDR allocation or a general SDR allocation, nor could she indicate whether such an occasion would arise, which was precisely why she was arguing for the preservation of the SDR and the full participation of the membership in that instrument. It was important to recognize, however, that the current condition of the global economy and the structure of the international monetary system were quite different from those that had prevailed in 1979, and certainly very different from the environment in which the SDR had been created. Indeed, the motivating factor for the creation of the SDR had been concern that the dollar would not be available in sufficient amounts to supply liquidity for other countries' reserves; at that time, the dollar had been virtually the sole reserve currency, as she had noted in previous informal discussions. At present, by contrast, there were three reserve currencies, and it was no longer possible to argue that the conditions that had given rise to the SDR, or that might have justified somewhat the issuance of SDRs in 1979-81, were present. In sum, her chair was trying to preserve the SDR as a valid and valuable reserve asset, without having to accept the argument that there was at present a global need for an SDR allocation.

Mr. Posthumus wondered whether and to what extent the 1978 decision on an SDR allocation had been based on a finding of long-term global need for additional reserves, as was the case with the Managing Director's current proposal.

The Treasurer replied that the existence of a long-term global need was one of the considerations that had led in 1978 to the proposal, which had been accepted by the Governors, for a general allocation of SDRs, but it had not been the only one. Great emphasis was also placed on the objective of making the SDR the principal reserve asset of the international monetary system; indeed, the Second Amendment of the Articles of Agreement, which had introduced the operative mandate in that regard, had come into effect only in April 1978. There had also been reference in the 1978 discussions to the fact that SDRs would be needed to pay for the new quota increase that had been agreed as part of a broader package.

The Chairman recalled that, at the ministerial level, an additional consideration in the 1978 discussions had been the looming debt crisis and the need to provide countries with more owned reserves and less borrowed reserves. Thus, the Board had considered a number of justifications for an allocation, including, of course, the existence of a long-term global need to supplement existing reserve assets.

The Executive Directors agreed to resume on September 15, 1994 their consideration of the draft report to the Interim Committee on access to Fund resources and an allocation of SDRs.

2. BULGARIA - STAND-BY ARRANGEMENT - AUGMENTATION, WAIVER AND MODIFICATION OF PERFORMANCE CRITERIA, AND REVIEW OF EXTERNAL FINANCING; AND DECISION CONCLUDING ARTICLE XIV CONSULTATION

The Executive Directors considered the staff report on Bulgaria's requests for an augmentation of resources under the 12-month stand-by arrangement approved on April 11, 1994 and for a waiver and modification of performance criteria, on the review of external financing, and on the 1994 Article XIV consultation (EBS/94/160, 8/16/94). They also had before them a communication from the Governor of the Fund for Bulgaria (EBD/94/152, 9/9/94).

Mr. Fischer, the First Deputy Managing Director, assumed the chair.

Mr. Posthumus made the following statement:

On September 2, 1994 the Government led by Prime Minister Lyuben Berov submitted its resignation to the Parliament. The resignation was accepted but, in accordance with the Constitution of the Republic of Bulgaria, the Council of Ministers will continue to fulfill its functions until a new government has been formed, including continuation and finalization of the negotiations conducted with the international financial institutions, namely, the World Bank and the Fund, as well as the achievement of bilateral agreements for financial assistance after the foreign debt restructuring arrangement.

In 1994, the Bulgarian economy has reached a crucial point in its development. The most important achievement since the Executive Board discussion on Bulgaria in April 1994 (EBM/94/33, 4/11/94), as well as the direct motive for this Board meeting, is the progress made in restructuring Bulgaria's foreign debt. The debt and debt-service reduction agreement signed between the Bulgarian Government and its foreign commercial bank creditors provides for a 47 percent ($3.8 billion) reduction in Bulgaria's $8.1 billion debt. The closure of the debt and debt-service reduction operation should restore the country's access to international capital markets, re-establish its links with Western commercial financing, and enhance Bulgaria's growth prospects. To accommodate the drawdown of international reserves associated with the up-front debt and debt-service reduction costs, my authorities have requested a modification, as was anticipated, in relevant performance criteria.

During the past six months, significant progress has been made toward establishing macroeconomic stability, but problems remain and new challenges have appeared. The unanticipated depreciation of the national currency, coupled with increased prices of energy products and the introduction of the value-added tax in March-April, resulted in higher than expected inflation and exerted considerable pressure on financial policies. Despite these negative developments, my authorities adhered to their nominal targets for the fiscal deficit, wages, and advanced structural reforms. On the monetary side, however, difficulties were experienced in keeping monetary expansion under control. The end-June performance criterion on net domestic assets of the banking system could not be met, and a waiver is being sought. Since July, the authorities have taken rigorous measures to contain money growth through a drastic reduction of the volume of refinancing, sterilization of the central bank's interventions on the foreign exchange market through open market operations, and higher reserve requirements. Moreover, the Bulgarian National Bank decided to discontinue the use of credit ceilings as an instrument of monetary policy and to rely instead on reserve money programming.

On the fiscal front, imposition of the valued-added tax, strengthening of tax administration, and firm control over budget expenditures have had a positive impact on government finances. This has resulted in higher than anticipated revenues and a lower than programmed budget deficit, which leads my authorities to be confident that their fiscal objective for 1994 is achievable.

Moreover, the authorities adhered to the nominal wage targets, which in light of the higher than expected inflation, led to a considerable drop in real wages. Given the importance of incomes policy in curbing inflation, the Government remains committed to retain the original nominal wage target.

In the field of structural reform, a wide range of measures is being taken. Almost two thirds of the agricultural land has been privatized and the pace of state and municipal enterprises' privatization has been accelerated. Furthermore, legislation enabling the start of mass privatization has been put into practice, and the process of cleaning up balance sheets of the commercial banks from pre-1991 nonperforming loans has been completed. The establishment of credit monitoring on a significant part of loss-making state-owned enterprises, and the recent approval of a modern bankruptcy law, should further strengthen financial discipline in enterprises.

To summarize, the successful completion of the debt and debt-service reduction operation deserves, in my view, support from the Executive Board for augmentation of the stand-by arrangement. In addition, the authorities' policy implementation under difficult circumstances warrants Directors' approval of the requested waiver of one performance criterion and modification of subsequent performance criteria.

The staff representative from the European I Department, updating recent developments in Bulgaria, said that he had little to add on the political situation as described in Mr. Posthumus's opening statement and in the letter from Governor Vulchev to the Managing Director. Speculative pressures on the lev had brought its value down to 64 lev per dollar, and the Bulgarian National Bank had acted by substantially increasing its basic interest rate from 83 percent to 101 percent at an annual rate, well above the recent annualized inflation rate.

In August, Bulgaria had received $50.5 million from a loan disbursed by the Japanese Export-Import Bank (JEXIM), which had helped replenish international reserves drawn down by the up-front cost associated with the debt and debt-service reduction operation, the staff representative continued. Gross international reserves at end August had remained virtually unchanged from their July level but were expected to recover in September, bolstering confidence in the lev, it was hoped. In addition to Fund resources, the World Bank was scheduled to consider its debt and debt-service reduction support loan on September 22, and disbursement of a European Union (EU) balance of payments support loan of $80 million might take place later in September.

Mr. Jonáš made the following statement:

> The Bulgarian authorities deserve our applause for their effort to cope with the exchange rate crisis and increased inflation. But their success in bringing inflation down and stabilizing the nominal exchange rate does not deliver the authorities from the need to make an even stronger adjustment effort, now that the conclusion of the debt and debt-service reduction operation has increased potential effectiveness of external assistance for helping them deal with the difficult tasks that still lie ahead.
>
> At this moment, there is no guarantee that the crisis will not reappear. Nonetheless, the authorities are not wholly at the mercy of events beyond their control: they can significantly reduce the risks of unfavorable development and build up the confidence of investors. Needless to say, the latter task will not be easy, particularly in view of past slippages.
>
> The staff suggests that there may not be much room for further adjustment of fiscal and income policies, and that the brunt of the stabilization burden will, therefore, fall on monetary policy. This could well be true if the projections on which the medium-term fiscal scenario is based materialize. Currently, total expenditures are more or less in line with projections, while revenues are performing better than expected. However, this pattern could change, as the staff assumes it will, and in that event additional measures will be necessary. It is obviously a good idea to have a contingency plan drawn up in advance.
>
> The staff also recommends a further tightening of monetary policy. Recent problems in keeping monetary aggregates on their projected nominal paths largely reflect weaknesses in the financial sector. Unless there is improvement in the financial position of the commercial banks, it will not be possible to enjoy

the advantages of indirect instruments of monetary control. The central bank will still be under pressure to rescue ailing banks, which will have negative effects on its monetary program. The financial soundness of the banking sector also depends, inter alia, on the financial soundness of the enterprise sector. It is my hope that the entry into force of the bankruptcy law and an acceleration of privatization will finally put an end to soft budget constraints and firmly establish the discipline of the bottom line. Let me also take this opportunity to congratulate the authorities on their wise decision to implement the Czech scheme of mass privatization.

For the foreseeable future, Bulgaria's external position will continue to be vulnerable. Insufficient external reserves and low confidence in the leva provide little room for policy mistakes and slippages. External assistance could somewhat relieve the emergency nature of the situation and allow the authorities to pursue policies based more on medium-term considerations. In view of the significant adjustment efforts, I support the proposed decision.

Mr. Desruelle made the following statement:

Let me go directly to the heart of today's discussion, namely, the debt and debt-service reduction operation and its financing.

This chair very much welcomes the debt and debt-service reduction agreement which, together with the agreement in the Paris Club, should bring over time all the benefits mentioned in Mr. Posthumus's opening statement, including renewed access to international capital markets and enhanced growth prospects for Bulgaria.

We welcome as well the fact that Bulgaria is the first country to benefit from the change to the modalities of Fund support for the debt and debt-service reduction enacted last January. This chair had for a long time argued for the elimination of the segmentation of this institution's support. We note that without this modification, the augmentation amount would have to have been reduced by half; thus, we are pleased to observe that Bulgaria is able to tangibly benefit from the increased flexibility in our debt and debt-service reduction support.

Turning to the overall financing of the operation, and specifically to the level and timeliness of financing from multilateral institutions, I would make two remarks.

As regards the Fund, this chair would have been comfortable with a somewhat higher level of augmentation, such as, for instance, 20 percent of quota, which, I understand, was initially considered. However, it is recognized that, with the two systemic transformation facility purchases, the level of financial involvement of the Fund under the current program is already significant.

More serious questions have to be asked about the present outcome of the cooperation between the Fund and the World Bank. I trust that it is worth raising this issue briefly in this forum, as support for debt and debt-service reduction operations has to be closely coordinated between the Fund and the Bank, and the benefits of support from one institution can be affected by the activities of the other.

I will not comment on the specific amounts of financial support by the World Bank--$125 million of augmentation and $75 million of set-aside. My concern is with the uncertainties regarding a substantial part of that support, namely, the $75 million of set-asides in the future Financial and Enterprise Sector Adjustment Loan (FESAL). It would appear that this operation has been further delayed since our meeting in April: the appraisal mission has not taken place during the summer; presentation to the Executive Directors of the World Bank now seems unlikely to occur this year. One may therefore seriously wonder whether this element of support to the debt and debt-service reduction will become available in a timely manner. I would welcome the staff comments on this issue.

