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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/24

10:00 a.m., March 15, 1995

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Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, First Deputy Managing Director

Executive Directors

M.-A. Autheman
J. Bergo
L. E. Berrizbeitia
I. Clark
B. S. Dlamini

K. P. Geethakrishnan

D. Kaeser

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

Alternate Executive Directors

A. A. Al-Tuwaijri
M. Sirat
E. Srejber
V. J. Fernández

J. Shields

L. M. Cheong

A. Chang Fong, Temporary
D. Daco, Temporary
H. A. Barro Chambrier
A. R. Ismael, Temporary
N. Coumbis
B. S. Newman
T. Fukuyama
S. Rouai, Temporary

Y. Y. Mohammed

J.-H. Kang

Wei B.

L. Van Houtven, Secretary and Counsellor
C. P. Clarke, Assistant

Also Present

External Relations Department: M. R. Kelly, Deputy Director. Fiscal Affairs Department: M. Sakaguchi. Legal Department: R. H. Munzberg, Deputy General Counsel; P. De Boeck, S.-D. Gong. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; H. M. Flickenschild, A. K. McGuirk. Secretary's Department: W. S. Tseng. Treasurer's Department: D. Williams, Treasurer; D. Gupta, Deputy Treasurer; G. Wittich, Deputy Treasurer; L. Aylward, J. C. Corr, Z. Farhadian-Lorie, G. M. Fitzpatrick, B. E. Keuppens, I. Otker, B. C. Yuen. Office of the Managing Director: S. Sugisaki, Special Advisor; G. R. Saunders, Personal Assistant. Advisors to Executive Directors: R. F. Cippa, S. K. Fayyad, R. Kannan, M. F. Melhem, S. O'Connor, K. Sundara, A. V. Vernikov. Assistants to Executive Directors: S. Al-Huseini, A. G. Cathcart, A. L. Coronel, A. Galicia, A. Guenewich, P. Jilek, T. Kanada, T.-M. Kudiwu, V. Kural, Ng C. S., J. Pesola, M. W. Ryan, F. A. Schilthuis, V. Trivedi, V. Verjbitski, E. Zamalloa.

1. PRECAUTIONARY BALANCES - REVIEW

The Executive Directors considered the staff paper on the review of the Fund's precautionary balances (EBS/95/22, 2/24/95).

Mr. Wijnholds made the following statement:

When discussing the subject of precautionary balances it seems useful to view the Fund as an international financial intermediary, albeit a unique one. Like other financial intermediaries, the Fund needs to protect itself against risks, so that the continuity of its operations is never compromised. As risk assessment is an art rather than a science, finding the optimal level of precautionary balances to cover the risks the Fund incurs contains a strong judgmental element. Ratios can help to form this judgment, but qualitative elements should play an important role in the final analysis. In this connection, factors such as the degree of concentration of Fund exposure should be clearly taken into account, and I welcome the fact that the staff has done so in its paper. Before setting out in more detail my views on what I consider a necessary level of precautionary balances, I would like to reiterate the long-standing view of this chair that it is important for the membership of the Fund as a whole to maintain a sufficiently strong financial buffer. Indeed, I believe that in a longer-term perspective it is equally in the interest of both debtor and creditor countries that the Fund remains--and is seen to remain--a financially solid institution.

In recent years the Fund has strengthened its precautionary balances, contributing to the marked improvement in the selected ratios shown in Table 2 of the staff paper. With this development, the overdue correction of earlier, inadequate levels of precautionary balances has probably been largely achieved as of this moment. And, as the staff paper mentions, many Executive Directors--but excluding my predecessor and a number of Directors for countries with substantial claims on the Fund--felt in April 1994 (EBM/94/29, 4/1/94) that "a substantial or at least some reduction in the rate of accumulation of [precautionary balances] would be appropriate." Since that time, a number of developments have taken place that could--and in my view should--modify that view. If one were to look at the situation in a static fashion, then the conclusion might be warranted that a slower pace of reserve accumulation would perhaps be in order. Figures, such as the decline in the arrears outstanding to the Fund--incidentally I note that the arrears that remain appear to be particularly difficult to erase--and the rise in the precautionary balances as a proportion of total credit outstanding to 11 percent in 1994, would point in that direction. However, I would emphasize that it is essential to take a dynamic view and look ahead to possible developments, as well as to take into account the surge in

outstanding Fund credit that is expected to occur this year and next. I would also point to the climate of increased unrest in world financial markets, and to what I would perceive as increased economic and political uncertainty, at least in some parts of the world. Moreover, the Fund, both as a monetary institution and as a financial intermediary, should, in matters of financial integrity, tend to err on the side of caution rather than on the side of laxity. Hence, I feel that the judgments of a year ago reached by a substantial part of the Board should be revised in the light of the considerations that I have mentioned.

Let me try to be a bit more specific. The programs that were recently concluded with a few large members, and some smaller ones, will lead to a rapid increase in the Fund's outstanding credit. The uncertain climate referred to earlier could lead to further--unexpected--substantial purchases from the Fund. It could well be that the staff's projections of future demands on Fund credit are too conservative and that the decline in the ratio of precautionary balances to total credits outstanding will be more rapid than indicated in Table 2. Moreover, the current concentration of the bulk of Fund lending to a small number of countries could also be seen as a factor that increases risk, as indeed is mentioned by the staff, which also mentions that this "portfolio" concentration could increase even more in the coming period. Finally, one cannot exclude the sudden emergence of new cases of arrears to the Fund on account of political developments. All these factors indicate, in my view, that it would be prudent and wise to aspire to maintain a ratio of precautionary balances to total credit outstanding of about 10 percent. This would also ensure that this ratio does not deviate even more from those prevailing in other international financial institutions, such as the World Bank where the level is presently 16-17 percent. While I recognize that because of institutional differences somewhat lower ratios are acceptable for the Fund than for other institutions, the gap between the ratio of so-called free reserves to credit for the Fund, about 4 percent, and the World Bank, about 13-14 percent, appears to be on the high side. If I am informed correctly, the Board has never endorsed the illustrative range for free reserves put forward by the staff in 1993.

The foregoing leads me to conclude that a continuation of the earlier increases of 5 percent of reserves, for both the Fund's reserves and the first Special Contingent Account (SCA-1), which may have looked adequate on a previous occasion, would now appear to be somewhat insufficient. I therefore feel that for FY 1996 a slightly higher percentual overall increase is called for, as is also hinted at in paragraph 33 of the staff paper. The additional amounts required can be generated through existing mechanisms, in anticipation of a switch to a system of uniform but

adjustable norms. The drawbacks to the introduction of an interim system, mentioned by many Executive Directors in our meetings of January 6, 1995 and January 9, 1995, need not be repeated here. As concerns the second Special Contingent Account (SCA-2), the staff proposes that the so-called shortfall of contributions by creditors--caused by the limit to the adjustment of the rate of remuneration set by the floor of the remuneration coefficient--be paid into SCA-1 in the future. As a merger of the two special contingent accounts, which I would have preferred, appears to be possible only with the agreement of each of the contributors, I could go along with the staff's proposal. In itself, it would be a welcome development if future SCA-2 resources could be used to augment SCA-1, which covers a wider range of arrears and is less likely to result in any refunding. At the same time, it should be clear that this proposal implies that the debtor countries would cease their contributions to SCA-2 and that, therefore, only creditor-country resources would be shifted to SCA-1.

In conclusion, a forward-looking analysis of the risks the Fund may incur in its role as provider of balance of payments support brings me to advocate a somewhat higher pace of accumulation of reserves than in recent years. A permanent fall in the ratio of precautionary balances to outstanding Fund credit to below 10 percent would be undesirable. Whereas the Fund is not in any way dependent on financial markets for augmenting its resources, and I favor keeping it that way, it does have to approach member countries, its shareholders, for that purpose when the need arises. As we may be approaching that situation, I wish to draw attention to the obvious point that member countries with a strong external position, able to provide usable currencies to the Fund, will tend to take into account the Fund's policy on precautionary balances when considering an increase in their potential claims on the Fund.

Mr. Clark made the following statement:

We wish to commend the staff on adopting a forward-looking perspective on the analysis of the adequacy of the Fund's precautionary balances. As we all know, these balances are accumulated to protect the Fund's financial integrity against unforeseeable, but not unlikely, future shocks. The proposition that precautionary balances should, at least, cover existing arrears is almost tautological. More interesting and less measurable is the proposition that these balances should cover some portion of the members' future obligations to the Fund that are at risk of becoming overdue.

It is a challenging task because there are few benchmarks against which to measure the adequacy of precautionary balances. In practice, the balances are judged in relation to the level of existing arrears and to some portion of projected future credit

positions that may potentially add to arrears. At issue is how to define that portion. For this, one relies on historical experience, practices at comparable institutions, and judgment about the unique characteristics of the Fund's current and projected credit balances.

First, we note that in the papers prepared for last April's discussion on precautionary balances, the minimum ratio of precautionary balances to outstanding credit at other multilateral financial institutions was about 10 percent. Several, particularly those that relied heavily on market financing, had even higher ratios.

Second, in the most recent document, the staff projects that: the current outstanding arrears will decline substantially this year but hold steady, at just over 1.1 billion SDR, for the next two years; outstanding Fund credit will rise 15 percent annually over the next three years, compared with less than 4 percent per year over the previous three years; and the concentration of loans outstanding to the five largest borrowers will jump to about 60 percent of total outstanding credit this year, from just over 50 percent last year.

The acceleration projected in credit growth and the substantial increase in the concentration of these loans suggest that the Fund's potential exposure to overdue credit obligations has increased significantly. Indeed, the staff has indicated that a substantial portion of the anticipated credit growth will be due to members whose programs have gone offtrack in the past. Also, on a more quantitative basis, the ratio of precautionary balances to outstanding credit, with or without SCA-2 balances, is projected to fall below 10 percent.

The staff points to the strength of adjustment programs associated with Fund credit as a risk-containment factor. However, the strengths of these programs are not uniform and are, at most, prospective in their risk-containment properties. For example, some of the Fund's recent lending has been under the systemic transformation facility (STF), which entails greater risk because of lower conditionality than do stand-by arrangements and extended Fund facilities. Also, the "exceptional circumstances" clause in the case of Mexico's stand-by arrangement refers to the size of the loan, not to its macroeconomic conditionality.

On the positive side, the projected sharp drop in the current arrears position yields a substantial increase in free balances. Excluding SCA-2, which is earmarked for rights accumulation programs, free balances in 1995 will be almost 35 percent of the average loan value for the five largest debtors and almost

2.8 times the average loan value of all debtors. In the past, this chair has suggested critical values of 0.25 as the ratio of free balances to the average large loan value and 2 as the ratio of free balances to the average of all loans. These threshold levels would become vulnerable only if arrears increase by about 15 percent from current levels. Furthermore, as a percentage of total credit outstanding, free balances are approaching 4 percent--a historically high value but under different credit-risk characteristics.

On balance, there is no clear signal to reduce or raise the rate of accumulation of precautionary balances over the near term. This suggests that the current rate of accumulation is probably still about right. Additions to precautionary reserves, specifically to reserves and SCA-1, equal to about 10 percent of current reserves remain acceptable. We agree that contributions to SCA-2 could be discontinued if the rights accumulation program is not extended beyond April 1995.

Finally, with respect to the method of financing the contributions to precautionary balances, a surcharge of 50 basis points on the rate of charge is too high. We have argued in the past that only a portion of the contribution should be financed via the surcharge. The remainder should be financed cooperatively through the uniform but adjustable norm. A surcharge of 25 basis points--or whatever would yield about half the required annual contribution--could achieve this objective.