On macroeconomic and structural issues, I can be very brief. First, I fully support the proposed decision. The authorities encountered difficulties in the management of monetary policy in the wake of the confidence crisis of May. However, the measures that have been taken to correct the situation--e.g., the increase in reserve requirements and the tighter control of credit to selected state-owned enterprises--and the positive performance on fiscal and incomes policies, for which the authorities must be commended, justify the requested waiver.

Second, even after the recent improvements, the conduct of monetary policy will remain difficult in the coming months, as uncertainties about money demand persist and the financial system remains weak. This highlights the importance of persevering with the implementation of a balanced policy package. In particular, it will be essential that the good track record of fiscal and incomes policies achieved so far under the program continues. I would appreciate comments by the staff on whether the very recent currency weakness could have a negative impact, particularly as regards holding the line on wages.

Third, and finally, the importance of proceeding more forcefully with structural reforms was highlighted at our previous Board meeting. Speeding up structural reforms remains as important today as it was five months ago, and it is to be hoped that the present political uncertainties will not affect the prospects for progress in this regard.

Mrs. Wagenhoefer made the following statement:

In recent months, each time a Board discussion on Bulgaria has been scheduled, something unforeseen seems to happen once the comprehensive staff paper has been distributed. Whereas, prior to the last Board meeting in April, there had been a confidence crisis leading--among other things--to a sharp depreciation of the lev, this time we had to learn both that the Bulgarian Government has submitted its resignation and that there has almost been a renewed exchange crisis.

Uncertainties about future economic developments--as is the case today, even about the future economic course to be taken by the new Government--are thus adding to our uncertainties normally associated with the future of any economy and of transition economies in particular. We have to cope with this. The communication from the Governor of the Fund for Bulgaria, dated September 9, 1994, is certainly somehow reassuring in this respect, as it expresses confidence that the future Council of Ministers will be committed to the economic strategy currently followed.

If I have read the staff appraisal correctly, and if my reading between the lines was also correct, I cannot but commend the staff for achieving a particularly difficult and balanced assessment of the future outlook of the Bulgarian economy. While I feel somehow reassured by staff's statements that the authorities' record offers reasonable assurance that, political conditions permitting, they will adapt policies to changing and difficult circumstances, I also note, on the other hand, that substantial risks of slippage exist and that further shifts in asset preferences cannot be ruled out. In fact, this may just have happened during these past few weeks, as we have heard from the staff. I would have welcomed any further information by staff on the actual political situation in Bulgaria and staff's assessment of the domestic policy outlook, but I understand that this is not possible at the moment. This being said, I am in agreement with the staff appraisal.

Moreover, I fully agree with Mr. Posthumus's statement that "the most important achievement since the last Board discussion is the progress made in restructuring Bulgaria's foreign debt." The regularization of Bulgaria's relations with private foreign creditors is not only, in our view, a major precondition to overcoming its image of a so-called problem debtor, but also a prerequisite to open the door to foreign direct investment and private capital flows. The Bulgarian economy, now and tomorrow, urgently needs to revive confidence. What can be done?

First, on fiscal policy, I admit that, on the occasion of our last meeting on Bulgaria, this chair was rather pessimistic regarding the fiscal prospectives and, in particular, the feasibility of revenue increases. Our assessment in the spring did reflect unpleasant experiences in a number of transition countries, especially with regard to the flexibility of fiscal policy. The results of fiscal policy in Bulgaria, thus far, however, are quite encouraging. The fiscal deficit and recourse to bank credit in the first half of this year were well within the program targets. Insofar, fiscal policy has fulfilled its role and has relieved, to some extent at least, monetary policy from the difficult stabilization task. I welcome the authorities' intention to stay the course with incomes and fiscal policies in the second half of this year. Nevertheless, considerable risks remain, owing to the expected intensified pressures on the budget this fall. We fully support the staff's view that contingency measures, like higher energy prices, should be considered in order to cover increased imports.

As far as monetary policy is concerned, its response to the March crisis was obviously not sufficient to restore confidence and to combat inflation and, therefore, a waiver is being sought for the June performance criteria on domestic banking assets. We welcome the recent changes in the operation and conduct of monetary policy, as set out in Mr. Posthumus's opening statement and in the staff paper. As one of the aims of monetary policy is to restore confidence in the lev, I wonder whether the staff representative--over and above the immediate response he has already made in the area of interest policy--might give us indications as to the authorities' intentions with regard to exchange rate policy. I did not succeed in finding anything on that subject in the report.

Finally, privatization activity remains at a low level. I was, therefore, pleased to learn from Mr. Posthumus's opening statement, and also from the staff, that the pace of privatization has been accelerated, and that mass privatization can now be started. This is not only important as part of structural policies, but also as an additional element of stabilization efforts. I am sure that the staff, in advising the Bulgarian authorities about the techniques of privatization, takes into account experiences in other transition countries, therefore avoiding difficulties such as conflicting interests by banks and/or investment funds. In conclusion, I fully agree with the staff that a front-loaded adjustment is now required in order to regain policy credibility, and that this is reinforced by developments in the last few weeks. With these remarks, I can support the proposed decisions.

The staff representative from the European I Department observed that the authorities had focused, thus far, on accumulating international reserves in order to finance the up-front costs of the debt and debt-service reduction operation. As a result, the exchange rate level had been of secondary concern. While the level of the exchange rate was important because of its inflationary implications, the authorities had relied on macroeconomic instruments--the budget, monetary policy--rather than on direct foreign exchange intervention to stabilize financial conditions so that the exchange rate could be managed in a fashion that was consistent with reducing inflation. The authorities had not been wholly successful in that effort, mainly because of the emergence of confidence questions. In March 1994, the timing of G-24 assistance had been in doubt and the Prime Minister had just had a heart attack, which had created considerable uncertainties and caused the exchange rate to depreciate. Most recently when the Government had chosen to resign, the foreign exchange market in Bulgaria entered into another unsettled period.

If the Bulgarian authorities continued to pursue the type of macroeconomic policies that they had pursued thus far, then the exchange rate would not necessarily continue to depreciate, the staff representative considered. The economic fundamentals appeared to be sound. For example, the external trade account had moved into a surplus in the first half of 1994, from a deficit in the comparable period the year before, representing a swing of about $400 million. The authorities' intentions in the future regarding exchange rate policy remained an open question, especially given the changes likely to occur soon in the Government.

The authorities' experience in the first half of 1994 with direct monetary policy instruments had not been satisfactory, the staff representative observed. Over time, commercial banks had become more effective in circumventing direct controls. Therefore, the authorities had moved to indirect methods somewhat faster than the staff would have liked. The domestic banking system still had liquidity and solvency problems, and severe macroeconomic imbalances had yet to be resolved. However, the authorities had felt that indirect methods were preferable, under the circumstances, and offered the greatest possibility of bringing inflation down. In that context, a technical assistance mission from the Fund's Monetary and Exchange Affairs Department had recently begun working in Bulgaria and would hold discussions on indirect monetary management. The Dutch central bank had also provided technical assistance. On Bank/Fund collaboration on the debt and debt-service reduction, no particular problems were seen, at least from the Fund's side.

The staff representative from the World Bank said that the Bank staff had been working with the Bulgarian authorities for some time on the Financial and Enterprise Sector Adjustment Loan (FESAL) operation. One of the factors that had made the process a lengthy one had been the difficulty of achieving consensus within the Bulgarian Government on how best to accelerate privatization, given the nature of a mass privatization program, issues of financial sector reform, and the enforcement of financial discipline on the state enterprises. Progress toward consensus had been made, and the Bank staff had scheduled an appraisal of the Financial and Enterprise Sector Adjustment Loan for October. With the latest political events, however, it had become necessary to wait for the new government to be formed and to confirm the consensus with the new authorities. Based on an optimistic projection, it was now expected that the Financial and Enterprise Sector Adjustment Loan would be considered by the Executive Directors of the World Bank some time in the early spring of 1995.

Mr. Ishida made the following statement:

It is welcome that the debt and debt-service reduction operation has been closed, and I would encourage the authorities to make the best use of this first step toward restoration of access to foreign capital markets and the promotion of foreign investment. I support all the proposed decisions, and would like to make some remarks on economic performance and policies.

The revised economic indicators for 1994 in Table 1 are rather disappointing, though not surprising. Real GDP growth is projected to remain negative; inflation is higher than last year; and it is difficult to find convincing signs of a recovery of external viability. Although the nominal exchange rate has been relatively stable in recent months after the sharp depreciation in the spring, and the level of inflation has been reduced since last June, it is rather hard for us to have confidence that the economy has been put on a path of stabilization; in other words, there remains a large risk that the currency will again depreciate and inflation re-emerge. As this chair emphasized at the world economic outlook discussion, the key to successful transitions to a market economy has been macroeconomic stabilization, with the main emphasis on the containment of inflation as well as structural reform, including privatization. This principle needs to be strictly applied in Bulgaria's case. My authorities have pledged to provide a loan cofinanced by the Japanese Export-Import Bank in the amount of $50 million with the World Bank's Financial and Enterprise Sector Adjustment Loan, and they strongly hope the Bulgarian authorities will implement the necessary measures at a faster pace.

As I broadly agree with the staff's view on fiscal, monetary, and external policies, I will limit myself to one comment on the necessary strengthening of institutional capability.

I would like to point out that, while the staff report implies that the March crisis and the low international reserves were partly due to the delay or shortfall in official foreign assistance, the fact is--at least in the case of Japanese assistance--the delay in disbursement of assistance was due entirely to delay on the Bulgarian side. For example, I remember that it took several months to submit all the required documents to my authorities despite a number of notifications by my authorities through different channels.

The authorities need to significantly improve their institutional capability as a matter of urgency, particularly concerning foreign assistance and debt management, and I hope the Fund provides appropriate advice for them.

Mr. Dorrington made the following statement:

Recent history in Bulgaria has obviously been plagued by uncertainty. When I learned that the Government had resigned, I wondered whether we should continue with this discussion today. But, given the importance of today's decision for Bulgaria, and with the assurances given in the letter from the Governor--assurances that I see no reason to doubt--I am sure that the decision to go ahead today was right. I, like others, welcome the successful conclusion of Bulgaria's negotiations with the London Club and the support we are able to give to the implementation of this agreement--without the segmentation constraint, I might add. The London Club deal, together with renewed efforts at reform seen recently in Bulgaria, represent major steps toward a re-establishment of Bulgaria's credibility in international capital markets. It may be a long road, but the next step should be to fully implement the stand-by arrangement program, and to press ahead vigorously with the mass privatization program approved by Parliament.

In April, when we discussed Bulgaria, I stressed the importance of contingency measures in the event of a revenue shortfall and the need to keep real interest rates positive. As far as revenue is concerned, I am very pleased to see that performance has exceeded the expectations underlying the program and, therefore, even more so, has allayed my fears. Measuring real interest rates is always difficult, especially when the inflation rate is volatile. But at least on a forward-looking basis, real interest rates now look high. But given the confidence situation, I think that is necessarily so. I can conclude simply by endorsing the last paragraph of Mr. Posthumus's opening statement, and supporting all the proposed decisions.

Ms. Bessone Basto made the following statement:

The events in Bulgaria, following the exchange market instability in March, have shown us that, despite the Government's efforts to pursue disciplined macroeconomic policies, remaining weaknesses in the economy could still hamper the achievement of the program's objectives.

The policy response to the developments of March was a reaffirmation of the authorities' commitment to the stabilization program. Restrained fiscal and income policies have been determinant factors in maintaining the budget performance on track and monetary policy was tightened through the imposition of restrictive credit limits. However, weaknesses in the management of monetary policy made the task of reducing inflation difficult to attain, and credit ceilings were not enough to control the monetary expansion that resulted from the substantial domestic refinancing required to keep major banks afloat and from the only partial sterilization of foreign exchange purchases by the Bulgarian National Bank to accumulate reserves. Without proper mechanisms to sterilize unwanted effects of purchases of foreign currency, the increase in broad money could not be prevented, putting the disinflationary goal at risk.

In addition to restrained monetary policy, measures to increase its credibility and effectiveness should be considered a priority, and it is heartening to see that the authorities are making efforts to address this issue.

The development of instruments allowing open-market operations is particularly encouraged. The recent change in the management of monetary policy--characterized by an increased reliance on reserve money controls instead of credit ceilings--was also an important step in this direction. Provided that the money multiplier remains stable, this shift to indirect instruments to conduct monetary policy--with its broader application--will enable a better control of monetary aggregates. However, to establish an efficient monetary policy, the fragility of the banking system also needs to be addressed. In this context, I welcome the fact that the authorities, together with the assistance of the World Bank, are considering the implementation of a program designed to improve loan collection, enhance the management of banks, strengthen supervision and restructuring, and privatize some state-owned banks. The recent approval of a modern bankruptcy law--referred to in Mr. Posthumus' statement--is also an important step towards the rehabilitation of the financial system.

Concerning fiscal accounts, it is encouraging to notice that the Government continues to be committed to maintaining a tight policy course in order to attain its target for the primary deficit surplus. There are essentially two reasons that can justify this action: first, in order to enable a debt reduction and the improvement of external viability; second, because a lack of success in this field would hamper the credibility of the authorities' commitment to the stabilization program, and market confidence in the currency would be difficult to restore. Several important steps have been taken in this direction, such as the introduction of the value-added tax and the imposition of tight nominal targets for wages. In addition to these measures, it is also reassuring that the authorities are considering the adoption of contingency measures for the eventuality of worse than expected developments.

In analyzing the structure of current expenses, the large share of social security costs cannot be unnoticed. It is true that some more vulnerable segments of the population might be negatively affected by the transition process towards a market economy, and it is important that a social safety net be provided. However, I have some concerns on whether the excessive burden on the budget that these costs represent is sustainable over the long term.

In order to ease the budget and enhance private activity, the intensification of the privatization process is required. The new legislation--introduced in June with the parliamentary passage of amendments to the Privatization Act--was an important step forward in facilitating the formulation of a program. However, the commitment of the authorities to a comprehensive privatization program still remains to be seen.

As mentioned in the staff report, growth prospects in Bulgaria are also dependent on the regularization of the country's relations with private creditors. The closure of the debt and debt-service reduction operation was indeed encouraging news, but the authorities need to continue the strengthening of external debt management in order to ensure greater access to foreign capital markets and to increase the attractiveness of needed foreign investment.

With these remarks, I support the proposed decisions.

Mr. Link made the following statement:

The direct motive for this Board meeting is the progress made in restructuring Bulgaria's foreign debt. I welcome the successful completion of the debt and debt-service reduction operation. I note with satisfaction the size of the debt agreement and the significant relief it will bring.

The comprehensive paper prepared by the staff on this occasion, recommends an augmentation of the stand-by arrangement as provided for under the Fund's debt strategy. Approval of the augmentation would bring to a conclusion a process begun a few years ago. I would like to say that the authorities are to be congratulated for their efforts in this regard and deserve support from the Fund.

Although the path was not always smooth, all the quantitative performance criteria for end-June 1994 have been met, with the exception of the net domestic assets of the banking system. As it is explained by the staff in its report, the Bulgarian National Bank has taken appropriate corrective policy actions, and the authorities have persisted with a tight monetary and fiscal stance. I believe the requested waiver of this one performance criterion, and the modification of subsequent performance criteria in accordance with the agreement with banks, is warranted.

I share Mr. Posthumus's view expressed in his opening statement, as well as by other Directors, that in 1994 the Bulgarian economy has reached a crucial point in its development, after a few years of stagnation and mixed results. During the last six months, progress has been made toward macroeconomic stabilization and structural reforms, despite difficult circumstances. I particularly welcome the emphasis given to revenue enhancement, as it represents the core of the fiscal adjustment, and as the pressures on the budget are still strong. This pressure is coming, among other things, from an inefficient social safety net system. Could the staff comment a bit more on how that problem is going to be solved?

On the structural side, I note the wide range of measures that are being taken by the authorities. However, much remains to be done. I agree with the staff that Bulgaria needs to intensify implementation of the reforms, which will be crucial for preserving the results of macrostabilization. Further progress in implementing privatization, rehabilitation, and good bank supervision are extremely important. Structural weaknesses usually limit stabilization efforts. Regarding the structural reforms in Bulgaria, assistance from the World Bank is crucial, especially that provided under the Financial and Enterprise Sector Adjustment Loan. That program has not started yet. I welcome the clarification in this regard made by the staff, but the problem still exists.

Finally, as I am in broad agreement with the staff report and share most comments made by Directors, I do not intend to repeat them again.

With these remarks, I support the proposed decisions.

Mr. Golriz made the following statement:

The Bulgarian authorities should be commended for their handling capably the confidence crisis that led to a sharp currency depreciation and abrupt inflation in March. Their continued commitments to key elements of the program, in general, and their undertaking of even greater adjustments, in particular, are reassuring enough to secure our support for today's proposed decisions. In view of challenges and risks ahead, a few comments seem to be in order.

If there was one positive point in the March turbulence at all, it was the fact that it prompted the authorities to press ahead with debt and debt-service reduction negotiations that had been under way for a long time. The completion of these negotiations should facilitate Bulgaria's further access to international financial markets, including the Fund and the World Bank. We, however, note that two creditors, namely, Russian commercial creditors and a Polish bank, accounting for almost

10 percent of Bulgaria's total debt, declined to participate in the package. The authorities are therefore encouraged to continue their negotiations and regularize their external relations with all creditors, which are crucial to the export driven strategy chosen by the country. Incidentally, on capital mobilization, the staff also refers to additional inflows from G-24 commitments. Additional information from the staff or Mr. Posthumus on this issue would be useful.

We share the staff's view that with already tight fiscal and incomes policies, the burden of sharply reducing inflation falls squarely on a tightening of monetary policy. Indeed, page 5 of the report contains a set of monetary measures that, if fully implemented, could secure a monetary stance consistent with overall tight macroeconomic policy. On the choice of instruments we are somewhat uncertain about staff's assessment that "the bank credit ceilings were no longer an effective instrument for conducting monetary policies." We assume that credit ceilings are not entirely ruled out by the staff, because in the same section the report says that "Bank and Fund staff have been working closely together to establish bank credit limits on selected SOEs [state-owned enterprises]." Given the fragile banking sector, Bulgaria may need to use direct instruments if reserve money programming proves to be less effective.

Progress made in structural reform is quite encouraging. The staff report refers to a number of promising steps taken by the authorities in different areas. Introduction of a value-added tax, further liberalization of exchange restriction, and establishment of the Center for Mass Privatization are steps in the right direction. As far as privatization is concerned, the staff reports an encouraging headway during the first half of 1994. The recent amendments to the Privatization Act should further accelerate the process and provide better environment for private sector activities. Bulgaria will need, in particular, to expose its banking system to more private competition, as the weak functioning of domestic banks remains a threat to the effectiveness of the financial policies.

Finally, we note that the supply side is still not quite responsive to adjustments, as GDP is expected to decline for the fifth year in a row. One reason may be that the private sector is still not in a position to generate sufficient income and employment to compensate for falling activities in the state enterprise sector. With the easing of the debt overhang issue and the steps taken to regain lost momentum and policy credibility, Bulgaria will be in a position to turn around the economy by accelerating the reform process, without risking macroeconomic stability. In this connection, the present program seems well designed. We believe, however, that the program would be more effective if it included a transparent and targeted social safety net as an integral element.

With these remarks we wish the authorities well in their future endeavors.

Mr. Newman made the following statement:

The recently announced resignation of the Government unsettled the exchange market and has raised questions regarding the course of stabilization and structural reform efforts. While we are pleased with the completion of the debt and debt-service reduction and can support the proposed decisions, we remain concerned about the steadiness of policy efforts to: bring down inflation; strengthen the banking system; and implement the mass privatization scheme, now that key legislative hurdles have been cleared. Strong action in each of these interrelated areas will be critical in the months ahead.

Inflation jumped substantially in April, and then again in May, before slowing in June and July. The authorities' response to confidence problems and the acceleration in inflation was hampered by reliance on porous credit ceilings in the conduct of monetary policy. Given the various loopholes in the credit ceilings, the resulting boost in reserve money was probably inevitable. The domestic refinancings linked to the bail-outs of some troubled banks were a key contributing factor and highlight the importance of strengthening this sector. Moreover, it appears that Bulgarian National Bank interventions to build international reserves were not sufficiently accounted for by those watching credit growth.

Thus, the shift to reserve money programming is both welcome and overdue. We understand that access to refinancing windows will be constrained and that the overdraft rate has been raised substantially. The lev's weakness--most recently because of the resignation of the Government--points up the importance of maintaining a tight policy stance over the months ahead.

Adherence to fiscal targets gains added importance in the current environment. The staff report notes some potential pitfalls in the months ahead. Given price rises, for example, holding the line on wages and pensions will be difficult but necessary. We agree with the staff on the need for better targeting of social expenditures, in part, to cushion the impact of potentially necessary limits on energy subsidies.

The banking system remains a question mark and a shadow over stabilization objectives. The plan to limit bank credit to selected state-owned enterprises seems reasonable, and one would hope to see limits maintained and tightened until the enterprises are rather far along the road to privatization. Privatization efforts appear to be gaining momentum, but Bulgaria has a way to go: only between 5-10 percent of state-owned enterprises have been privatized. The role of the Financial and Enterprise Sector Adjustment Loan in addressing problem banks and supporting the mass privatization scheme is essential to putting Bulgaria on a more stable path of lower inflation and market-led growth. Possibilities for debt-equity swaps ought to be fully exploited.

In sum, there appear to be few doubts about Bulgaria's need for Fund assistance, but questions do linger regarding Bulgaria's commitment to the reform path necessary for balance of payments viability. More must be done to earn credibility. In the near term, this will require maintaining tight financial policies and moving ahead with a comprehensive privatization program.

Extending his remarks, Mr. Newman asked whether monetary policy action by the authorities would be sufficient, given that fiscal policy actions had already been exhausted. He also wondered whether the staff had in mind any contingency plans.

Mr. Lvin made the following statement:

Completion of a debt and debt-service reduction operation may become the most significant achievement of the Bulgarian authorities in 1994. This move would open the way for Bulgaria's presence in international capital markets, and for foreign participation in the privatization and restructuring of the national economy. We commend the authorities for their efforts in reaching such a settlement of outstanding debt arrears. Accordingly, as in the case of Poland, the international financial community should be praised for its ability to demonstrate understanding of the exceptional circumstances of transitional economies. Given these circumstances, and the advantageous conditions of the finalized debt-related operation, this chair fully supports the proposed decisions, including the necessary waivers.