Mr. Daco, on behalf of Mr. Kiekens, made the following statement:

Judged by some standards, the Fund's precautionary balances are fairly high, covering approximately 10 percent of credit outstanding, and appear adequate to the needs of the present moment. The credit outstanding to countries in protracted arrears, which is completely covered by the present precautionary balances, will continue to decline in 1995 following the completion of Zambia's rights accumulation program. The existence of free reserves, which will stand at 4 percent of credit outstanding by the end of FY 1995, appears to confirm this view.

However, this static assessment does not take account of recent shifts in the Fund's present and future lending activities. A more inclusive analysis, covering anticipated commitments, seems to foreshadow a worrisome concentration of Fund credit: by the end of FY 1995, it is expected that 25 percent of all Fund credit will be extended to a single member, and almost 60 percent to only five members. The purchases in the pipeline are equally troubling, with only two members accounting for 57 percent of total credit outstanding. The picture of the regional distribution of credit is no better, but shows a heavy concentration in transition countries whose performance with

regard to the systemic transformation facility has been rather mixed, and in the Western Hemisphere. Obviously such concentration increases the risk level of the Fund's portfolio, and the risk picture would not be improved by the recently proposed creation of such new facilities as a short-term financing facility and a currency stabilization fund. The large increase in Fund credit planned for the next financial year will also considerably lessen the ratio of precautionary balances to total credit outstanding.

The response to this development should, in our view, be twofold. First, it is wise to continue accumulating reserves at the present rate; second, strong emphasis should be given to the conditionality content of Fund programs, as this appears to be the best way to ensure that members to whom large amounts of Fund resources are committed will remain in a position to meet their repayment obligations.

Reducing the rate of reserve accumulation would greatly decrease the ratio of reserves to credit outstanding and would send a wrong signal to the markets. And even though we agree that the Fund's large holdings of gold are substantially undervalued at SDR 35 per ounce, revaluing the Fund's gold at the present time would send a wrong signal to some member countries and give them the excuse they seek for taking a less cautious stance with respect to the accumulation of reserves.

As the balances in SCA-2 exceed the amount of General Resources Account (GRA) resources used in connection with the encashment of rights at the end of rights accumulation programs, we can agree to discontinuing the accumulation of resources in this account. This would eliminate the present situation where the sharing of the burden of accumulating SCA-1 reserves between creditors and debtors is biased by limitations on the rate of remuneration. If the staff should make such a proposal, we would support it. In our view such a solution is to be preferred over continuing to explore the possibility of dissolving SCA-2 and adding its balances to SCA-1, which because of the need to obtain the approval of each contributor appears procedurally much more difficult and time consuming.

As to the implications of reserve accumulation for the issue of a variable unified norm, we would note that the "easy solution," that is, the notion that a variable uniform norm system will permit creditor countries' net contributions to remain level if the accumulation of precautionary balances is slowed down, is no longer valid. Moreover, reducing the Fund's operating costs by decreasing the rate of reserve accumulation is not consistent with the Fund's character as a monetary institution. These two issues should therefore continue to be discussed separately.

That portion of the paper dealing with alternative methods for determining the rate of charge for FY 1996 seems more closely linked to the topic "reform of the financing of the Fund" than to the topic "review of the Fund's precautionary balances." Nonetheless, the simulations usefully show the importance of the surcharge. As to the surcharge itself, we would repeat that we do not favor a surcharge of 0.5 percent, which would substantially increase the debtor countries' share in the financing of the Fund.

Mr. Newman made the following statement:

The Board's discussion of precautionary balances is particularly timely in view of the convergence of a number of events: the sharp rise in credit outstanding and its concentration; ongoing deliberations over possible changes to the financial structure of the institution; and the need to decide on net income and SCA-1 targets for FY 1996, assuming a broader reform of the system is not agreed upon sooner.

Two broad issues underlie consideration of precautionary balances: determining what level is appropriate to ensure the financial integrity of the institution; and determining an equitable, transparent, and stable method for financing their accumulation to this level.

As regards the level of precautionary balances, one is struck by two trends. One is the steady buildup since the second half of the 1980s in reserves and provisions against the credit risk. The other is the more recent increase in Fund credit outstanding. The two trends intersect at a rather favorable time. Precautionary balances have risen to levels in recent years of about 10-11 percent of credit outstanding. This is a benchmark that we have found generally adequate in considering movement to a more stable and secure financial structure, namely, the variable uniform norm. Thus, the institution is reasonably well positioned to accommodate, with prudent additions to reserves, the recent large jump in Fund lending and concentration, without imposing onerous new provisioning costs. In our view, prudent additions to reserves means maintaining a ratio of precautionary balances to credit outstanding of, at least, 10 percent and maintaining a ratio of free reserves of at least 4 percent. The substantial concentration of Fund lending, which is actually underrepresented in Table 3 of the staff paper if prospective disbursements are included, is an important indicator in our view and suggests the advisability of treating current ratios as floors. These two key precautionary balance ratios are complementary and seem to be far more logical benchmarks of needed precautionary balance accumulations than do the current methods of targeting a growth rate of reserves.

Comparing the level and financing of the Fund's precautionary balances with those of the multilateral development banks is instructive. The Fund's precautionary balance ratios are substantially less than those of the multilateral development banks, as is highlighted in Mr. Wijnholds' statement. This is due in large measure to their reliance on capital markets as a source of financing and the need to provision and price lending accordingly to satisfy market perceptions of risk. The implication is that the Fund's public sources of financing are less risk-averse than are private sources. We are skating on thin ice in subjecting taxpayers' money to less risk assurances than those provided to private creditors. In addition, the apportioning of financing the costs of Fund precautionary balances among debtors and creditors is extraordinary. No other institution shares these costs.

These issues have been raised before, but they are worth repeating at this juncture. As substantial calls are being made on creditor positions and new demands are contemplated, the institution must take the necessary steps to reassure creditors that these positions are secure, liquid, and offer a competitive return.

Needless to say, we could not agree to a slowing in the rate of accumulation of precautionary balances under current circumstances. Moreover, the staff's suggested reduction in the size of the net income target from 5 percent to 3 percent seems to us to be misguided. If any reduction in accumulation were called for under the current system, and we do not see such justification, SCA-1 would seem to be a more logical candidate given its exceptional character and the more circumscribed availability of its resources, as compared with reserves.

It is difficult to separate consideration of levels of precautionary balances from their financing. Prior to the recent run-up in Fund lending commitments, we had noted our willingness to consider a slowing in the rate of accumulation of precautionary balances as part of the move to a variable uniform norm. In our view, establishment of a more stable and secure source of financing would provide an additional measure of confidence that could permit a somewhat lower stock of balances than under the current system.

We continue to believe that a variable uniform norm with a reasonable surcharge provides the most transparent, equitable, and cost-effective means of financing the Fund's operations, including precautionary balances. As we have indicated, such a surcharge should be imposed on all new purchases in order to match current debtors with current risk. When credit outstanding declines and precautionary balance levels are deemed adequate, the surcharge on

current borrowers would remain in place, but retroactive reductions in the rate of charge could be provided to previous surcharge payers. Thus, the effective surcharge over time is reduced from the 50 basis point rate, or whatever premium is chosen. Such a forward-looking scheme reduces intradebtor inequities that are intrinsic to the current backward-looking system as well as some of management's recent proposals. We would emphasize that the refund would not be automatic, but rather would occur when reserve levels were adequate and further net accumulations were not seen as necessary.

At times when more rapid accumulations of precautionary balances are required and not achievable through the surcharge, some topping-up through the uniform norm could be in order. It might also be worth considering adding a supplement to the surcharge for those making exceptional use of Fund resources. This would address a potential equity concern of some debtors regarding the costs associated with larger precautionary balance requirements occasioned by exceptional use of resources.

As we have indicated previously, we favor merging SCA-2 into SCA-1 as a means of strengthening the Fund's precautionary balances. We recognize that creditors have provided a disproportionate share of SCA-2 and foregoing possible refunds would represent a substantial cost. Nevertheless, these costs are outweighed by the additional security offered by expanding SCA-1. However, we have some difficulty with the staff's proposal that future creditor contributions to SCA-2 be diverted to SCA-1 while previous contributions to SCA-2 by debtors and creditors would be refunded. We recognize the legal reasons for the proposed approach but view it as undesirably weakening the Fund's precautionary balances.

We do not believe the obstacles to a full merging of SCA-2 into SCA-1, namely, approval by each contributor, to be as daunting as do the staff. Debtors would surely find it an advantageous way to avoid future surcharges or burden sharing costs that would be triggered by SCA-2 refunds and the need to replenish precautionary balances. The advantages to creditors are less direct and are driven importantly by the need to ensure adequate provision against their claims. In our view, this benefit overrides potential short-term costs, to which we are obviously sensitive given our position as the largest creditor to the Fund and biggest contributor to SCA-2. It would be helpful for chairs to indicate their inclinations or positions on this issue, so that we might gain a better idea of its feasibility.

Looking ahead, we continue to favor movement to a variable uniform norm accompanied by a surcharge. Such a system has been widely recognized by many debtors and creditors as far preferable,

in principle, to the current system. One might expect support from debtors to flag somewhat given the recent projections by the staff of FY 1996 burden sharing costs under the various scenarios. We would argue against this tendency.

First, a longer view of the Fund's financial structure has guided consideration of the variable uniform norm and should not be ignored now. The relatively higher costs assumed by debtors when SDR rates and Fund credit outstanding are lower are a still recent memory that will surely repeat itself over the course of business and interest rate cycles.

Second, the cost reflected by the surcharge could be cushioned by a rebate mechanism similar to that used to retroactively reduce the rate of charge. Thus, the provisioning costs associated with high levels of net lending need not pose a permanent burden to surcharge payers. Rather, they could be reduced over time as credit outstanding returns to more average levels. The staff has outlined problems with certain rebate proposals, but we have yet to see a convincing refutation of a scheme that parallels current practices.

Third, particularly at a time when creditors are being asked to consider new calls on their resources, it is doubly important that reserve positions remain sufficiently attractive. Proposals that reduce the security of claims and add to funding inequities are highly problematic. They risk creditor delays in responding to new funding needs as well as consideration of other more expensive funding sources.

Mr. Tulin made the following statement:

I would like to commend the staff for the well-focused paper before us and for the additional country-wise data on burden-sharing contributions that the Treasurer's Department has prepared at my request, which appear quite useful for our further work on improving the system of financing the Fund's operations.

The staff paper convincingly attests to the validity of our view that the Fund's precautionary balances have reached in the recent years a very comfortable level, amply covering all quantifiable credit risks. At this juncture it might be helpful to look back at the basics of this issue, in order to put our present and future deliberations in a proper perspective.

The following considerations may be particularly relevant. The Fund is a unique global cooperative financial institution of a monetary character. The Fund's role in assisting its members is quite distinct from that of other international financial intermediaries. It has the status of preferred creditor that is

recognized both by the membership and by the international financial community, in general. When providing resources to its members, the Fund analyzes a borrower's capacity to repay and imposes its own policy conditionality which is custom-tailored for each specific borrower. A country's capacity to repay is normally expected to improve over the medium term, as a result of the implementation of Fund-approved adjustment programs. The strength of these programs is the major factor guaranteeing timely repayment of loans while limiting the Fund's risks. In cases of weak prior policy track records, these risks are minimized by tranching and back-loading techniques, and closer monitoring of the programs by the staff, including on a monthly basis when necessary.

The Fund has never recorded a loss of general resources in its entire history, in part, because of its internal procedures and the specific method by which the Fund provides its general resources to the membership--through selling to a borrower currencies of other members or SDRs for an equivalent amount of a borrowing member's currency, thus substituting one type of currency held by the Fund for another. In the earlier Fund papers on the issue of precautionary balances (EBS/87/97, 5/6/87) appears particularly helpful), the staff appropriately placed the risk assessment exercise in the context of greater application in the Fund of the Generally Accepted Accounting Principles (GAAP), in order to meet the requirement of "a true and fair representation of the current financial position of the organization." The underlying assumption was that, as I quote from page 5 of the aforementioned staff paper, "In view of the scale and duration of overdue obligations to the Fund, there would seem little doubt that the effective realizable value to the Fund of a not inconsiderable portion of its assets representing overdue credit extended to its members is less than indicated by their nominal book value as shown in the Fund's financial statements." In this regard, it has been prudent for the Executive Board to aim to protect the Fund's position through an accelerated buildup of reserves to cover 100 percent of GRA credit outstanding to members in protracted arrears. In our view, this policy has served the Fund well in the past, and must be continued.

In the absence of any experience of loss, the Executive Board has traditionally steered away from targeting the size of the Fund's precautionary balances as a proportion of its total credit outstanding, which is otherwise customary among the commercial banks. With increased volatility in the global financial markets, future demand for the Fund's resources could be subject to wide fluctuations over the short term. The resulting large and rapid changes in the Fund's total credit outstanding would provide poor guidance for a prudent policy on the Fund's precautionary balances.

Over the previous two years, application of the GAAP has been appropriately strengthened in the Fund through changes in the methods of accounting for the Fund's capital expenditures and future liabilities under the staff medical benefits plan. In our view, application of the GAAP needs to be extended further to assessing--albeit unofficially--the true and fair value of all Fund assets, besides currency holdings, whose effective realizable value is at variance with their nominal book value. It is notable that presently the Fund values its gold holdings on the basis of two prices--the traditional one, SDR 35 per fine ounce, and the December 1992 price of an actual gold purchase transaction, about SDR 238 per fine ounce. In accordance with the GAAP, a valuation adjustment of about 100 million fine ounces of gold, using the latter price, could yield more than SDR 20 billion in additional "hidden" reserves. Even discounted by 50 percent, this huge financial gain would still provide considerable protection to the Fund against conceivable unquantifiable credit risks over the long term. The notional "triple A" rating of the Fund in the financial markets--where gold is now valued at some SDR 250 per ounce--appears unshakable.

As total precautionary balances are projected to reach SDR 3.2 billion at the end of April 1995, and the amount of overdue repurchases in the General Resources Account is expected to shrink to SDR 1.2 billion, Directors may wish to consider whether it is necessary to continue to amass the Fund's reserves at the same pace as in the second half of the 1980s, when the Fund was much smaller than now, the amount of total credit outstanding was higher than at present, and the problem of arrears was more pronounced. Against the background of a highly successful intensified arrears strategy, and with Sudan moving toward formulating and implementing a rights accumulation program to be monitored by the Fund's staff, the possibility of a first asset write-off is presently as remote as ever.

Does the Fund need to invent a new criterion for reserve accumulation because the Fund's precautionary balances have outgrown the size of the arrears problem? Our answer to this question is no. We believe that the basic GAAP-oriented approach to provisioning in the circumstances of the Fund is the most transparent and comprehensive. Nevertheless, until the Fund puts in place a more equitable and transparent system of financing its operations, this chair would be prepared to continue to err on the side of caution and support continuation of moderate strengthening of the Fund's reserves. However, the margin of such error should be somewhat smaller. The Fund's annual net income target rate for the forthcoming financial year could be safely adjusted downward from 5 percent to its original level of 3 percent. Simulations in Table 3 of the staff paper indicate that even with this lower net income target the Fund will be able to add SDR 267 million in

FY 1996 to its precautionary balances. In any case, we would oppose raising the target rate now, as it might immediately send the wrong signal to the financial markets, indicating a lack of confidence in the Fund regarding the recently approved large arrangements, or those pending Board approval. At the next review of precautionary balances, we shall be prepared to be flexible on this issue and support, if necessary, raising the net income target rate back to its present or higher levels.

The role of the Special Contingent Accounts under the proposed system of uniform adjustable norm--I would suggest dropping "but" from the modified name of the proposal--is not clear to me. Until recently, the balances in these accounts have been expected to cover only quantifiable risks of asset "write-off." As the members eligible to avail themselves of the rights approach increasingly prefer to use, to the extent possible, concessional financing under the enhanced structural adjustment facility (ESAF), the original SDR 1 billion target amount for the balances in SCA-2 may be regarded as too high, given the projected use of GRA resources by these countries of SDR 621 million through 1997. Therefore, I can support the staff's proposal to redirect the shortfall in creditor country SCA-2 contributions to SCA-1. Changes in the mechanism of burden-sharing under the new quota-based system will mean that the special contingent accounts will need to be merged with the regular reserves of the General Resources Account, terminated, or used to partially finance reconstitution of reserve tranches. The latter option would certainly facilitate the transition under the new mechanism for the ESAF-eligible countries. In the meantime, before a consensus on this issue is reached, this chair would have no problem with merging the two special contingent accounts together. As the lists of contributors to both accounts are practically the same, with some exceptions, it looks possible that such a merger could eventually be accomplished.

A risk premium or surcharge on the rate of charge under the new system will represent an unnecessary deviation from a quota-based principle of sharing the general and prudential expenses of the Fund. We noted on previous occasions that prudential expenses of the Fund would ultimately increase value for all the Fund's shareholders, while the growth of interest-free reserves would lower the norm for unremunerated positions for all members. Therefore, the surcharge approach, in our view, would contradict the purpose of our ongoing exercise, as it would be tantamount to giving "a free ride" to creditor and so-called neutral countries.

Mr. Kaeser made the following statement:

It should not come as a surprise if I take the opportunity of this discussion to reiterate the conservative position of this chair regarding the adequacy of the Fund's precautionary balances. Indeed, since March 1994, when we already opposed any substantial reduction in the rate of accumulation of reserves, a number of developments occurred that could only substantiate our position and suggest further caution for the future. In this respect, I very much endorse Mr. Wijnholds' dynamic approach and forward-looking analysis, and share his concern as regards the risks the Fund may incur in its--likely increased--future activity as provider of financial assistance to countries with balance of payments difficulties.

I would, therefore, not support any reduction in the rate of accumulation of precautionary balances; like Mr. Wijnholds, I would rather favor an increase of both the Fund's reserves and SCA-1 that would be slightly higher than 5 percent. Even if this will not be sufficient to keep precautionary balances as a proportion of total credit outstanding above the limit of 10 percent in the coming years, it will indicate our commitment to financial prudence. Regarding the contribution to SCA-2, I can endorse the Managing Director's proposal that the contribution to that reserve account be discontinued and the shortfall of the creditors contribution be paid into SCA-1.

The pursuit by the Fund of conservative and financially sound policies will not only guarantee the continuity of its activity, but will also represent the condition for being able to respond to future challenges. I am indeed convinced that it is only under these conditions that creditor countries will be willing to consider a substantial increase in their claims to the Fund. Moreover, the Fund's financial strength would also become of paramount importance should we opt for considering any financing of our future activity though borrowing on the financial markets. I already indicated to the Treasurer what kind of provisioning my supervisory authorities would request from a bank with a portfolio similar to the one of the Fund.

I commend the staff for its explicit analysis of possible future developments and associated risks. I am especially concerned by the following ones.

The globalization of financial markets and their underlying instability will probably lead to periodic crisis, whose solution will require a large involvement of Fund resources. We read everywhere that the Fund should "brace" for the potential financial market crisis of the twenty-first century. But already now, a number of chairs are expressing the fear that members of

their constituency could be dragged into financial market turmoil. This could lead to very large drawings on the Fund with a rapid decline in the ratio of precautionary balances to outstanding credits; the more so if the Fund is ready to grant maximum access to its resources or resort to the special circumstances clause.

Another source of concern is the increasing concentration of Fund credits with a few large borrowers. This increasing concentration is an important indicator of growing risk. A private investor would try to correct such a potentially risky portfolio concentration. As we cannot behave like private investors, we will have to live with that clustered risk for some time. Therefore, we should undertake two things. First, we should continue to build up adequate precautionary balances to protect the Fund against a situation in which borrowers currently fulfilling their obligations may suffer economic or political problems that could hinder them in repurchasing their currency in due time. Second, we should make sure that an adequately strong conditionality applies to borrowers that are granted large access to Fund resources. In this respect, we shall, nevertheless, be aware that higher conditionality does not necessarily imply lower risks. Indeed, other things being equal, the stronger the program, the more difficult is its implementation, and therefore the risks are greater that it will eventually go off track. At the same time, the Fund can be faced with circumstances that make it impossible to negotiate an adequately strong economic program. This has been the case of Mexico, whose program has had to be strengthened twice since the Fund granted to this country an exceptionally large amount of resources.

Another development that is of concern is the apparent erosion of the preferred creditor status of the Fund. During the discussion last April on the adequacy of precautionary balances, a number of Directors emphasized that additional protection against the risk was to be found in the Fund preferred creditor status. Would they reconfirm this view now? It seems, at least, that our Legal Department has some difficulty in demonstrating that the collateral given by the Mexican authorities to the Government of the United States does not harm the integrity of this status. On the other hand, there is a widespread view among the nongovernmental aid organizations that the Bretton Woods institutions should renounce this status in order to facilitate the solution of the poorest countries' indebtedness toward the multilateral financial institutions.

The staff has made some calculations about sharing the cost of financing the Fund under three different systems. I shall not, on this occasion, discuss in detail our position regarding the financing of the Fund's operations. I shall only mention my preference for the uniform variable norm, and my strong support

for financing a substantial portion of the Fund's costs by means of a surcharge or, in other words, a risk premium on credit committed to member countries. Anyway, I do not believe that any kind of surcharge that we could possibly envisage would alter the fact that the Fund's credit will remain the cheapest source of financing.

Mr. Wijnholds observed that most speakers had conveyed essentially the same message as he had in his own statement. He was particularly pleased that Mr. Newman had emphasized the need to at least maintain the critical ratios with respect to precautionary balances, a strong signal from the Fund's largest shareholder. Also like Mr. Newman, he continued to favor moving to a system based on a uniform but adjustable norm, and would also favor some kind of surcharge under such a system. The suggestion made by Mr. Newman in that regard for a possible supplement to a surcharge for countries making exceptional use of Fund resources was interesting, and it would be useful if he could elaborate somewhat on the implications of his suggestion; some comment from the staff on whether such an approach would be legal would also be helpful.

On the merging of the two special contingent accounts, he had indicated in his statement that he would prefer such a solution but that he could go along with the proposal the staff had made in that respect, Mr. Wijnholds recalled. However, he wondered whether Mr. Newman might in fact be correct that the previously stated problems surrounding a merger of those accounts were somewhat overblown and not perhaps insurmountable. With that in mind, he would prefer to keep an open mind on the merger issue.

The Deputy General Counsel remarked that it might be useful to review the legal context in which any proposal for a surcharge on the use of Fund resources would have to be considered. As noted on previous occasions, it was first necessary to establish whether the intention was to introduce a surcharge under the existing Articles of Agreement or under an amendment of the Articles. From the discussion, it was his impression that such a proposal would be considered in the context of the existing Articles. Within the existing Articles, a surcharge could be built into the rate of charge, stemming from the authority granted to the Fund under the Articles to levy charges. The Articles did not prescribe a particular method for levying charges. However, one requirement for such a surcharge was that, under the existing Articles, it would have to be uniform for all members and, therefore, would have to be determined on the basis of objectively defined and relevant criteria.