It may be appropriate, however, to use this opportunity to make some brief observations about the transition process in Bulgaria once the period of external arrears and negotiations is over.

The authorities were able to reverse some negative trends that occurred in the first months of 1994 and return the inflation curve to a declining path. However, reaction of the public to the March events--mostly in terms of lowering its demand for a national currency and shifting interest to foreign-denominated deposits up to the pre-reform level--looks fairly understandable and predictable. Given the current environment of foreign trade opportunities still affected by sanctions imposed on Yugoslavia, and of the already compressed budget expenditures, it seems as though the authorities have a very limited amount of room in which to maneuver. To restore confidence, they should do their best to improve track records and to prevent future deviation from the stabilization pattern. Their intention to switch the fiscal primary balance from a deficit to a sizable surplus equal to 5.7 percent of GDP is particularly noteworthy in this regard.

In contrast to the German chair, we were quite optimistic during the previous discussion with respect to Bulgaria's prospective fiscal performance, particularly that of the value-added tax. Fortunately, our optimism proved to be well-grounded. While expecting these outcomes, we even proposed that consideration be given to an increase in the value-added tax rate in order to accommodate, eventually, an early elimination of export duties. The staff indicates, however, that strong pressure on the expenditure side of the budget, along with shortfalls in revenues, may be expected this fall. I would appreciate it if the staff would elaborate on these issues--with the exception of those related to energy prices and those mentioned in the report--and outline the authorities' contingency measures.

With the current tight fiscal and monetary policies, some speeding up of structural reform measures would open new windows of opportunity for Bulgaria's economy, and allow it to reverse the decline in growth. We remember that, according to the assessment that the staff made in its previous report on Bulgaria, it was the weak performance of state-owned enterprises that was responsible for the setbacks experienced during 1993 and 1994. We are pleased to learn that bankruptcy--as well as mass privatization--legislation was passed, thus paving the way for a substantial transformation at the enterprise level. To make this transformation more efficient, and to allow the existing state-owned enterprises to improve their operations, further diminishing and streamlining of state regulations is warranted.

When the stand-by arrangement currently in place was discussed here five months ago, this chair expressed its concerns about the sophisticated incomes policy and reliance on direct bank-specific credit ceilings policy. So far, as the staff points out, the incomes policy looks rather irrelevant to actual wage setting, which is influenced primarily by the authorities' fiscal and monetary policies. Credit ceilings, in their turn, "proved inadequate owing to their increasingly partial coverage," as the staff indicates, and as we predicted. Therefore, we praise the decision of the Bulgarian National Bank to discontinue its use of credit ceilings and urge the authorities--despite some political uncertainties--to reconsider their incomes policy and adopt a more transparent and more easily executable approach of avoiding direct interference in either wage bargaining or in credit allocation.

Finally, it is our hope that Bulgaria will make full use of the favorable settlement of its debt issues, will arrest economic decline, and will return to growth in the next year.

The staff representative from the European I Department recalled that Mr. Golriz had raised a question concerning the consistency of the staff's views on the effectiveness of credit ceilings. In particular, Mr. Golriz had noted that the staff contended that bank credit ceilings were no longer an effective instrument for conducting monetary policy and had recommended their removal. Meanwhile, the staff had argued for imposing bank credit ceilings on selected state-owned enterprises. The key difference was in how these two types of ceilings operated. The central bank imposed, monitored, and enforced credit ceilings for the purposes of monetary control. The imposition of credit ceilings on selected enterprises would be monitored and enforced by the Ministry of Finance in conjunction with the line ministry overseeing the enterprise. Thus, control would be exercised by the effective owners and managers of state-owned enterprises, rather than from the outside, as was the case with the Bulgarian National Bank's use of credit ceilings on banks. The key difference, therefore, would be increased governance by the Bulgarian authorities over their enterprises, working through a mechanism where credit ceilings would be observed by the enterprises rather than enforced by the banks.

On the issue of contingency plans, the staff representative continued, the authorities would need to consider how the increase in electricity and heating prices would be compensated in a more targeted fashion to reduce the net cost to the budget. Also, in the second half of the year, the existing incomes policy would make it necessary to have a catch-up in wages, and fiscal constraints would be a factor in determining the magnitude of that catch-up. Finally, there was room for expenditures to be cut in a number of social areas--such as education and health--and pension benefits could be trimmed and targeted better. With the help of the World Bank, the authorities had prepared a white paper to examine pension benefits and contributions over the medium term.

Mr. Posthumus, thanking the Board for its support, noted that the decision would help maintain the momentum of Bulgaria's adjustment. He hoped that the international community would continue to assist Bulgaria financially.

The Executive Board took the following decisions:

Stand-By Arrangement - Augmentation, Waiver and Modification of <u>Performance Criteria, and Review of External Financing</u>

1. Bulgaria has consulted with the Fund in accordance with paragraph 3(c) of the stand-by arrangement for Bulgaria (EBS/94/52, Sup. 3, 4/13/94) and the fourth paragraph of the letter of the Minister of Finance and the Governor of the Bulgarian National Bank dated March 11, 1994, in order to review progress in reaching satisfactory agreements with creditors.

2. The letter of the Minister of Finance and the Governor of the Bulgarian National Bank dated August 3, 1994 shall be attached to the stand-by arrangement, and their letter dated

March 11, 1994, with annexed memoranda, shall be read as supplemented and modified by the letter dated August 3, 1994.

3. Accordingly, the limits referred to in paragraphs 3(a)(i), 3(a)(ii) and the floor referred to in paragraph 3(a)(iii) of the stand-by arrangement shall be amended to read as follows:

"(i) the limit on net credit from the banking system to the general government set forth in Appendix I of the letter dated August 3, 1994, or

(ii) the limit on the net domestic assets of the banking system set forth in Appendix II of the letter dated August 3, 1994, or

(iii) the floor on net international reserves of the Bulgarian National Bank set forth in Appendix III of the letter dated August 3, 1994, or"

4. The Fund decides that the financing review contemplated in paragraph 3(c) of the stand-by arrangement for Bulgaria has been completed. The Fund also finds that satisfactory arrangements with commercial banks and other private creditors have been reached, and decides that the January 31, 1995 financing review contemplated in paragraph 3(c) of the stand-by arrangement for Bulgaria and paragraph 4 of the letter dated March 11, 1994 shall no longer be required; and that, notwithstanding the nonobservance of the performance criterion on net domestic assets of the banking system specified in paragraph 3(a)(ii) of the stand-by arrangement, Bulgaria may proceed to make purchases under the arrangement.

5. (a) Bulgaria has requested that the Fund augment the amount of the stand-by arrangement by the equivalent of SDR 69.74 million and make this amount available for the replenishment of Bulgaria's official reserves used in connection with its debt and debt-restructuring operations.

(b) In light of these requests and the representation of Bulgaria, the Fund, having reviewed the financing of Bulgaria's program, determines that the debt and debt-service reduction operations were consistent with the objectives of the program and with the guidelines on Fund involvement in the debt strategy, adopted May 23, 1989, as amended, and that the purchase of the amount specified in sub-paragraph (a) above is needed for the replenishment of Bulgaria's official reserves used in connection with its debt and debt-service reduction operations.

(c) Accordingly, the Fund decides that the stand-by arrangement for Bulgaria is augmented by the equivalent of SDR 69.74 million. Thus, paragraph 1 of the stand-by arrangement is amended by replacing "SDR 69.74 million" with

"SDR 139.48 million" and paragraph 2(a) is amended by replacing "SDR 46.50 million" with "SDR 116.24 million." For purposes of the purchase of the augmented amount, the Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 10782-(94/83), adopted
September 12, 1994

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1994 Article XIV consultation with Bulgaria.

2. Bulgaria's restrictions on payments and transfers for current international transactions, as described in EBS/94/160, are maintained under the transitional arrangements of Article XIV, Section 2. The Fund encourages Bulgaria to eliminate these restrictions, as soon as circumstances permit.

Decision No. 10783-(94/83), adopted
September 12, 1994

3. KOREA - 1994 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1994 Article IV consultation with Korea (SM/94/220, 8/16/94). They also had before them a background paper on recent economic developments in Korea (SM/94/229, 8/29/94).

The staff representative from the Central Asia Department made the following statement:

> This statement reviews economic and policy developments in Korea since the staff report for the 1994 Article IV consultation (SM/94/220, 8/16/94) was issued. The additional information confirms the strong forward momentum of the Korean economy, which is fast approaching full employment. It does not alter the thrust of the staff appraisal or call for a revision of the short-term forecast.
>
> Output continued to grow rapidly in the second quarter of 1994, with real GNP reaching a level 8.1 percent higher than the corresponding quarter of 1993--after growing by 8.9 percent over the year through the first quarter of 1994. Domestic demand increased by 8.6 percent during the year to the second quarter, led by private consumption, fixed capital formation and stockbuilding. The growth contribution from the net foreign balance was negative (0.5 percentage point), despite a rapid increase in exports of goods and services as imports--largely investment goods--surged by 19 percent.

The view that rapid economic growth is bringing output close to potential is supported by developments in capacity utilization and the labor market. With industrial output increasing by 10.5 percent in the first half of 1994 (compared with the same period in 1993), factory capacity utilization reached 84 percent in June 1994; the 82.6 percent average for January to June was the highest first half figure since the mid-1980s. In June 1994, the rate of unemployment fell to 2.1 percent, compared with 2.9 percent in January 1994. The low point for the unemployment rate in the previous cycle was 2 1/4 percent, in 1991.

In the 12 months preceding July 1994, consumer price inflation reached 6.9 percent, up from 5.9 percent in the year to June. The rise in measured inflation was associated with rapidly rising food prices, which increased by 11 percent in the year to July 1994. Excluding food prices, the rate of inflation over the same period amounted to 4.8 percent and has remained below 5 percent over recent months.

Regarding the external sector, the current account registered a deficit of $2.7 billion in the first half of 1994, compared with a deficit of $1 billion for the same period of 1993. In dollar terms, merchandise exports rose by 13 percent in the first half of 1994, reflecting strong growth of exports of home appliances, semiconductors, ships, and cars. Merchandise imports increased by 15 percent (in dollar terms) in the first half, as a result of surging imports of machinery and electronic parts. Imports of consumer goods, which are still a relatively small share of total imports, increased by 19 percent over the same period. Strong capital inflows contributed to an increase of foreign reserves by some $1 billion in the first seven months of 1994 to $21.5 billion by the end of July. In terms of import cover, the level of reserves remains in the range of 2 1/2 months of imports of goods and services. The nominal value of the won has remained broadly stable since August 1993, both relative to the dollar and in effective terms. The real effective value of the currency--based on relative consumer prices--increased by about 3 percent from August 1993 to June 1994, reflecting somewhat faster inflation in Korea than the average for trading partners.