Refundability was another aspect of proposals on a possible surcharge, the Deputy General Counsel said. As explained in previous discussions, mechanisms with a refundable nature had in the past been built into the rate of charge. In the case of burden sharing, for example, refundability had been found possible because a claim would be created from the outset subject to certain objectively defined conditions. Refundability would have to

respect uniform application, and a surcharge could not therefore be rebated on an individual basis.

The Chairman asked the Deputy General Counsel whether the principle of uniformity would be respected if, as suggested by Mr. Newman, a surcharge were applied to all purchases made on the basis of exceptional circumstances.

The Deputy General Counsel replied that, in the context of Mr. Newman's suggestion, the existence of exceptional circumstances for providing access to Fund resources would not be a relevant aspect. However, the relevance of a certain level of holdings in excess of quota could be explored, obviously to be applied on a uniform basis for all members.

The Chairman remarked that the issues surrounding the introduction of a surcharge, although complex, did not appear to be insurmountable.

Mr. Waterman wondered whether it would be possible under the existing Articles to introduce a rate of charge that was a function of the level of purchases relative to quota.

The Deputy General Counsel said that he would want to explore more fully the issues that Mr. Waterman had raised before providing a definitive answer to his question. Clearly, the level of holdings outstanding was relevant to the rate of charge, and it might be worth pursuing those ideas further.

The Treasurer observed that the original Articles had permitted charges to progress according to both amount and time.

The Deputy General Counsel commented that the system of charges had indeed been changed with the Second Amendment, and the staff would need to carefully review the legislative history of that change before making a determination of the legal framework in which Mr. Newman's suggestion might be considered.

Mr. Newman remarked that he had made his proposal with an eye to the provisions of the original Articles, although without being sure whether the Second Amendment had fundamentally changed the situation. Nevertheless, the proposed additional surcharge was intended to be uniform, based on the level of outstanding obligations as a proportion of quota.

With respect to the remarks of Mr. Tulin on the implications of a surcharge, the point was well taken that the Fund should run its operations in a manner consistent with accepted accounting rules, Mr. Newman commented. Indeed, a surcharge was fully consistent with generally accepted accounting principles, in which the cost of a transaction should be met by charging a levy against members giving rise to that cost. The cost implications of a surcharge were not crystal clear, taking into account the full range of subsidies and cross-subsidization under the current system, but a surcharge

seemed to make both economic and financial sense and was worth considering further.

On Mr. Kaeser's point relating to the preferred creditor status of the Fund in the light of recent developments, Mr. Newman continued, it was his understanding that the staff was currently examining those issues. The United States had provided the staff with all of the documents relating to the recent agreement between the United States and Mexico. In the context of its analysis of those issues, he wondered whether the staff could also examine the implications of cash collateral under the BIS arrangement and its impact on the Fund's preferred creditor status.

Mr. Shaalan made the following statement:

Of the various variables and ratios considered important in judging the adequacy of the Fund's precautionary balances, the ratio of these balances to the total credit outstanding to members in protracted arrears is, in my view, the most relevant. Thanks to the substantial progress achieved under the arrears strategy, and also reflecting a sharply stepped-up pace of reserve accumulation, this ratio has increased markedly over the past few years. Indeed, by the end of FY 1995, the ratio of balances in reserves and SCA-1 to total credit to members in protracted arrears is projected to stand at more than 200 percent.

With these developments in mind, and taking into account the favorable evolution of other ratios, many of us have considered in recent discussions that the Fund's precautionary balances have reached satisfactory levels, with some, including this chair, calling for a substantial deceleration of reserve accumulation. I recognize, of course, as many Directors have noted in their statements, that our discussion today takes place against the backdrop of a changed, and still evolving, environment. Notably, Fund credit is projected to rise sharply, and the increase in credit is projected to be concentrated among a few member countries. However, whereas this could be seen as arguing for, in the staff words, "at least maintaining the current rate of accumulation of the Fund's precautionary balances," a number of attenuating considerations are equally relevant: first, the expansion of Fund credit is associated with strong adjustment programs; second, Fund practices regarding the time that elapses before a loss must be recognized have not changed; third, full coverage of credit outstanding to members in protracted arrears is more than most lenders do in respect of borrowers with overdue obligations; fourth, even with some reduction in the rate of reserve accumulation, coverage of the so-called free reserves is expected to continue to be close to the upper end of the illustrative range suggested by the staff; and last, but not least, the Fund has a substantial amount of hidden reserves. I note, in connection with this last consideration, the staff

statement that it is difficult to measure the extent of the offset to a potential impairment of Fund assets that derives from the hidden reserve aspect of the Fund's gold holdings. Hopefully, however, this difficulty will not continue to be reason enough to disregard the offset altogether; and I think that, somehow, no matter how crudely, we need to find a way to enable us to factor the hidden reserves into our judgments regarding the adequacy of the Fund's precautionary balances.

In view of the above considerations, I believe that there is, on balance, scope for a modest reduction in the pace of reserve accumulation. Accordingly, I would favor setting the net income target for FY 1996 at 3 percent of reserves. As for SCA-1, I can go along with additions of 5 percent of reserves and, following a discontinuation of additions to SCA-2, the SCA-2 shortfall that can be recouped within the remuneration coefficient. Finally, I would favor retaining the present method for determining the rate of charge in FY 1996.

Let me close by underscoring the importance we attach to having the decision on the net income target for FY 1996 incorporate symmetry provisions like those included in the FY 1995 decision.

Mr. Shields made the following statement:

I would like to address the following issues in turn: first, the adequacy of precautionary balances; second, the implications for the rate of charge and for burden sharing; and finally, what we might do about SCA-2.

On the adequacy of precautionary balances, it seems to me there are a number of factors bearing on our decisions. If we look on the positive side, we have certainly made progress on resolving arrears cases and no new cases have recently emerged. But much of the progress has actually been anticipated for a number of years. The single largest instance of arrears, Sudan, still unfortunately remains unsolved. In addition, the world economy, particularly for developing countries, is set to improve, notwithstanding what has been happening in financial markets. Overall, that should bode well for the nonemergence of new arrears cases, at least over the short term. That being said, clearly our policy on precautionary balances should be conducted with an eye on the longer term and should not just be fine-tuned according to the current state of the cycle. These positive factors look, if anything, short term, and we must appreciate that they are subject to some reversal.

If we turn to the negative side, things look a little bit more permanently worrying. First, between 1988 and 1994, GRA

credit remained roughly around the range of SDR 20 billion to SDR 25 billion. During that period of relatively low levels of GRA credit outstanding, the opportunity was taken to build up precautionary balances. However, recent developments in Mexico, Russia, Argentina, and Ukraine now mean that the use of GRA credit is shooting up once again. Second, past peaks in Fund credit have gone hand in hand with low levels of concentration. The rise now in train is different. This time, concentration is set to increase very sharply. Third, even with the existing rate of buildup of precautionary balances, the ratios set out in Table 2 of the staff paper are set to deteriorate. In particular, the ratio of total precautionary balances to GRA credit outstanding is projected to decline markedly over the next year.

On balance, therefore, it seems to me that the negative reasons do seem to outweigh the positive reasons. That leads me to the judgment that, at the moment, the Fund's precautionary balances are not fully adequate. Moreover, the prospective rapid growth in Fund credit and the increase in its concentration could provide a persuasive argument for a still more rapid buildup in precautionary balances. Indeed, I am somewhat attracted to this argument. Nevertheless, for the moment, I am prepared to go along with the existing arrangement for building up reserves in SCA-1, namely, that we should simply keep both net income and additions to SCA-1 at 5 percent of reserves. I will come back to SCA-2 later.

The second area I want to talk about is burden sharing. There are a number of issues related to burden sharing and the Fund's financial structure that are raised in the paper. First, I agree with Mr. Wijnholds that additions to precautionary balances in the forthcoming financial year should be financed through existing mechanisms. Moreover, if there were to be a consensus among us that the rate of accumulation should be increased, I would prefer a marginal change to come about through the addition to SCA-1 rather than through the net income target, but the obverse clearly also applies; as Mr. Newman noted, reductions would also be through SCA-1. That approach seems to be in line with the cooperative nature of our institution and it holds out the prospects of reimbursement for the whole membership.

The paper raises once again the proposal for a transitional financial structure prior to the adoption of a uniform but adjustable norm. I continue not to be persuaded by the need for a transitional system, and certainly not by the proposal in the papers that we have seen. As I made clear in a previous discussion, the proposal on the table does not do anything to address the key issue of the distribution of costs within the groups of creditors or debtors. It is not, therefore, an improvement at all. However, I do still support a move, in time,

to a uniform but adjustable norm, with an appropriate level of surcharge.

On the subject of the surcharge, like Mr. Newman, I take issue with Mr. Tulin's conjecture that the surcharge will provide a free ride to creditor or neutral countries. I think this is really turning the whole issue of interest charges on its head. In a monetary institution, borrowers, particularly those from mature economies, must surely bear an appropriate share of the cost of their own borrowing. In my books, this includes the cost of insurance against the possibility of deferred charges or default. This possibility exists, however strong the program. It also may be greater the higher the proportion of outstanding credit to quota. I accept that it was appropriate to address the issue of inadequate levels of precautionary balances by cooperative effort, but now we are in the process of moving forward. What we need to do now is to maintain an acceptable steady state, and it seems to me that the future burden of maintaining this should rest with borrowers through a surcharge, and the surcharge itself could, in fact, be introduced in incremental steps.

Finally, on the subject of SCA-2, I can agree that new contributions to SCA-2 be ended, but I do not agree with the idea that the creditors' shortfall be added to SCA-1 instead of SCA-2. The SCA-2 was the product of a decision on extended burden sharing. That decision should not be altered without consideration of its ramifications. The SCA-1 and SCA-2 are, in fact, different animals. Losses might be incurred by the Fund that could be written off against SCA-1 but not against SCA-2. The criteria for reimbursing members that have contributed to SCA-1 are different from the criteria relating to SCA-2. I prefer therefore to add the creditors' shortfall to SCA-2 in line with the decision, but I am not obsessive about precautionary balances and I do not see any need at present to build up SCA-2 beyond that.

An issue arises as to whether the Fund is best served by the existence of these two rather separate special contingent accounts. We have had suggestions, certainly, that these special contingent accounts be combined. I have suggested some reservations. Nevertheless, if the idea of combining the two does turn out to be practical, I do not at the moment think I would wish to stand in its way. I do agree with Mr. Wijnholds that it looks rather unlikely, although maybe less so than he first thought.

Mr. Bergo made the following statement:

Let me at the outset thank the staff for a paper that is interesting and balanced when it comes to weighing the arguments

regarding the appropriateness of the precautionary balances. However, I would have appreciated it if that balance had also been extended to the numerical examples in the tables, for instance, an example showing a path for the precautionary balances that would fairly quickly bring them back to the present level as a proportion of total credit outstanding.

The paper also contains an interesting section and tables on determining the rate of charge for FY 1996. As we will come back to that issue in April, I will concentrate my remarks on the question of precautionary balances and only make a few comments on the other questions.

My task here has been made very easy by the excellent statement that have been issued, which basically cover my points. I can especially support Mr. Wijnholds' statement, almost without exception.

One area where I might have a slightly different view is regarding the extent to which methods for risk assessment can be utilized in determining the appropriate level of precautionary balances. I can agree that risk assessment is, to a substantial degree, an art, but sometimes art can benefit greatly from being supported by science. The staff paper makes reference to the conclusion by the Board that "risk evaluations on a country-by-country basis...basically are inappropriate." I have reservations to that conclusion. In my view, it would be perfectly natural for the Fund to try, in a systematic way, to assess sovereign risk, as any financial institution would do, including the World Bank. This can be done discreetly, as I understand it is done in the World Bank, but could give us some useful indications about how the risk in the portfolio is developing. Appropriate adjustments, largely of a judgmental character, to take account of the uniqueness of the Fund would, of course, have to be made before arriving at conclusions regarding the need for precautionary balances.

As a cooperative multilateral institution, the Fund has a special status, which is partly reflected in the global acceptance of the Fund's preferred creditor status, even if the precise implication of this is not perfectly clear. The cooperative strength is further helped by the fact that the Fund is "owned" jointly by virtually all countries. On the other hand, this obligates the Fund to conduct a prudent financial management, in order to safeguard the investments the member countries have made in the Fund. The primary safeguard for the Fund's financial integrity lies in strong adjustment programs being closely monitored by the Fund, and I will repeat once more this chair's strong conviction that every effort must be made to make the conditionality commensurate with the access. Nevertheless, this

does not eliminate risk and there is a need to maintain adequate precautionary balances. The staff and Mr. Wijnholds and others have pointed to a number of factors that indicate that the Fund might be facing increased risks in the future. It also appears that the Fund's outstanding credits might increase further, in view of the proposed arrangements with Ukraine and Argentina, not to mention the possibility of a short-term financing facility.

I do not find the present level of precautionary balances as a proportion of outstanding credit especially high, and I am concerned about the forecasted clear fall of this proportion and the other related proportions in Table 2 in the years to come, a fall that might be even larger as new arrangements materialize. I would thus prefer that we set the accumulation of precautionary balances on a path that would, pending development of a more comprehensive risk assessment system, fairly rapidly bring back these proportions to their present levels. In this context, like others, I can support discontinuing accumulations to the SCA-2 and the channeling of the shortfall of contributions from creditor countries to the SCA-1. Personally, in a future system, I should have liked to see SCA-2 merged into SCA-1, but I am afraid that might be a fairly complicated affair. I would be skeptical about making further changes in the present system in the interim until a system of uniform but adjustable norms could be introduced, which I believe is the most appropriate method for financing the Fund. There is a strong need for simplification, transparency, and a more stable financial system of the Fund, and I believe that efforts should be concentrated on undertaking the fundamental reforms as rapidly as possible.

A sound principle is that borrowers take the main responsibility for financing the necessary reserves for covering the risks associated with lending. In a new system of financing the Fund, a surcharge should be introduced to cover most of the costs of building the precautionary balances. However, the Fund as a global financial institution has a collective responsibility where the extension of Fund credit is based on programs approved by the institution. Thus, it can be argued that the cost of financing the Fund's precautionary balances should, to some extent, also be shared by creditors through the adjustable uniform norm, for instance, in times where a more rapid accumulation of precautionary balances is required, as indicated by Mr. Newman.

Mr. Schoenberg made the following statement:

The staff has again presented this complex matter of today's discussion with its usual clarity and competence, and I would like to commend the staff on that.

In spite of recent relatively favorable developments of the quantitative indicators traditionally used to assess the adequacy of the Fund's precautionary balances, various qualitative factors call, in our view, for a further strengthening of the Fund's reserves. I would like to refer in this context to the numerous statements in the paper that deal extensively with those qualitative factors, and the need to take a dynamic view and to look ahead when assessing the adequacy of the Fund's reserves.

Before doing so, let me make a few observations about the remarks of previous speakers on this qualitative aspect. In fact, some Directors have come up with quite interesting arguments that go beyond the staff's line of reasoning. Mr. Wijnholds, for example, points to the climate of increased unrest in world financial markets and to what he perceives as increased economic and political uncertainty. Mr. Kaeser says that we read everywhere that the Fund should brace for the potential financial market crisis of the twenty-first century and to the apparent erosion of the preferred creditor status of the Fund. Mr. Clark refers to the Fund's recent lending; that the Fund's recent lending has been under the systemic transformation facility, which entails greater risks because of lower conditionality. This is echoed by Mr. Kiekens, who states that the risk picture would not be improved by the recently proposed creation of a short-term financing facility and a currency stabilization fund. Mr. Newman draws from all these observations the correct conclusion in arguing that we would be skating on thin ice in subjecting taxpayers' money to less risk assurances than those provided to private creditors.

Let me single out only two or three other factors. The staff indicates, for instance, that credit to the two largest borrowers could amount to 57 percent of total credit outstanding in FY 1996. It should also be taken into account that not all of the largest debtors of the Fund have already undertaken strong adjustment efforts. The performance of some of them seems to be rather mixed, if not mediocre, and credit to members whose programs have gone off track is projected by the staff to increase considerably. Moreover, progress thus far under some ESAF and STF arrangements appears uncertain at best.

A number of Directors have pointed out that the amount of total precautionary balances as a proportion of total credit outstanding, presently about 10 percent, looks fairly comfortable. I have some difficulty to see the rationale of this concept, because I think that it is difficult to apply a general reserve ratio to both credits for which risks have already materialized and credits for which no particular risks are yet discernible; at least, such an approach would be highly unusual in commercial financial institutions. To illustrate the weakness of this

concept, one only has to imagine a situation in which the volume of credit outstanding to members in protracted arrears were to grow to a point where the amount of reserves to be held against such arrears would exceed total precautionary balances, a situation quite conceivable in a context in which the Fund's exposure vis-à-vis two member countries could soon exceed 50 percent of total credit outstanding. In other words, if the failure of one major debtor could wipe out total precautionary balances, then the size of such reserves in comparison with total credit outstanding obviously becomes less meaningful.

Therefore, we share the staff's assessment that the increased and increasing riskiness of the Fund's portfolio argues for at least maintaining the current rate of accumulation of the Fund's precautionary balances, if not increasing the rate of accumulation. While, in our view, the objective factors demand an increase in the rate of reserve accumulation, we could agree to a continuation of the current policy to accumulate precautionary reserves if that would facilitate the establishment of a consensus among Directors.

Let me deal now with a few related issues. Since the current balance of SCA-2 exceeds the projected use of GRA resources to finance the encashment of rights, we are prepared to support the proposal to discontinue further additions to SCA-2. In this context, we could also accept a reimbursement of SCA-2 contributions to debtor countries in order to restore the originally agreed ratio of contributions to the SCA-2 between debtors and creditors. However, we would have difficulty in consenting to more far-reaching proposals, such as the reduction of the net income target, the diversion of SCA-2 contributions to SCA-1, or a merger of both special contingent accounts.

Since the main objective of precautionary balances is to protect the Fund against possible loan losses, the Fund should as a general policy strengthen open reserves, because they are permanently at the Fund's disposal. Special contingent accounts, as compared with reserves, have a more temporary character, serve special purposes, and are, therefore, less suitable to protect the Fund against financial risk.

Turning to the Managing Director's proposal for a modification of the present system of financing the Fund so as to reflect, to the extent possible, the principles underlying the uniform norm before an amendment of the Articles could come into operation, I can be rather brief. This chair supports a reform of the financial structure of the Fund based on a uniform but variable norm, but we believe it would not be advisable to adopt an interim solution. Arguments against such an approach have been spelled out on various occasions, and I do not need to repeat them here.

Therefore, I would like to recommend that, as stressed by many Directors at earlier meetings (EBM/95/1, 1/6/95; and EBM/95/2, 1/9/95), we concentrate our efforts on a genuine reform based on the uniform norm.

Finally, concerning gold, I support the staff's cautious position. Since gold holdings are an important element of the Fund's financial integrity, any considerations of using the hidden reserves in the Fund's gold holdings, through the sale of gold or other transactions, should be approached with utmost caution.

Mr. Newman noted that Mr. Schoenberg had argued that precautionary balances were too low, but that the Fund should in effect refund about SDR 700-800 million in SCA-2 balances rather than merge them into SCA-1. He wondered why Mr. Schoenberg would object to a merger of SCA-2 into SCA-1.

Mr. Schoenberg observed that any process of reimbursing contributions made to SCA-2 to the original contributors could be stretched out over a period of time, and would not therefore conflict with the general objective of increasing the Fund's precautionary balances.

Mr. Shields remarked that Mr. Schoenberg's suggestion to reimburse the debtors' share of balances in SCA-2 appeared to be limited to the counterpart to the shortfall in creditors' contributions to SCA-2.

Mr. Schoenberg replied that Mr. Shields' understanding of his suggestion was correct.

Mr. Newman commented that Mr. Schoenberg appeared also to object to the merger of SCA-2 into SCA-1, which implied that the remaining SCA-2 balances would be fully refunded.

Mr. Berrizbeitia made the following statement:

I would first like to commend the staff for its very clear and well-balanced presentation of the complex subject at hand, which has implications not only for the review of the Fund's precautionary balances, but also for the more general issue of reforming the financial structure of the Fund.

The staff paper presents convincing evidence that the Fund has substantially strengthened its precautionary balances, while reducing at the same time credit to members in arrears. The relevant ratios and other quantitative variables show general improvements and satisfactory levels. Thus, I can agree with Mr. Wijnholds' statement that "the overdue correction of earlier, inadequate levels of precautionary balances has probably been largely achieved as of this moment." The implication is that current balances are adequate; the issue is whether the current rate of accumulation will continue to be adequate into the future.

As we look forward on this issue, two newly relevant factors need to be contrasted with the progress made during the past few years: these are the rapid increase and the expected increase in Fund credit, and the increasing credit concentration among a few member countries. These issues are well discussed in the staff paper and succinctly and appropriately treated by Mr. Clark, so it will suffice for me to say that these factors argue against a decrease in the current rate of accumulation of precautionary balances at this point in time.

Therefore, without prejudging in any way the strength of the adjustment programs being adopted by members that are making a large use of Fund resources, nor the effectiveness of the related conditionality, I would agree with Mr. Clark, Mr. Kiekens, and others on the convenience of maintaining the current rate of accumulation.

At this point in time, I do not consider it necessary to increase the rate of accumulation to precautionary reserves as suggested by other Executive Directors. Although round numbers such as 10 percent of outstanding credit and 4 percent of free reserves are attractive, they should be viewed over longer periods of time than one fiscal year. The current rates of accumulation have provided the Fund with a satisfactory level of precautionary reserves, and will probably continue to do so over time, even under the current changed circumstances. We should therefore give ourselves the necessary time to observe the behavior of the relevant ratios during at least one fiscal year, before considering any decision to increase the rate of accumulation.

I also agree with the discontinuation of additions to the SCA-2, and with the staff's suggestion that the shortfall of contributions from creditor countries be added to SCA-1.

In this context, it could be considered that the corresponding proportion of debtor contributions to SCA-2 would also be transferred to SCA-1, thereby balancing the contributions of both groups of countries from SCA-2 to SCA-1. However, as suggested by Mr. Newman, if the merger of SCA-2 into SCA-1 is not as difficult a proposition as is generally thought to be, I would not oppose the idea.

On the related subject of the method for determining the rate of charge, I would point out that it is a moot issue to discuss the possibility of establishing a surcharge under the current system. This is the case because the burden sharing for SCA-1 is currently established on a 50/50 basis, and the net income target is basically financed through the rate of charge anyway. Hence, a surcharge could only be applied if a decision is taken to change the current cost structure of the Fund.

As regards the broader issue of burden sharing and the reform of the financial structure of the Fund, I wish to reiterate this chair's position that, in general, the distribution of all nonoperational costs should be shared on the basis of quota shares. This would ensure the greatest degree of equity, transparency, and simplicity, and would establish the closest possible relation between the rights and responsibilities of all members on the basis of their respective quotas.

Therefore, I will support the adoption of an adjustable uniform norm, according to which contributions would be proportional to quota shares, when the matter is again brought to the consideration of the Board. I would not, however, agree to a surcharge, which--as indicated by Table 3 of the staff paper--would imply a very significant shift of cost distribution between debtors and creditors, and would also detract from the greater degree of equity embodied in the adjustable uniform norm. In light of the cooperative nature of this institution and of our confidence in the Fund's conditionality process, I would also oppose any supplemental surcharge applicable to some members, as suggested by Mr. Newman.