In response to the cyclical situation, the Bank of Korea has begun to encourage a tightening of monetary conditions. In August, the Bank of Korea announced that, during the remainder of the year, it would place priority on demand restraint so as to curb inflation and reduce the current account deficit. To this end, steps would be taken to bring the growth of M2 close to the lower limit of the 14-17 percent target range. Reflecting tightened short-term liquidity conditions, the overnight call money rate began to increase in early July from around 12 percent and, following a period of wide fluctuations, it stabilized at about 13 percent by mid-August. During this period, 3-year corporate bonds edged up from around 12 percent to just above

13 percent by mid-August. The rise in market interest rates since early July appears to reflect a policy step in the direction recommended in the staff report.

The staff representative from the Central Asia Department observed that a difference of some significance had existed between the authorities and the Fund staff at the time of the Article IV consultation in June regarding Korea's monetary policy stance. However, because of steps taken by the authorities in July and August to raise short-term interest rates by about 1-1 1/4 percentage point, that difference had narrowed significantly. That development should be noted, so that subsequent discussions would be on the right track.

Mr. Lee commented that he agreed with the remarks of the staff representative from the Central Asia Department.

Mr. Lee then made the following statement:

My authorities are grateful to the staff for a very good report and for their policy advice. They are in broad agreement with the staff's assessment of the Korean economy and their policy orientation. However, they take a somewhat different view on whether the current monetary policy stance is appropriately tight.

After a slowdown in 1992, the Korean economy strengthened over the course of 1993, led by investment and strong export growth. The recovery gained momentum in the first half of 1994, with GNP growth of 8 1/2 percent (year-on-year). My authorities broadly agree with the staff's forecasts for 1994. As is apparent from their policy response to the slowdown in 1992, my authorities continue to be committed to a stable macroeconomic environment. The main macroeconomic policy objective is to sustain the economic growth without an acceleration of underlying inflation.

As noted in the staff report, Korea has followed a conservative fiscal policy, which has succeeded in keeping deficits and public debt low. However, infrastructure investment was neglected during the process of fiscal consolidation over the last decade, and this is considered to be a serious obstacle to further economic development. Moreover, inadequate infrastructure contributes to inflationary pressures by increasing the costs of transporting goods. Against this background, the 1994 budget was framed with a substantial increase in expenditure on social overhead capital, but was planned to be cyclically neutral with a deficit of 0.6 percent of GNP. The budget for 1994 is now expected to be in balance, reflecting greater revenue because of stronger growth and delayed expenditures.

My authorities recognize that fiscal policy should play a key role in stabilizing the economy at present, given that financial liberalization is limiting to some extent the scope for monetary policy to play such a role. In line with this policy, expenditure will be held at budgeted level in spite of larger than expected revenue this year. In this connection, the supplementary budget (348 billion won)--which was passed by the National Assembly in July 1994 and provides for agricultural support measures to alleviate the impact of trade liberalization under the Uruguay Round Agreement--is fully funded by additional revenues from a newly-introduced special agricultural tax. With the economy expected to be operating close to or at potential, my authorities share the staff's view that fiscal restraint in 1995 is very important. Thus, the Government recently decided to have a surplus budget for 1995--the first surplus budget in the recent history of Korea. The decision was made in the face of a planned substantial increase in spending on infrastructure.

Monetary policy this year is directed at achieving a gradual reduction of M2 growth but in a way that avoids an abrupt increase in interest rates, thus helping to ensure the implementation of the financial reform program. Interest rates have followed a gradual upward trend, particularly since June 1994, and that has been associated with gradual slowdown of M2 growth. The 91-day commercial paper rate had risen to an average of 15.49 percent by August, from 12.52 percent in January and 12.86 percent in June 1994. This was the desired outcome, and my authorities believe that monetary policy has been appropriately restrained.

The staff argues that in spite of the recent tightening, monetary policy might not be tight enough. For their part, my authorities do not believe that rapid monetary tightening would be appropriate in the present circumstances. As explained in the staff report, an abrupt or severe tightening would push up short-term interest rates rapidly through borrowers resorting to "precautionary borrowing" in anticipation of higher interest rates. This would not only disrupt the financial market, but would also hamper the ongoing financial reform process. Moreover, my authorities believe that a gradual and flexible approach to monetary policy has helped build confidence in financial markets and has eliminated the need for "precautionary borrowing." With favorable stock market conditions and more financial liberalization, companies' increased reliance on the stock and bond market for financing--including bond issues abroad--has also been an important development. Nevertheless, financial markets are expected to become tighter as economic activities continue to expand in the second half of the year. In these circumstances, my authorities stand ready to keep M2 growth at the low level within the target range.

Since the announcement of a blueprint for financial liberalization and capital account opening in June 1993, the government has steadily implemented the reform program with a number of measures introduced ahead of schedule. My authorities remain fully committed to financial reform and to making the Korean economy more market-based generally. With the aim of joining the Organization for Economic Cooperation and Development (OECD) in 1996, my authorities intend to implement substantial structural reform measures beforehand and to complete the reform program in the next year or so. In this regard, my authorities greatly appreciate the Fund's technical assistance in the formulation of the reform program.

Mr. Shaalan made the following statement:

The strengthening of the recovery in Korea, at a rate presently exceeding 8 percent, is taking the economy back to its historically high levels of growth and putting an end to the short-lived slowdown in 1992. With the economy now close to full employment, the authorities have appropriately set themselves the objective of sustaining the growth of the economy without exacerbating inflationary pressures. Toward that goal, they have also appropriately placed a high priority on the development of infrastructure, and on completing their extensive structural reform program--two crucial measures that are necessary for the Korean economy to be able to continue on its relatively high path of noninflationary growth.

The staff's statement indicates that the growth momentum is now strongly gathering pace, so the major issue presently facing the authorities is the need to avoid additional inflationary pressures in the economy. The issue is a pressing one in view of the fiscal stimulus that would be provided by the planned deficit in 1994. In this respect, the call by the staff for a significant tightening of the fiscal stance is quite justified, particularly that an alternative appropriate policy would shift the burden of adjustment on the exchange rate, a course of adjustment that the authorities appear to be hesitant, for good reason, to take. The authorities have clearly recognized the importance of fiscal restraint because, as explained in Mr. Lee's statement, they have recently decided on a surplus budget for 1995. I must add, in this context, that the long-term view taken by the authorities on the financing of investment in infrastructure and social welfare through an increase in the revenue/GNP ratio--as envisaged in their tax reform plan--is a farsighted and commendable policy that underscores the basic conservative fiscal stance that the authorities have usually adopted.

The issues are, however, more controversial on the side of monetary policy. The staff believes that the inflationary risks in the economy call for a tighter monetary stance through higher interest rates. I find the authorities' views--with their preference for a more flexible approach given the uncertainties associated with the ongoing liberalization of the financial system--more convincing on this matter. The recent increase in interest rates by one percentage point, in response to indications of overheating in the economy, is an illustration of that flexibility. An increase in interest rates could, furthermore, exacerbate the problems associated with the increasing capital inflows to the economy.

I also sympathize with the authorities' reluctance to let the won appreciate in the face of continuing capital inflows. Their reluctance is justified by the deteriorating external current account, and the need to accumulate foreign reserves, especially in view of the relatively low level of import cover by reserves. The authorities are, nevertheless, adopting a flexible attitude toward this issue, and have also expressed their intention to establish a freely floating exchange rate system by 1996-97.

My final comment is in relation to the ongoing structural reform process. Much has already been accomplished in the domain of trade liberalization, and tax and financial reform. If anything, the history of that process in Korea indicates that a successful reform process can be much more erratic and time consuming than originally thought, and that the authorities' adoption of their own pace of reform has served the economy well. In this regard, I continue to believe that Korea's impressive growth experience still carries many useful lessons that we can all learn from.

Mr. Mesaki made the following statement:

I note with pleasure that Korean economic activity began to recover during the second half of 1993 and that the forward momentum of the economy is being maintained in 1994. It is encouraging that robust economic growth of about 8 percent is expected in 1994.

I believe that the recent strong capital inflow is evidence of the increasing international credibility of the Korean economy. In this regard, I commend the authorities for having achieved a favorable economic performance through sound policy implementation. Nevertheless, according to the latest staff statement, it is a matter of concern that overheating conditions are emerging, namely, strong domestic demand, an increase in the rate of inflation, and a deterioration of the external current account. Under these economic conditions, it is understandable that the authorities are focusing on containing inflation and maintaining the momentum of economic activity achieved so far. To this end, it is crucial to maintain the tight financial policy, especially given the recent economic conditions. In this connection, I support the staff's policy recommendation that fiscal restraint and structural reform should play a large role in tackling the rising inflation reflecting the excess liquidity from the surge in capital inflow--as pointed out in the staff paper.

That said, as there was a substantial discussion at the previous Executive Board discussion on the Article IV consultation in February this year, and I am basically in broad agreement with the staff appraisal, I will limit my comments to a few areas.

Regarding the recent overheating situation, I agree with the staff's policy recommendation of fiscal and monetary restraint, and implementation of structural reform. In association with this issue, I will make a few comments.

First, on fiscal policy, as the expenditure has tended to be expansionary, expenditure restraint--including the possibility of delaying outlays--is necessary. Given the possible continuing momentum of economic activity, consideration should be given to containing fiscal stimulus for the purpose of tightening fiscal policy in 1995 as clearly pointed out in the staff paper. In this regard, it is welcome that the authorities have expressed their intention to pursue fiscal restraint in 1995, as Mr. Lee noted in his opening statement.

Second, on monetary policy, I recall that at the previous discussion some speakers pointed out the inappropriateness of the implementation of a monetary policy focused solely on the growth of M2. Judging from recent developments in monetary conditions--as pointed out in the staff paper--there could be a shift in money demand. It is, therefore, understandable that the staff is suggesting, that depending on the economic activity in the latter half of 1994, the authorities should be prepared to take steps to tighten interest policy. In this connection, it is reasonable that the Bank of Korea has indicated that its policy priority is to contain domestic demand with a view to reducing inflation. It is important to monitor the situation carefully and to be ready to take any necessary action without delay.

In the area of structural reform, domestic financial reform is becoming important in order to cope with possible further capital inflows as a result of the liberalization of exchange and capital transactions. In this connection, it is welcome that the authorities' policy agenda makes financial system reform a priority. I also note the authorities' stance to push ahead with structural reform in the areas of trade and tax reform. Anyhow, I expect the authorities to make a determined effort to pursue the planned structural reform steadily without delay, as rightly noted in the staff paper.

Finally, development of the social infrastructure is crucial in order to achieve sustainable economic growth. In this connection, it is welcome that the authorities emphasized the development of social overhead capital in 1994. Given the possible solution of the regional issues in the future, fiscal consolidation in the medium-term perspective is crucial. It is also important to enhance economic capacity through the implementation of macroeconomic policy and structural reform.

In conclusion, I expect the authorities to pursue economic liberalization, especially in financial and capital markets, under sound macroeconomic policy.

Mr. Ismael made the following statement:

The staff has rightly recounted the reasons for the remarkable success of the Korean economy in the past three decades. A high investment rate supported by a high saving rate, conservative fiscal policy, and investment in human capital, have been the major factors for the successes of many East and Southeast Asian economies. The substantial adjustment on the wage front, since 1989, has paved the way for the restoration of an orderly labor market. With the initial success and continued efforts in the rationalization and restructuring of the industrial base, good progress in moderating inflationary pressure, a sound current account balance, and a comfortable level of foreign exchange reserve, the conditions for the resumption of a sustained good growth of the Korean economy are now at hand.