Nonetheless, if it were absolutely necessary to adopt some kind of a surcharge in order to achieve an overall more equitable financial structure for the Fund, I would be prepared to consider it, if it were small and rebatable, so as to ensure that any differential contribution to burden sharing--differential with respect to that which would prevail under a system based on quota shares--would only be of a temporary nature. In this context, Mr. Newman's suggestions could be useful in exploring an appropriate rebate mechanism.

Finally, the adoption of an adjustable uniform norm would probably imply significant changes in the distribution of costs among individual members, although not necessarily between debtors and creditors, as indicated by Table 3. Given that these changes may make it difficult to adopt the adjustable uniform norm, it could be desirable to develop a transitional process to put it into practice, perhaps over a period of two or three years. Hopefully, such a transitional process could be put into practice progressively, even before the required amendments were adopted by the member countries, as suggested in the Managing Director's proposal for a modified system.

Mr. Fukuyama made the following statement:

The Fund's precautionary balances have been strengthened in recent years. Credit to members in protracted arrears now accounts for a smaller share of total credit outstanding and is covered more than fully by precautionary balances. At the same

time, however, credit concentration among a few member countries is projected to increase further, and demand on the Fund's credit will continue to increase in the near future. Thus, both positive and negative aspects are observed in the staff paper. Under such circumstances, it is not easy to make a decisive assessment on the adequate level of the precautionary balances and the rate of the accumulation. Therefore, I prefer that we monitor the developments in the credit expansion and maintain the present method, at least for the time being.

On the idea that contributions to SCA-2 should be terminated and the shortfall of contributions by creditors should be paid to SCA-1, I more or less understand the objective. However, as SCA-2 was established to finance the encashment of rights under the General Resources Account following the completion of a rights accumulation program, I understand that contributions of both creditors and debtors will be refunded to them in accordance with the ratio of their contributions after the completion of the encashment of rights. Once the shortfall of contributions by the creditors is paid to SCA-1, in light of its perpetual nature, these contributions may never be refunded to the creditors. In this case, an equity issue between creditors and debtors seems to arise. I think this is the point that Mr. Newman made in his statement. I would like to check whether my understanding is correct. For my reference, I would also appreciate the staff's view on whether or not a partial, but uniform, refunding of contributions to SCA-2 is possible if creditors continue to contribute to it.

Regarding the interim measure of modifying the present system, I recall that at the previous Board discussion, negative views for the interim measure were predominant. I have not observed major changes since then. What we must do is accelerate examination of the norm.

Mr. Newman noted that as contributions to SCA-2 were to be made in a ratio of 3:1, a merger of SCA-2 and SCA-1 implied that creditors would be making a larger contribution to the permanent reserves of the Fund, forgoing their much larger refunds. In his statement, he had recognized the implied cost of a merger for creditors, which his authorities were willing to accept in the interest of strengthening the Fund's overall precautionary balances. Maintaining those balances in the Fund--rather than refunding them, only to have to recoup them in the future through a new mechanism--would seem to be a preferable way of building the Fund's precautionary balances.

Mr. Schoenberg, following up on a comment made by Mr. Fukuyama, agreed that issues of legality and equity had to be taken into account in considering his proposal to reimburse certain SCA-2 contributions. His authorities would be inclined to consider such a possibility in order to facilitate the

agreement of debtor countries on a continued strong pace of reserve accumulation.

The Deputy General Counsel said that, in responding to the question raised by Mr. Fukuyama whether a partial refund of SCA-2 balances would be possible, it was necessary to bear in mind the distinction between balances already held in SCA-2 and the accumulation of an amount equivalent to the shortfall in contributions to that account. With respect to balances already held in SCA-2, as explained on previous occasions, all balances in that account would be refunded automatically to contributors when all repurchases had been made with respect to purchases for the encashment of rights following a rights accumulation program. In addition, the Board could decide with a 70 percent majority that all or part of those balances were no longer needed and that SCA-2 balances should be reduced. It would not be possible, however, to change the distribution key for a refund of the balances held in SCA-2. The necessary finding by the Board would be based on whether the balances were needed, in light of the purposes of SCA-2, not whether they were needed from a particular group of contributors, such as debtors or creditors.

Mr. Geethakrishnan made the following statement:

Basically, we need to look at this issue on two different levels. As Mr. Newman has pointed out in his statement, the first is the requirement per se, that is, to what extent we need precautionary balances to protect the financial integrity of the Fund and to protect the interests of those creditors to the Fund that have made the funds available. The second is how we raise funds and finance these precautionary balances.

As far as the first aspect is concerned, we have traditionally looked at it on the basis of the need or the demand after it has arisen. In other words, whatever we did was on the basis of the strengthened arrears strategy, not as sort of an advance precautionary arrangement; but then we said that this is the kind of arrears that has developed, so we need to have this arrangement.

When we go back to 1985, when all these major changes took place, we compared ourselves with other international institutions. At that stage, we found that the Inter-American Development Bank was close to a ratio of precautionary balances to total lending of 45-49 percent; the Asian Development Bank was close to 30 percent; the BIS was close to 21-27 percent; whereas in the Fund the ratio had come down to 3.4 percent. Naturally, we became worried about it. We then instituted a higher net income target. We set SCA-1 at 5 percent. Later on, for different reasons, we also brought in SCA-2. When we go back to 1985, we find that these higher levels of precautionary balances were necessitated because arrears were increasing. Also, we found that

in comparison with various institutions all over the world, our own reserves were at a very, very low level.

Today, when we look at the staff paper, we find that there has been a change in our situation. We find that today we are comfortable, whatever yardstick we use. Basically, we have about SDR 3 billion as our total reserves in the various accounts and, when we look at it in terms of arrears, we have a cover of more than 100 percent, and for the amounts that are not in arrears, we have a healthier cover than do most of the other institutions. If we look at it that way, there is definitely a case for moving slowly in the buildup of precautionary balances. Whether we reduce the net income target or abolish it, or reduce SCA-1 from 5 percent to a lower level, including zero--these are matters of arithmetic that can be discussed. Provided there is a consensus, a view can be taken.

However, we have to recognize one thing. If I can make a totally inappropriate comparison, it is like the Barings Bank of the previous 70-80 years, a very leisurely and gentlemanly bank, which was totally conservative; and then Mr. Leeson entered, and the whole ball game changed. If we look at the Fund, we have generally been lending less than SDR 6 billion a year. Suddenly we find that in the latest discussion about the demand for Fund credit, overnight we are talking in terms of even \$28 billion. When we look at the projections, we find a demand of \$21 billion in 1995 and \$10 billion in 1996.

We have demonstrated our ability and flexibility to meet new challenges. We have done it at the time of the oil crisis, at the time of the debt crisis, and at the time of the breakup of the Soviet Union. We have now done it when Mexico ran into major problems. Today we are talking in terms of our total liquidity position of SDR 60 billion being inadequate. However, if we look at the staff paper, we find that the net increase in credit outstanding was never more than an increase of SDR 1 billion a year in the last five years--that is all.

If we are projecting on the basis of the past, then the SDR 60 billion should last for the next five generations. However, we are a little worried. We find that we need to augment our resources; and what are all the ways? That is one major and drastic change in the rules of the game. We are no longer talking in terms of the past levels of lending. We have moved on to a much higher plateau of lending, and we are projecting much larger increases.

The second development is that, when we look at the geographical distribution of our lending, you will find a major shift again. We have moved away from the traditional

Asian/African/Latin American countries to Europe. We find that geographically there is a large concentration in a particular area. Maybe it is good; maybe it is bad. Maybe it is good because all those countries have similar problems; maybe they could all successfully tackle them, in which case it is very good for us. Maybe it is bad because they could come up with the same problems and they could have the same difficulties. We also have the systemic transformation facility as an instrument that, by definition, is front-loaded with minimum conditionality. It also follows that it carries more of a risk than the other facilities. We want to extend the systemic transformation facility and increase access.

I am drawing attention to all these things merely to point out that the rules of the game have totally changed in the last two years. It would be totally inappropriate for us as an organization to take a view on what should be the level of precautionary balances, whether we are comfortable or not, based on the past, on the grounds that the only experience that we have is the past. If we look at the past, we are very, very well off. We can afford to be generous. We can reduce all the percentages. But when we look at the future and the likely risks, some people may feel more panicky and may ask for a substantial increase in numbers. Others may feel less panicky and suggest that we wait and see what happens before taking a view.

On this net income target and the SCA-1, my view is therefore very simple. If we look at the past trends and today's position, there is definitely a case for a reduction. If there is a consensus, we can reduce the numbers. But it should be with the explicit understanding that there will be an automatic increase, at least up to the present levels, if the situation should warrant it in the near future. We should not then be compelled to come back to the Board for a decision requiring a 70 percent majority, or a 50 percent majority, and so on, because the Fund's interest and the interest of the creditors to the Fund should be paramount. If there is going to be a reduction in these numbers, I would go along with that, provided there is a simultaneous decision that there will be automaticity in increasing it back to the present levels, should the need arise in the near future.

As far as SCA-2 is concerned, the concerns that I have are totally different from the concerns that are discussed in this staff paper. We created SCA-2 specifically to meet the contingency of default by 11 countries. The creditors were very generous in agreeing to a 3:1 ratio in these contributions. We are now reaching the end of this fund. It has served its purpose. The purpose is not so much the use of the resources in this fund but the availability of the resources to give confidence to everyone.

To the extent that there is a surplus in this fund, and to the extent that it is not required by these countries--as Mr. Schoenberg said earlier, this can be determined only over a period of time--I can be totally flexible on what to do with the surplus, whether we merge it with SCA-1 or refund it to the creditors and debtors that have made this fund available. If I have any preference, it would be for a refund, for a very simple reason. At one stage, we wanted to build up a fund. The creditors were very generous in offering to contribute in a 3:1 ratio. That generosity should not be abused. We should keep faith with them. We ran to them when we had a problem. We made them contribute three fourths of it. If today we find that it is an excessive requirement and refund it to everybody who has contributed, we keep faith. But I am not rigid on this. The problem that I have is totally different. We have been talking a lot about multilateral debt in this organization. We never believe that charity begins at home. We tell the Paris Club that it should not only reschedule but also forgive the loans due. We have even gone to the extent of saying that, for some countries, there should be 100 percent loan forgiveness; the average itself has gone up to 66 percent.

But when it comes to the question of multilateral debt we say "no, no, no, we cannot reschedule anything unless we are compelled." If somebody says "I cannot pay you," then we are willing to wait. Otherwise, by definition, we cannot reschedule. We cannot forgive loans because it is not in our Articles of Agreement. More than that, we have a preferred creditor status. I have a suggestion for the Managing Director and this Board. Maybe, as usual, I am talking through my nonexistent hat.

My suggestion is very simple. If we find that in SCA-2 we have a large accumulation that is in excess of the requirement, can we make it into an SCA-3 for supporting multilateral debt reduction? If we find that this SDR 1 billion in SCA-2 is a surplus to the requirement, and all those who have contributed to SCA-2 are willing to let it remain with the Fund, then we can use it for supporting a group of countries, say, the sub-Saharan countries, for whom everybody sheds tears but when it comes to the actual, practical, nitty-gritty we do very little.