The authorities are to be commended for adhering to their conservative fiscal stance by formulating a cyclically neutral budget for 1994 despite the urgent need for stepped-up expenditures for long-neglected infrastructure developments. Reflecting their prudent tradition in fiscal policy, the windfall revenues arising from an unexpected faster growth of the economy were conserved and a nearly balanced budgetary outcome was brought about. The authorities are right to recognize the need to use fiscal policy to supplement the working of monetary policy in stabilizing the economy under an environment of financial liberalization. It is, therefore, noteworthy that a surplus budget is planned for 1995, notwithstanding the need for enhanced infrastructure development, and for agricultural support measures to compensate for the adverse impacts of trade liberalization under the Uruguay Round.

While monetary targeting had been the major ingredient for the success in the conduct of monetary policy in the past, financial market liberalizations have rendered this well-trusted indicator increasingly less reliable, as has been the case in a number of industrial countries. I agree with the staff that flexibility should be exercised in approaching monetary targeting, with more consideration given to other indicators of monetary stance. In this connection, I am pleased to note that the authorities seem to have recently begun to make some tentative moves to tighten policy in anticipation of a continued strong demand in the economy. It should also be acknowledged that while interest rates in Korea are high by international standards, they are, nonetheless, relatively low by historical Korean standards.

Financial liberalizations in Korea have given rise to strong capital inflows in recent years. It has presented the authorities with the opportunity to rebuild their foreign reserve position. In this connection, I agree with the staff that the strong inflows should help to provide more leeway to enable the authorities to further strengthen their efforts in the liberalizations of imports and capital outflows. A stable nominal exchange rate coupled with a comparatively higher inflation rate in Korea have, nonetheless, resulted in a real effective appreciation of the currency. With the strength of the Korean economy and the soon-to-be-reached foreign exchange reserve target, the authorities are well placed to pursue a brisker pace of currency appreciation so as to allow the exchange rate to play a constructive role in the adjustment process. A stronger exchange rate should help to moderate inflationary pressure and to enable the authorities to move the inflation rate closer to the rates prevailing in most industrial countries. Eventually, it will have an important beneficial impact on the standard of living and help to alleviate pressure from the wage front.

Taking into account centuries of unpleasant experience with foreign influences, the progress made in the liberalization of the financial and trade sectors has been remarkable. The authorities are to be commended in implementing some of the measures ahead of schedule. Finally, I welcome the authorities' intention to bring all remaining restrictions on merchandise imports into conformity with GATT rules by 1997.

Ms. Lissakers made the following statement:

Korea's gradualist approach to economic liberalization has been a constant theme in its Article IV discussions. Korean authorities appear to agree that the path to advanced industrial country status requires less government intervention and greater reliance on the market. However, the pace and extent of this liberalization has been uneven. In the case of the financial sector, for example, Korea has made important strides relative to internal conditions five or ten years ago, but relative to comparator countries, Korea continues to lag. Our view has been that an accelerated and more aggressive opening of the economy is desirable in order to remove distortions, smooth economic performance, and improve policy management. Given Korea's current robust growth and my concurrence with much of the Fund's advice regarding policy objectives in the near term, I will frame my remarks in the context of the liberalization issue and related matters.

The policy response to capital account inflows is illustrative of how old habits die slowly. Limited capital account openings have resulted in a surge of inflows and balance of payments surpluses. Further planned loosening will result in further inflows. The Korean authorities have indicated their discomfort with the possibility that these flows could contribute to inflationary pressures or an appreciation of the won. Thus, they have tended to intervene in exchange markets to suppress any rise in the won, and have then sought to sterilize the intervention to limit any boost in liquidity. Also, in addition to still existing capital controls, new measures have had the effect of impeding financial inflows. The result is a troubling coincidence of substantial balance of payments surpluses in 1992-93 and a depreciation of the won.

Resistance to won appreciation frustrates the adjustment process and subsidizes less competitive producers at the expense of more competitive ones and Korean consumers. It undermines foreign confidence in Korea's liberalization commitments. It risks contributing to trade tensions. It complicates monetary management and makes more difficult the attainment of inflation objectives. Authorities have explained their exchange market interventions in part as resulting from a desire to boost reserves to three-months import cover. Attention to reserve levels is not unreasonable given recent tensions with the Democratic People's Republic of Korea, but meeting this objective is hardly incompatible with allowing the won to find its equilibrium level. Moreover, intervention over the period preceded recent political tensions.

We are in broad agreement with the staff's recommendations for dealing with increased capital inflows. Greater liberalization of barriers to imports and capital outflows is a natural corollary to reductions in barriers to capital inflows. In addition to promoting efficiency gains and lower inflation, these measures would provide a countervailing weight on the exchange rate that could prove stabilizing. As the staff notes, however, exchange rate flexibility still needs to be part of the equation. The move to a floating rate regime would be facilitated by prior structural openings so that existing distortions do not create the sort of exchange rate instability that authorities want to avoid.

The concern that increased inflows will lead to an appreciation of the won and adversely affect export competitiveness seems overdone. The inflows are not responding to fiscal imbalances or speculative bets on the currency. They are attracted to private investment opportunities, heavily weighted recently toward the Korean equity market. And if one assumes that the market is effective at picking winners, one ought to be confident that foreign capital is going to contribute to enhanced competitiveness. In any event, the composition of Korean imports--almost entirely raw materials and capital goods--and the strong and steady growth of Korean exports do not suggest a vulnerable tradeable sector. In fact, greater liberalization in the trade and exchange regimes is likely to divert resources toward higher value-added tradables.

While an increase in the pace of liberalization will inevitably result in faster restructurings and dislocations, overall economic and welfare gains should more than compensate. Moreover, such adjustments are likely to be more firm and sector-specific and, therefore, less disruptive than the cyclical shocks associated with the stop-go policies of Korean authorities over the years. Resistance to such adjustment may be related to concerns over the impact on bank portfolios already weakened by policy loans to less competitive firms.

To the extent the Korean authorities are concerned about the nature of the inflows and want to encourage greater foreign direct investment, the appropriate response is a removal of those distortionary policies and regulations which currently act as disincentives--as opposed to new incentives which seek to compensate for one distortion with another.

Further capital account openings should complement greater financial sector liberalization as contemplated under the 1993 five-year plan. The banking sector is saddled with substantial nonperforming policy loans and is still subject to a patchwork of mandates and controls. Access by small- and medium-sized firms to bank financing is secured by mandate, for example, as limits on the big firms' access to outside capital would otherwise squeeze smaller borrowers out of the competitive end of the domestic credit market.

This patchwork approach to financial sector regulation and its ill effects were evident earlier this year when authorities perceived the stock market to be overheating and so imposed advanced deposit requirements on stock purchases to dampen trading. This action had its intended effect of cooling the market, but had the unintended effect of undercutting authorities' credibility in the international financial community. Given the limited channels available to Korean investors, speculative movements in stocks should not be surprising. But the solution does not lie in government intervention. Rather, the focus should be on liberalizing and deepening the financial system so that investors have a broader range of opportunities to channel their savings.

Greater liberalization of the financial sector could be expected to increase the interest-sensitivity of savings behavior and lead to reductions in domestic savings as household access to liquidity increases. This possibility need not pose constraints to investment objectives, but rather indicates the need for comprehensive internal and external liberalization.

Phase-out of directed credits and interest rate regulation will strengthen the conduct of indirect monetary management and the ability of authorities to achieve price stability. The authorities continue to be hampered by the dual role of supporting policy loans and reducing inflation. Their ability to meet monetary targets points to their successful juggling of these tasks, but it is not an optimal situation. Liberalization will bring its own complicating factors, of course, as money demand is subject to possible changes. At that point, however, the Bank's role in pursuing price stability will have been clarified.

As noted earlier, we welcome the indications in the staff report that the Korean authorities are in agreement with the staff on many of these points. The question seems to be not "if" but "when" and "how much" liberalization is to occur. We hope the answer is "sooner" rather than "later" and "more" rather than "less."

One impetus for faster change might be the prospect of re-engagement with the Democratic People's Republic of Korea and the need to ensure that an efficient financial system is in place to steer domestic and foreign savings toward the investment needs and opportunities that will undoubtedly arise. Absent faster improvements, the Korean authorities risk being placed in a situation in which rigidities in the financial sector, including capital controls, shift the burden of reconstruction and investment financing toward the Government. We would be interested in others' views on this point. This issue is prospective, of course, but it was touched on last year in the context of fiscal policy.

Mr. Blome made the following statement:

As I am in broad agreement with the staff appraisal, and as basic conditions in Korea have not much changed since the Article IV consultation discussion held seven months ago (EBM/94/12, 2/15/94), I will be relatively brief. Korea's economic performance over the last three decades has been very impressive, and the country has become a textbook case for successful development. The continuously favorable growth prospects should enable Korea to complete its transformation into an advanced industrial economy within the next generation.

This requires, however, the maintenance of macroeconomic stability and a shift from interventionist to more market-oriented policies, as the staff has rightly pointed out. Current government policies seem to broadly meet these requirements, as the government budget is broadly in balance, most interest rates are strongly positive in real terms, nominal wage increases remain considerably below nominal GDP growth, thereby facilitating investment, and structural reforms have been progressing well. These policies do not leave much room for critical comments or additional recommendations.

The main challenge facing the authorities at the moment is to avoid an acceleration of underlying inflation. The recent rise in consumer price inflation to nearly 7 percent is per se a cause for concern in this regard. I note, however, that this increase was primarily caused by rising food prices, while the inflation rate excluding food prices has remained quite stable below 5 percent over recent months. Wage increases in the private sector too do not seem to be overly excessive, as the average negotiated wage increase of about 6.25 percent until mid-1994 remains even somewhat below real GDP growth. The development of the current consumer price inflation index could thus somewhat overrate the actual inflation problem. Inflationary pressures may be, to a large extent, caused by structural factors, like rigidities in the agricultural sector, and external factors, like the capital inflows. The authorities should, therefore, put particular emphasis on accelerating structural reform when combating inflation. A further liberalization of the agricultural sector, of imports, capital outflows, and the exchange rate regime would be particularly helpful in this regard. A limited appreciation of the won could also be accepted, in my view, as external competitiveness seems to be quite strong.

Such reforms should be supported by somewhat tighter financial policies as recommended by the staff and also intended by the authorities. The recent steps in this direction aimed at achieving a surplus budget for 1995 and at limiting M2 growth are to be welcomed in this regard. However, I wonder whether the room for a tightening of financial policies is not rather limited. I note, in this context, that it is at least contentious in post-Keynesian theory whether fiscal policy should be used as an instrument for shorter-term macroeconomic management. Instead, one could hold the view that fiscal policy should be formulated in a medium-term context and aim at a balanced budget. As Korea's budget is already roughly in balance, there may not be much room for additional measures in this area.

As an aside, but still on fiscal policy, I wonder whether the consolidated central government balance account is an appropriate indicator for the overall stance of fiscal policy. I note in this context that the local government sector has grown rapidly in recent years and now accounts for 38 percent of total government spending. The local governments also seem to have a considerable room for maneuver in the area of their budgetary policy, as they are allowed to issue bonds for financing their deficits. Against this background, it may be useful to take the budgets of local governments into account when calculating the fiscal impulse.