The SCA-2 was started after arrears had commenced, but can we make it into an SCA-3, where we say, before new arrears have commenced, that we will use it as a fund? Let us take a classic group of countries like the sub-Saharan countries, where, instead of formal rescheduling, instead of forgiving debt, we use such a fund the same way we used SCA-2, namely, if you owe monies to the Fund, you will not have to pay it; we will give you time; we will still make you eligible for further borrowing. I think that this would establish our bonafides with extremely poor countries at a time when we are pressing the bilateral donors and the private

sector to do their bit. I think we should also chip in with something. We do not have to forgive the debt.

I am not unduly worried about the legal aspects of whether it can be done or not, because the legal aspects flow from the rules of the game that we, the owners, put down for this organization. If all the owners, all those countries that contributed to SCA-2, are convinced that, yes, it is a worthwhile thing, then nothing prevents us from recording a decision that the surpluses in SCA-2 will be automatically transferred to SCA-3, which shall be used as a mechanism for providing relief to any group of extremely badly off countries before they start defaulting. This is only a suggestion. But I think that this is one way in which we can contribute to the resolution of this problem, apart from mere lecturing to the others about what they should do.

Then we come to the question of financing. Here, we have been looking at basic changes in financing. There are suggestions that we should go in for a uniform variable norm and that there should be a surcharge. From the statement on page 22 of the staff paper, I take it that what is relevant is that, for the net income of 5 percent of reserves and SCA-1 of 5 percent of reserves, the present share of the debtors is 18.1 percent and 21.7 percent, under the two formulations. When we move on to the adjustable uniform variable norm with surcharge, the debtors' share goes up to 50 percent.

I can accept a point that I had made earlier, that is, when we want to change for the sake of simplicity, for the sake of transparency, we should all be prepared to have some change in our level of contribution. On the other hand, if that change is going to result in a drastic change either for the debtors or for the creditors, I am afraid that I, at least, will not be able to support it.

A point is often made about the question of what is equitable and what is not equitable. My answer is very simple. Equity always starts with a given position, not at an absolute level. I can give an illustration. If a country that is a borrower from the Fund with a major problem wants to introduce a school meal program for the disadvantaged, and let us say \$1 billion is being set apart, then I am sure every chair here in the Fund and management will say "stop, we cannot do that." On the other hand, in the United States, for the same program, we find not only that the U.S. President does not say "no" to that, but also that he is willing to go and join the same meal program-- and we see it on television.

So, there is no such thing as absolute equity. Equity starts at a given level. Today, in this organization, we have a certain

pattern of sharing in the cost, support, and advice that we give. When we make drastic changes, that equity balance is upset. I find that when we talk in terms of the surcharge model, the balance is totally upset. So, I will not be able to support it at all. If we are able to come up with an arrangement that will protect the precautionary balance requirement of the Fund, and is necessary from the creditors' point of view, then let us look at the total pool of costs and come to a new arrangement for sharing. If it does not change the balance substantially, I can support it.

I would find it equally difficult to support an arrangement under which the total cost requirements were artificially made too low. This is a point that I made right at the beginning of the debate on reform. Today it is possible to argue that we do not require SCA-1, SCA-2, or the net income target, in which case the totality of the funds to be raised is merely the administrative overhead of the Fund, perhaps SDR 300 million or SDR 350 million.

If we must have only such a limited funding arrangement, then it is possible to come up with any number of formulas that all 24 chairs can support, because in relation to our absolute contribution today, it will be much less of a burden. But that will again be elusive, because two years later the Fund will come back and say we need to have an SCA-1, SCA-2, or SCA-3. So, I would like us to determine before we want to change the rules of the game as far as the financing, or "picking up the bill," is concerned--we must be clear that we are not going to make the Fund worse off; we are not going to increase the risk for the creditors.

If we are going to change the sharing pattern, if the change is not large, I can support it. If the change is large, I cannot support it. Today, as I see it, the change is very large. That is why I am saying I cannot support the surcharge model. As I do not support it, the question of my making any comments on the modified system does not arise, because the modified system is only an interim arrangement. So, I would not even like to comment on the interim arrangement.

The Chairman said that Mr. Geethakrishnan's suggestions for utilization of SCA-2 were very interesting. Indeed, Mr. Geethakrishnan might have found a fruitful route to addressing the issue of multilateral debt, which had been discussed in the Board most recently on February 24, 1995 (EBM/95/19). Moreover, his suggestions echoed the as yet unfulfilled aspiration of his predecessor, Mr. Arora, on voluntary contributions.

Mr. Schoenberg remarked that he, too, was extremely interested in Mr. Geethakrishnan's interesting proposal on financing debt forgiveness in respect of multilateral debt. There were, however, some important issues involved in considering debt forgiveness by the Fund, which would need to be considered carefully. For example, the Fund, unlike commercial creditors,

did not apply a risk premium and lent on concessional terms. Another argument was that in following the approaches taken by other creditors, the Fund would risk undermining its preferred creditor status.

The Chairman proposed that the suggestions made by Mr. Geethakrishnan be examined to determine whether they could be reconciled with the basic principles mentioned by Mr. Schoenberg and the points that had been underlined at EBM/95/19 on the problems of countries overburdened by debt.

Mr. Autheman agreed that Mr. Geethakrishnan's suggestions were very interesting, but he shared Mr. Schoenberg's concern about placing those ideas under the umbrella of multilateral debt reduction. In that context, it was interesting to note that SCA-2 balances were in excess of need in part because the members directly affected were in fact ESAF-eligible countries. He wondered, therefore, whether some consideration might be given to using SCA-2 resources to strengthen the ESAF.

Mr. Geethakrishnan said that he would have no problem with Mr. Autheman's suggestion. In making his proposal, it had occurred to him only that the Fund had at its disposal surplus resources that could be used to support the poorest of the poor among its members; various options for using those resources could be envisaged.

Mr. Newman commented that Mr. Geethakrishnan's suggestions were certainly imaginative, and he would be interested in his elaboration of the details. Presumably, the legal problems surrounding a refund of SCA-2 balances or a merger of SCA-2 with SCA-1 would apply equally to Mr. Geethakrishnan's proposal.

On Mr. Geethakrishnan's argument about the need to avoid abrupt changes in the relative shares of members in the financing of the Fund, those issues had been discussed at length on previous occasions, Mr. Newman recalled. Of course, those discussions had been based on the presumption that the current system was sustainable, and that members would be willing to continue financing an increase in precautionary balances on an exceptional basis. At a time when members were being asked to provide additional resources to the Fund, however, it was worth asking whether the current system was in fact sustainable.

Mr. Shields said that he shared the interest of others in the very interesting suggestion of Mr. Geethakrishnan on the possible uses of the resources in SCA-2. Obviously, his chair could support anything that could be done to assist the poorest countries, particularly those with a high multilateral debt burden. The idea of using SCA-2 resources as a means of improving existing ESAF arrangements--by extending them, for example--was well worth exploring. The issue was not debt forgiveness, of course, but assistance to countries in particular difficulty.

On another point, Mr. Shields continued, he was somewhat struck by the suggestion of Mr. Tulin that maintaining the current net income target of

5 percent of reserves might send an adverse signal to the markets, and the related point made also by Mr. Geethakrishnan that the net income target could be reduced to 3 percent, subject to an upward adjustment if necessary. In his view, such an approach would be risky, because the reaction of the markets was likely to be especially sensitive at precisely the time when the Fund would need to decide whether to increase the net income target. Moreover, in the light of recent developments in the size and concentration of Fund credit, it was unlikely that the markets would expect the Fund to reduce the rate of accumulation of precautionary balances. A better approach would be to send a signal that indicated that the Fund was aware of the situation and that it was not yet prepared to make a change in the rate of accumulation.

The Deputy General Counsel stated that two conditions would have to be met in order to put into effect a proposal to merge SCA-1 and SCA-2. First, either the criterion for refunding SCA-2 balances would have to be met or the Board would have to decide to dissolve the account or reduce the amount held in it. Second, each individual contributor would have to instruct the Fund to transfer the relevant amount to SCA-1.

The same issues would arise under Mr. Geethakrishnan's proposal, the Deputy General Counsel commented. Thus, in order to satisfy the first condition, either the criterion for automatic refunding of SCA-2 balances would need to be met or the Board would have to decide that the balances in SCA-2 were no longer needed in the light of--to take Mr. Autheman's suggestion as an example--the view that the protection was provided elsewhere. The necessary decision would require a 70 percent majority. The second condition would be satisfied by obtaining the consent of each contributor to transfer the amount to be refunded to, for example, an existing or new administered account or a trust, under which the transferred resources would be used to further the purposes of the Fund. The proposal made by Mr. Arora several years previously had envisaged a similar technique for voluntary contributions.

Mr. Kaeser agreed that it would be useful to convert SCA-2 into some kind of debt-reduction facility or as a means of strengthening the ESAF, although he understood the concerns of some Directors in that regard. Indeed, claims on SCA-2 were for the most part claims of central banks. For most members, a conversion of SCA-2 would be akin to transferring the central bank's monetary claims for development aid purposes. Thus, a situation could arise in which the central bank provided capital for an ESAF-type instrument while the interest subsidy would be provided through the budget, which could cause legislative problems for many countries.

Mr. Geethakrishnan remarked that the legal issues that had been mentioned were not insurmountable. The primary issue was essentially one of policy; if the Board decided on a particular policy approach, the appropriate legal instruments could be found.

Mr. Newman said that he did not share Mr. Geethakrishnan's optimism on the ease with which the legal obstacles to his proposal could be overcome. From the perspective of domestic politics, presenting a proposal such as that of Mr. Geethakrishnan would raise complex issues of an entirely different order than merely arguing for the conversion of one type of precautionary balance into another.

The Deputy General Counsel noted that the legal issue that would arise in putting Mr. Geethakrishnan's proposal into effect was, as alluded to by Mr. Kaeser, an issue to be addressed within the context of national law and national procedures. Each contributing country would have to decide whether it was entitled to transfer resources along the lines suggested by Mr. Geethakrishnan. The Executive Board could not take those decisions.

The Treasurer remarked that Mr. Geethakrishnan had referred to the use of the surplus in SCA-2, namely, the surplus in excess of what the Board would regard as needed to maintain SCA-2 to cover the credit outstanding to members that reflected the encashment of rights through the General Resources Account. There would be a continuing need for balances in SCA-2, of course, because there was at least one member that had drawn GRA resources to encash rights, and other members could in due course encash rights to the General Resources Account, rather than under the ESAF. Thus, the surplus currently corresponded approximately to the amount that had not yet been accumulated in SCA-2, and could be run down only over time. The legal issue to be resolved, therefore, was whether a reduction in remuneration could be transferred under both national law and the Articles into an administered account. That issue would need to be examined carefully, because at least SDR 700 million would have to remain in SCA-2 until the Board decided that the problem of overdue obligations that had given rise to that account no longer existed.

Mr. Coumbis made the following statement:

During the Board's last consideration of reforming the financing of the Fund's operation, this chair expressed the idea that, as the precautionary balances had reached a comfortable level, we might consider a reduction in their rate of accumulation in order to facilitate, to a certain extent, the solution of the problem of distributing the cost of the accumulation of precautionary balances between debtors and creditors.

All of the indices presented in the staff document on precautionary balances support the hypothesis that the level of reserves is still satisfactory. Thus, Fund precautionary balances projected for the end of April 1995 will equal twice the amount of credit outstanding to members in protracted arrears and about 10 percent of total outstanding credit. All the other indices--arrears as a proportion of Fund credit outstanding and free reserves as a proportion of credit to members neither in arrears nor under the rights

approach--are relatively high on a historical basis and validate our argument that the level of precautionary balances is satisfactory.