On monetary policy, I note that growth rates of the monetary aggregates continue to exceed somewhat nominal GDP growth, which could indicate the need for some monetary tightening. However, the authorities seem to be in a dilemma in this regard, as any rise in domestic interest rates might lead to a further increase in capital inflows and, as a consequence, monetary expansion. In this context, I would also point out that real capital market rates have already reached a level of above 6 percent, which is relatively high when compared with the levels in other industrial countries, and which may--in connection with capital account liberalization and expectations toward a rising exchange rate--create incentives for further capital inflows. Therefore, monetary policy should primarily focus on further interest rate deregulations, in particular as far as policy loan rates and shorter-term deposit rates are concerned.

The staff representative from the Central Asia Department stressed that the Korean economy had not overheated yet, and that the policy discussions with the authorities had been aimed precisely at how to forestall such overheating.

Fiscal policy should have a medium-term orientation, even though that did not imply that short-term considerations should be completely ignored, the staff representative agreed. Although there was an element of risk associated with discretionary fiscal policy during business cycles, in the case of Korea, the economic situation and prospects were relatively clear-cut, and the risk of destabilization due to lags was limited. The economy was growing strongly and was expected to remain strong. Moreover, the staff was calling for a relatively small shift in the position of the consolidated central government, equivalent to 1-1 1/2 percent of GNP.

Much of the revenue for local government operations came from the central government, and the central government had a tight control over the local government, the staff representative pointed out. In addition, the number of bonds that the local government could issue was limited. There was also a question of the timing of the data available from the local governments. For those reasons, disaggregating local government finances in the assessment of fiscal policy seemed unnecessary.

Another staff representative from the Central Asia Department noted that the possible effects of the unification of the Republic of Korea and the Democratic People's Republic of Korea had not been raised in the staff's formal discussions with the authorities. In the light of that prospect, however, the best course for Korea would appear to be to pursue policies aimed at maximizing output and prosperity, so that, eventually, the costs of unification might be more easily absorbed.

The staff representative from the Central Asia Department noted that much of the acceleration in inflation--to nearly 7 percent over the 12 months through July 1994--had come from higher food prices resulting from the string of bad harvests. The underlying inflation rate--the consumer product index less food items--was 4.8 percent over the same period--about the same rate that had been prevailing over the previous 15-20 months. Looking at the consumer price index alone gave an exaggerated view of the inflation picture.

Korea's reform efforts over the preceding 10 years had been rather uneven, the staff representative acknowledged. However, the authorities were demonstrating a higher degree of commitment and determination toward liberalizing and opening up the economy at present. For example, in the financial sector reform, the authorities had implemented reform measures either on time or ahead of schedule.

Ms. Lissakers remarked that, although the Korean authorities were clearly committed to a faster pace of liberalization, she was concerned that the economy would be placed under increasing pressure if some sectors were deregulated while the financial sector remained under tight control.

Mr. Cailleteau made the following statement:

I would like to add some support from our standpoint to what has already been said, in two areas: first, the question of the policy dilemma; and second, the question of M2 as a relevant indicator.

First, regarding the policy dilemma created by capital inflows, I would like to stress, in short, the three following points.

As a first step, the authorities should continue to purchase foreign reserves.

Second, as regards the use of fiscal policy as a tool to accommodate huge inflows of capital, we plead in favor of a prudent stance. We should be cautious not to advocate the discretionary use of fiscal policy as a cooling down weapon, if this policy eventually puts at risk the growth prospects. I have in mind, in particular, the need to increase infrastructure spending. This being said, I would like to commend the authorities: I understand from Mr. Lee's statement that, notwithstanding the fiscal surplus, increased spending on infrastructure is also planned; so, I cannot but commend the satisfying conciliation of these two generally divergent objectives.

Three, concerning the exchange rate, we have no theoretical opposition to the use of the exchange rate. We just need to be convinced.

I would emphasize two different issues in this regard: first, it is noteworthy that the boom in 1986-88 ended abruptly--as you write in the report, in 1989--when exports declined in response, in particular, to a market appreciation of the won. That experience points out, if needed, that we must be very careful in the use of the exchange rate as an instrument of short-term policy. Second, I think our institution has more to say to the authorities than, "Let your currency go upward or go downward." Here I want to recall what we said last year: that there is no reason to expect a priori that as growth takes place--as the country rapidly acquires new technology, new human capital, develops new products, and explores new markets successfully--the real exchange rate should stay constant. Historically, the real bilateral exchange rate of a country experiencing high growth seems to increase. As fast-growing countries such as Korea increase their participation in world trade and in the international financial system, a better understanding of the relation between growth and the evolution of the exchange rate would probably be very useful in that regard.

So we have to mobilize probably our transversal knowledge of this kind of situation of catch-up to be able to give some useful advice to the authorities regarding the appropriate level--or range of levels--for exchange rate, given the stage of development and also given its prospects. Then we can go along with the appreciation of the currency, the won, but we would like to know where exactly we are going.

Let me now quickly address the issue of M2 as a relevant indicator of monetary conditions. I understand that innovations are complicating in some countries--and particularly in mine--the reliability of relatively narrow aggregates. But I only wonder if this is not a bit early to call for the abandonment of the only real anchor of Korean monetary policy when there is no decisive evidence of its potential obsolescence. I fail to find in the background paper this kind of evidence.

I remember the Board discussion of the previous Article IV consultation with Germany (EBM/93/107, 7/28/93), when it was stated that it was too early to be convinced of the unreliability of the rather controversial M3.

So I suggest more caution probably, as there is a risk in terms of credibility, to declare taking concurrently due regard of other indicators than M2.

To conclude on that point, I think the authorities should be encouraged to stick to monetary aggregates, provided that they remain relevant, and also provided that it can certainly be necessary to be pragmatic in their interpretation at certain structural turning points affecting the economy.

Mr. Wu made the following statement:

We would like to start by commending the Korean authorities for their sound economic management, which has contributed to three decades of remarkable economic growth. Starting in 1993, the Korean economy has reversed from slowdown to a high rate of growth, expected to be above 8 percent in 1994. The stark contrast in economic performance over this period demonstrates the need for a different financial policy stance. A tighter financial policy is now needed.

We agree with the authorities that continued financial liberalization has, to some extent, has limited the effectiveness of monetary policy, but it still has an important role to play. We note that the authorities have directed their policy stance toward achieving a gradual reduction of M2 growth without causing a sharp increase in interest rates. However, we find the staff's argument justifiable for taking early steps to tighten monetary conditions in order to avoid sharp action later on. We believe the difficulties in finding appropriate timing for monetary tightening are caused by uncertainty and the less reliable main monetary indicators, as a result of financial liberalization.

With this in mind, and taking into account the sizable effects of foreign capital inflows on the formulation and implementation of monetary policy, we hope that the authorities can look at the broader range of economic and financial indicators, with M2 as one of the core indicators rather than the exclusive indicator. In this process, the Fund will be of great help with its policy advice and technical assistance, and its broad experience with many countries undergoing significant financial liberalization and facing large capital inflows.

The authorities are commended for having pursued, over the past decade, a conservative fiscal policy that has been very conducive to Korea's relatively stable financial environment. Notwithstanding the successful fiscal consolidation, infrastructure investment has been neglected. This inadequacy is a serious obstacle to further economic development. So, it is understandable that in the 1994 budget more attention has been given to capital expenditure. But this should not be an excuse for pursuing a necessarily expansionary fiscal policy stance. In this regard, we welcome the authorities' assurance that the effect of such action will be cyclically neutral.

With regard to the supplementary budget, we agree with the staff that the intention of spending the fiscal dividend should be avoided. Because the economy has been close to potential, larger than expected revenues should place the authorities in a better position to play a more restrictive role in restraining aggregate demand, rather than making it an excuse for more budgetary spending.

We appreciate the progress made by the authorities in liberalizing the capital account. In addition, as pointed out by the staff, the central policy objective in the period ahead should be to complete Korea's transformation into an advanced industrial economy. In this respect, the authorities have made it clear that they intend to implement substantial structural reform measures in order to join the OECD in two years. We hope that, as the authorities' good track record shows, these commitments and intentions will be implemented in due course. Finally, like the staff, we hope the authorities will take firm action to eliminate all remaining trade restrictions.

Mr. Mojarrad made the following statement:

I join the previous speakers in commending the Korean authorities for another year of strong economic performance. Indeed, the economy performed better than forecasted by the staff on the occasion of the last Board discussion of Article IV consultation with Korea. The authorities have renewed their efforts and are ahead of schedule in the implementation of their undertaking of a comprehensive reform of the financial sector and capital account opening.

The staff is concerned about inflationary pressures stemming from stronger than expected growth, as well as the anticipated surges in capital inflows. In addition, it appears that some wage pressures might arise during 1994, given labor shortages facing small- and medium-size industries. In view of these developments, the staff has emphasized tighter monetary stance in order to keep monetary growth near or below the low end of the target band. While we agree with the staff that the financial sector reforms bring the stability of demand for money into question and consequently have implications for maintenance of monetary targeting, it is instructive to perhaps look at the underlying money demand function. With the opening of the capital account and the implementation of sweeping financial sector reforms, factors related to the openness of the economy will play a stronger role in the demand for money. Indeed, various empirical studies have shown that if external monetary influences are not included in Korea's money demand function, monetary policy actions will generate uncertain results, at best. Nonetheless, the staff is quite correct in asserting that should the stability of money demand diminish further, even the flexible approach to monetary targeting pursued by the authorities, thus far, could encounter difficulties.

The staff, while acknowledging the authorities' concern for large capital inflows, recommends that early steps should be taken to increase interest rates as well as to appreciate the currency. Clearly, one has to consider the policy dilemma faced by the authorities as they liberalize the capital account and reform the financial sector. Under these circumstances, there would be stronger momentum for capital inflows and consequently higher interest rates, and the appreciation of the currency could only exacerbate this policy dilemma. In addition, in view of the recent fall in the dollar vis-à-vis the Japanese yen, we wonder if the option of appreciation of the currency is appropriate as Korea has a bilateral trade surplus with the United States and a bilateral trade deficit with Japan.

Regarding fiscal policy, the authorities have maintained a conservative fiscal stance and, even though the 1994 budget was intended to be cyclically neutral, the outcome--according to the staff--has been procyclical. We agree with the staff that much strengthened fiscal consolidation, along with financial reforms and capital account liberalization, may help ease the pressure of continuing strong capital inflows over the medium term. One would hope that, as a result of these actions, differentials in the rate of returns to financial assets between Korea and the rest of the world would be reduced to allow less disruptive resolution of the problem of capital inflows.

Finally, reports indicate that Korea's banks are faced with a large number of nonperforming loans. The solution to this problem is important for the pace and extent of financial liberalization. We missed any reference to privatization of public enterprises. This issue is also closely intertwined with deregulation and economic liberalization.

Mr. Al-Tuwaijri made the following statement:

One can only complement the authorities for Korea's impressive economic achievements. The challenges facing Korea at this time are those associated with economic success. The increased development and complexity of the economy has made the task of economic management through policy tools used in the past more challenging.

I am in broad agreement with the staff appraisal, and I will limit my remarks to only one point.

The staff and the authorities, as Mr. Lee points out in his helpful statement, are in agreement on all policy areas excepting the stance of monetary policy. Recent economic developments, reported in the staff's statement, reinforce the staff's arguments, and I welcome the Bank of Korea's recent decision to tighten monetary conditions.

The process of financial liberalization has certainly complicated the task of monetary management. The staff argues that monetary targeting needs to be sufficiently flexible to permit adjustments in response to signals provided by indicators other than M2. This point is certainly well taken. Although the staff is agnostic with respect to the appropriate monetary aggregate, I felt that the section on monetary targeting in the background paper suggests that there is a case to be made in favor of placing a greater degree of emphasis on M3.

In many ways, Korea finds itself in a predicament similar to that of several industrial countries during the 1980s when financial deregulation reduced the reliability of some monetary aggregates. Some countries targeted the growth rate of M3. I could think of other situations where the authorities found M0 a useful aggregate. The background paper on recent economic developments does not provide any analysis that could shed some light on the usefulness of M0 in the case of Korea. I understand that there were shifts in the demand for M0, following the adoption of the "real name system." Nevertheless, I wonder if M0 could still play a useful role in monetary targeting. I would appreciate some comments from the staff on this issue.

Mr. Mancebo made the following statement:

Korea has reached a decisive point in its path from an agrarian economy to a leading exporter of industrial products. Growth and development have been increasing for three decades. These achievements were made possible by prudent fiscal policies, high private domestic savings and investment, and rapidly growing human capital. Sound macroeconomic management, a well-educated labor force, and an effective system of public administration provided an encouraging framework for private investment.

The area of fiscal policy gave rise to constructive discussions between the staff and the authorities. While Korea pursued a conservative fiscal policy in the past, infrastructure investment was given a low priority. For this reason, the budget for the current year was designed to increase expenditure on social overhead capital, and the same is true for next year. The corresponding funding will be obtained by cutting down on expenditure in other items and by generating new revenues, as the authorities intend to have a budget surplus in 1995, to help ease inflationary pressures derived from an economy operating at close to potential.

On the monetary front, the authorities' policy aims to promote a gradual reduction of M2 growth, so as to avoid an undesirable increase in interest rates. However, the staff states that monetary policy might not be as tight as intended despite the deceleration of monetary growth. The staff's comments on this subject would be appreciated.

Government intervention in the past has been one of the key elements for growth. However, as the economy keeps steadily growing and Korea is close to becoming an advanced industrialized country, it becomes clear that less intervention is surely the best course to be followed now. At present, according to the staff report, it seems that the economy has reached a well-stabilized condition that should encourage the Korean authorities to move forward in the pursuit of essential structural reforms. In this respect, I concur with the authorities that the financial markets, the exchange and trade systems, and tax policy, are the areas that deserve priority in the transformation process.

On financial reform, I welcome the comprehensive five-year plan presented in 1993 for financial liberalization and capital account opening, as it promotes interest rate liberalization, improvement in policy loans, and strengthening of indirect instruments of monetary control. At the same time, such a plan is leading to an easing of exchange regulations, which is expected to result, in the medium term, in a freely floating exchange rate system.

Finally, on tax policy, I share the authorities' commitment to undertake tax reform in order to increase the revenue/GNP ratio and, at the same time, to enhance tax equity and to improve income distribution.

Ms. Kouprianova made the following statement:

The authorities' achievements in transforming the Korean economy into the twelfth largest in the world over the last three decades have been very impressive. The country, as was expected, has speeded up its growth in 1994, and now faces the most important challenge of all--sustaining its economic growth without an acceleration of underlying inflation in the medium term, building on past successes and experience, and maintaining the momentum of successful continuation of the economic transformation process in all important policy areas. I am in a broad agreement with the staff assessment and policy recommendations, and join other speakers in commending the Korean authorities for their achievements on the road to transforming the country into an advanced industrialized economy. I would like to briefly comment on two general issues regarding the pace of economic reform in the fiscal and monetary areas.

First, pursuing a sound fiscal policy will assist the efforts to sustain a more stable macroeconomic environment. I share the point made by other directors on the importance of maintaining a tight fiscal stance, and closely monitoring fiscal developments. I welcome the intentions of the Korean authorities, in respect to the tax reform, to broaden and deepen the tax base and to enhance tax equity. Successful implementation of the tax reform will increase the revenue/GDP ratio from 19 percent in 1992 to 22-23 percent by 1997, and will provide additional flexibility in spending. At the outset of a substantial increase in expenditure on social overhead capital, the authorities' intentions to maintain a prudent fiscal stance mentioned in Mr. Lee's statement are welcome.

Second, I join the staff in stressing the importance of maintaining a tighter monetary policy, as inflation control remains the main medium-term objective. I am encouraged by the fact that, in response to the increasing inflationary pressures, the authorities are taking the right steps to encourage the tightening of monetary conditions. With the financial sector liberalization proceeding, the Bank of Korea is pursuing a more flexible approach to monetary targeting, and interest rates--together with other financial variables--are assuming an increasing role. I urge the authorities to move further away from rigid monetary targeting, to closely monitor the developments of other monetary indicators, and to rely more on market-based mechanisms.

The staff representative from the Central Asia Department noted that M2 had, so far, played a critical role as an intermediate target of monetary policy, but was likely to become less useful, as the structure of the financial sector was changing and demand for M2 was shifting. As for other monetary aggregates, the staff's analysis suggested that M3 was just as stable, but it was more difficult to control, because many of the financial instruments included in M3 were not subject to reserve requirements. Moreover, the sensitivity of the demand for M3 to changes in opportunity cost complicated the task of controlling it. While there was no empirical work on the stability of M0, recent developments suggested that demand for M0 was rather unstable.

Regarding exchange rate developments and policy, exchange rate policy should avoid tinkering with the nominal exchange rate with the aim of keeping the real exchange rate away from the range indicated by market forces, the staff representative from the Central Asia Department stressed.

The staff representative from the Policy Development and Review Department said that, while it was difficult to pinpoint the equilibrium exchange rate in a growing economy such as Korea's, the rate appeared to be appreciating.

Another staff representative from the Central Asia Department observed that Korea's high savings rate had financed rapid capital accumulation, which, according to the staff's analysis, accounted for a large part of output growth. While dynamic inefficiencies resulting from too high a savings rate were, in principle, possible, staff studies did not suggest that that had been a particular problem; for example, it had not been a problem in Japan.

Mr. Lee noted that the Directors had sent a clear message to his authorities that there was a need for tighter financial policies--particularly fiscal restraint--to forestall inflationary pressures. His authorities had little disagreement with that view, and they would keep a watchful eye on emerging developments. Measures necessary to avoid an acceleration of underlying inflation would be undertaken. In that regard, his authorities recognized that macroeconomic policy would have to rely more on fiscal policy in the period ahead. A politically difficult decision had been made to have a surplus in the budget for 1995, which was expected to be passed by the national assembly in December. To alleviate the pressure on the budget from existing commitments for infrastructure investment, the Government would rely on private financing of some infrastructure projects. More attention would be paid to interest rates as an indicator for monetary policy. There was a need to be cautious about the level of foreign exchange reserves. Although reserves had returned to normal levels after previous shortfalls, it was recognized that reserve accumulation could not be the main policy response to capital inflows, and that the exchange rate would have to be determined in a more flexible way. Financial reform was gaining momentum, and his authorities intended to implement reform measures as quickly as feasible.

The Acting Chairman made the following summing up:

Executive Directors endorsed the thrust of the staff appraisal for the 1994 Article IV consultation with Korea. They commended the authorities for the remarkable record of growth and development that has been achieved over the last three decades. They attributed this sustained success to a high investment rate supported by a high private sector saving rate, a conservative fiscal policy, a strong emphasis on education and the accumulation of human capital, and a long-term and increasingly outward orientation of the economy. Directors supported the authorities' central objective of completing Korea's transformation into an advanced industrial economy through the maintenance of macroeconomic stability and a sustained movement away from interventionist microeconomic policies to a fully market-based approach.

Directors agreed that, with the economy approaching full employment, the main challenge for macroeconomic policy was to sustain the economic expansion, inter alia, by avoiding a renewed bout of inflation. Economic growth had shown continued strength while the unemployment rate had dropped further to just over 2 percent. But the rate of inflation had picked up, primarily because of adverse movements of food prices. Therefore, Directors cautioned that, with tight labor market conditions, the case for early action to tighten financial policies was clear, and that such a tightening would allay the need for more difficult measures at a later stage.

Directors observed that the task of containing demand pressures was complicated by the prospect of continuing large capital inflows. They took note of the authorities' concern that such inflows could contribute to inflationary growth of the money supply or an appreciation of the won, with implications for export competitiveness. Directors agreed that a set of policies emphasizing fiscal restraint and such structural measures as liberalization of imports and capital outflows could help to address the authorities' concern.

Given the need for fiscal policy to play a greater role in restraining aggregate demand in view of the current cyclical situation, Directors noted with satisfaction that the recently passed supplementary budget related to reform of agricultural imports was fully funded by additional revenue from a newly introduced tax. As regards fiscal policy for 1995, Directors underscored the need for a significant withdrawal of stimulus and welcomed the authorities' recent decision to aim for a surplus in the 1995 budget. While Directors were fully aware of the difficulty of achieving such a fiscal stance--particularly given the authorities' commitment to strengthen infrastructure and improve the provision of public goods more generally--they stressed that insufficient fiscal tightening at this juncture would further complicate the conduct of monetary and exchange rate policies.

On monetary policy, Directors noted the record of success achieved by the Bank of Korea with its flexible approach to monetary targeting over recent years. Nevertheless, with financial reform moving ahead and patterns of financial intermediation changing, Directors agreed that assessment of the monetary stance would increasingly need to rely on a broader range of indicators in addition to monetary growth rates. They endorsed the Bank of Korea's latest efforts to push up short-term interest rates in order to achieve monetary growth at the lower end of the target band. Several Directors observed that gradual appreciation of the currency could be expected in the period ahead as part of the process of tightening monetary conditions. A number of Directors emphasized that such an exchange rate adjustment would have a beneficial effect on inflation and that it should be viewed with equanimity in light of the economy's strong competitive position.

Directors welcomed the authorities' commitment to steady implementation of the structural policy agenda, including financial sector reform, steps to liberalize the external capital account, a reduction of remaining import protection, and a phased reform of the tax system. Directors saw the coordinated reform programs for the financial sector and external capital account as a top priority. In the area of trade policy, Directors endorsed the efforts under way to phase out barriers to agricultural imports, while urging the authorities to go further in that direction.

It is expected that the next Article IV consultation with Korea will be held on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/82 (9/9/94) and EBM/94/83 (9/12/94).

4. REPUBLIC OF ESTONIA - ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4

The Fund notes with satisfaction that, with effect from August 15, 1994, Estonia has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement. (EBD/94/150, 9/6/94)

Decision No. 10784-(94/83), adopted September 9, 1994

5. SRI LANKA - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - THIRD ANNUAL ARRANGEMENT - EXTENSION

1. The Government of Sri Lanka has requested the extension of the commitment period of the three-year arrangement for Sri Lanka under the enhanced structural adjustment facility (EBS/91/135, Sup. 2) until March 29, 1995. (EBS/94/176, 9/6/94)

2. The Fund approves the request.

Decision No. 10785-(94/83), adopted September 9, 1994

APPROVAL: March 5, 1996

LEO VAN HOUTVEN
Secretary