The staff report, however, because of some recent developments in the Fund's lending activities, indicates that a more dynamic approach may be needed, in considering the problem of the level of the Fund's precautionary balances. In fact, a substantial increase of Fund credit is taking place in 1995 and is expected to continue in 1996. This means that the ratio of precautionary balances to total credit will decrease as indicated in Table 2 to about 9 percent and will probably reach a lower level. Moreover, at the end of the current financial year it is projected that about 25 percent of Fund credit will be extended to one member and about 12 percent to another. Approximately 60 percent of credit outstanding will be assigned to the Fund's five largest debtors. This trend will continue into financial year 1996 where the two largest borrowers could owe the Fund 57 percent of its total outstanding credit. There is no doubt that the concentration of Fund credit to just a few borrowers has increased substantially recently, and even further in 1996, which means that the riskiness of Fund credit has increased; this fact points in the direction of increasing reserves.

More serious in that respect are recent disturbances in developing countries' money markets indicating the insecurity of financial investors in these countries and their extreme sensitivity to rumors as well as political and economic developments. This means that foreign capital in certain areas is too hot and ready to go to safer places, thus creating major problems in the abandoned countries. Thus, we cannot exclude, in the near future, the possibility that the Fund will be obliged to face cases similar to the Mexican one. I agree with Mr. Wijnholds that it is important for the Fund's membership as a whole to maintain a sufficiently strong financial buffer. I also agree that the Fund as a monetary institution should, in matters of financial integrity, tend to err on the side of caution and not on the side of laxity. On that grounds, I cannot recommend any further reduction in that rate of accumulation of reserves--even a modest one. However, I will not go as far as Mr. Wijnholds in proposing an increase in that rate. I believe that the current rate is sufficient to guarantee the Fund's financial integrity.

As to determining the rate of charge for 1996 and the distribution of prudential expense between debtors and creditors, during the Board's last discussion on reforming the financing of the Fund's operations, we expressed the view that a part of the risk-related costs should be attributed to members making use of the Fund's resources. However, we added that in order to achieve a compromise solution, we could accept the size of the risk premium close to the burden-shared amount borne now by debtor

countries. With respect to SCA-2, I agree with the staff proposal to discontinue the accumulation of resources to SCA-2 except for the shortfall of contributions by creditors which the staff proposes be part of SCA-1. A merger of the two SCAs appears to be possible only with the agreement of each contributor which is a difficult and time-consuming procedure. At this point, I would like to reiterate our reservations expressed in our last Board meeting about introducing a transitory, modified system of financing the Fund's operations.

Mr. Waterman made the following statement:

I would like to thank the staff for a very clear paper, and particularly for the quantitative work that has been done, but I think the discussion this morning underlines that the quantitative work can take you only so far. At the end of the day, there is a good degree of judgment involved in assessing the adequacy of precautionary balances. We have reached a point where we are basically debating whether total reserves should be one percentage point or so off a benchmark of 10 percent of total lending. I am inclined to favor a lower rate of accumulation than some speakers. But it is important that the debate on the numbers not blur our view of what I think is the more important underlying issue, namely, is program performance and effectiveness.

In coming to a view on reserve adequacy, I am inclined to put some weight on the Fund's experience over a 50-year period in which it has not written off any loans, and also the experience of recent years. We have demonstrated that we can build precautionary balances quite quickly. In saying that, I recognize there is a risk that we will need to write-off some loans in the period ahead, but in general there is a great incentive for member countries to maintain a good creditor status with the Fund, and I think we need to do everything to ensure that remains the case.

As some others have noted, the supporting calculations on precautionary balances do not allow adequately for the Fund's holdings of gold, which to my mind must bear on the assessment of the adequacy of precautionary balances. There is a valuation issue here, but clearly the current market price is a much better guide to their value than the historical figure. When gold is allowed for, the current reserve position looks fairly comfortable to me. I think this point is relevant when we start making comparisons with other international organizations.

On the other hand, I think we all accept that there will be a substantial expansion in lending in the next year or so, and our liabilities will be concentrated in a limited number of countries. But if we are really concerned about that, maybe we should think a bit more carefully about the total lending to those countries and

the conditions, including the rate of charge attached to the loans. In this context, I can strongly support moves to implement intensive surveillance and improve reporting requirements on the very large borrowers, including the introduction of regular but brief information reports to the Board.

Our main insurance in respect of these loans should be the policies that they are supporting. In terms of potential risks in these countries, it is also relevant that the lending will be to countries that, despite all their problems, are better off than the poorer member countries. If we want a high rate of reserve accumulation because of this prospective concentration of lending, we could consider a higher rate of charge for the very large borrowers, as suggested by Mr. Newman. If it is possible, I would certainly be sympathetic to the idea of allowing any higher charge to be rebated.

Overall, I accept the case for some further reserve accumulation, but my objective would be a little more modest, and I would be more comfortable with a faster rate of accumulation if it was by way of large borrowers paying a higher rate of charge. In general, though, I would place greater weight on program quality and close monitoring of performance than the precise level of reserves.

Mr. Rouai made the following statement:

We had the opportunity during previous Board discussions to emphasize the need for assessing the adequacy of the Fund's precautionary balances before reaching a final decision on reforming the financial structure of the Fund. In this context, we consider that the staff paper prepared for today's discussion provides a candid and objective assessment of the level and adequacy of precautionary balances held by the Fund. Specifically, Table 1 in the attachment to the staff paper clearly shows the dramatic improvement in the indicators of coverage against risks provided by the increasing consolidation of various reserves held by the Fund. This improvement is the direct result of the dual strategy adopted by the Fund to consolidate reserves through the increase in the net income target and the subsequent creation of SCA-1 and SCA-2, while implementing a collaborative policy to help countries in arrears normalize their financial relations with the institution. This strategy received the support of the membership with the understanding that the temporary additional financial burden imposed on members would be eased, and eventually eliminated, with the improvement in the arrears situation.

When reviewing the level of precautionary balances and the various relevant quantitative ratios, the staff concludes, "in

general, each of these ratios could be considered relatively high and substantially in excess of the share of arrears to credit outstanding on a historical basis." On the basis on this conclusion and other objective assessments reached recently by the Board with regard to the level of precautionary balances and the success of the arrears strategy, we reiterate our call for a slowing down of the speed of accumulation of reserves. Our preference is to reduce the net income target to 3 percent as proposed by the staff, and also to adopt the same ratio with regard to the accumulation of reserves by SCA-1.

We would like to point out that even a reduction of the net income target to 3 percent of reserves, at the beginning of the year, would still provide for a continued accumulation of reserves at a rate much higher than that retained in 1981 when the formal net income target policy was adopted by the Fund. As the net income target is calculated using a variable with an increasing trend, namely, the level of reserves, 3 percent of reserves at the beginning of FY 1996 represents about 7 percent of reserves at the beginning of FY 1981. We would like the staff to comment on these figures and on the possibility of adopting a net income target based on an average of reserves during the preceding years rather than on the stock of reserves at the beginning of the year.

The staff and other Directors have raised the issue of the riskiness of the Fund's portfolio induced by the high concentration of Fund lending. We would like to make the following comments with regard to this issue.

Unlike other financial institutions, the Fund is a cooperative and collaborative international institution. As demonstrated during the emergence of the arrears issue, its members will certainly continue to exhibit readiness to provide financial support whenever the institution is confronted with a serious problem that could affect its financial integrity.

It is our strong understanding that the first-best strategy for shielding the Fund is not the accumulation of reserves but rather the adoption of effective surveillance and the design of comprehensive and strong programs that could help countries achieve and sustain balance of payment viability.

The staff points out that "any assessment of risk, and the related need for precautionary balances, must, inter alia, take into account the context in which the expansion of credit occurred." While we welcome this recognition, we would appreciate it if the staff could substantiate this conclusion. In any case, the recent increase in Fund lending is the result of difficult decisions taken by the Fund in response to exceptional circumstances and systemic considerations, with the understanding

that the Fund's preferred creditor status is reaffirmed and safeguarded by all members.

Since 1993, precautionary balances not only cover the total credit of members in protracted arrears but also result in the constitution of free reserves.

During previous Board meetings, this chair along with others, raised the issue of hidden reserves, including gold. We continue to believe that any assessment of the adequacy of precautionary balances should include a reference to gold. This is all the more relevant when the assessment of the adequacy of precautionary balances is based not on objective benchmarks but on judgmental elements as proposed by some Directors.

With regard to SCA-2, we can support a discontinuation of contributions after the creditors' shortfall is made up. We cannot support a merger between SCA-1 and SCA-2. The resources held in SCA-2 should be refunded to contributing members when no longer needed.

Finally, with regard to the financing of precautionary balances by members, we reiterate our position, namely, that these expenses should be distributed among all the members without adding a risk premium to the rate of charge.

Mr. Dlamini made the following statement:

I welcome this review of the Fund's precautionary balances and hope that it will lead to important conclusions that address the genuine concerns of the debtor members. This discussion could also have positive implications for future discussions on the reform of the Fund's financial structure. At this juncture, I would like to join other Directors in commending the staff's effort to objectively address the difficult issue of precautionary balances. I agree that protection against the risk of loss is essential for any lending institution. Precautionary balances have served this purpose in the case of the Fund, and I concur with the staff that the maintenance of sufficient precautionary balances should continue to serve as a general operational guide of the Fund. In this regard, it is noteworthy that, despite the large expansion in credit outstanding, the level of precautionary balances now covers about 10 percent of total credit outstanding, which, as the staff has indicated, is a relatively high ratio. Moreover, credit to members in protracted arrears since 1993 has been more than covered, and in 1995 the Fund's reserves and balances in SCA-1 will more than double the amount of credit outstanding to members in protracted arrears.

It is also important to note that the share of credit to members in protracted arrears in total credit outstanding is expected to fall to 3.7 percent at the end of FY 1995, from a peak of 13 percent in 1989, and it is anticipated to decline further to below 3 percent by FY 1997. These developments strongly indicate that a slower pace of accumulation of the precautionary balances is warranted. The policy could, however, be reviewed if new risks were to emerge or additional arrears accumulated or became protracted.

In this regard, I do not believe that it is appropriate to go beyond the present policy of covering the risk associated with credit outstanding to members in protracted arrears. In the first place, as indicated, the precautionary balances adequately cover the risks posed by members currently in protracted payment arrears. Moreover, there is no certainty that either members that are now current in meeting their obligations to the Fund or members that are prospective users of Fund resources will fall into arrears. Any attempt to project future risks could be misleading and might result in unwarranted increases in the rate of charge. In this context, I share the staff's view that the Fund's exposure to the risk of loss on credit extended to those members that continue to meet financial obligations as they fall due is likely to be low, or even minimal, compared with the risk associated with members in protracted arrears. In fact, the Fund's strengthened cooperative strategy has considerably diminished--through its preventive and deterrent aspects--the risk associated with protracted arrears.

It is encouraging to note in the staff paper that an increase in Fund lending has been associated with strong adjustment efforts on the part of members making exceptionally large use of the Fund's resources. Indeed, this is a welcome development, because the current and projected increase in credit outstanding is concentrated among a few member countries. I consider that the Fund's exposure to the risk of loss on credit extended to such countries can be contained, as the staff's discussions with the authorities on developments in domestic and external sector policies will help to identify early any emerging problems that could lead to delays in payments. Moreover, the present policy of reviewing annually the level of precautionary balances offers the Board a useful opportunity to take, in a timely fashion, any required remedial measures that may be required.

As stressed by this chair and several other Directors on previous occasions, the main protection for the Fund lies in the quality of the adjustment programs that support the use of its resources. It should also be noted that the maintenance of the Fund's financial integrity depends not only on the level of precautionary balances, but also on the Fund's gold holdings,

which at present are substantially undervalued in its balance sheet.

Mr. Geethakrishnan has made an interesting suggestion on the possible treatment of SCA-2. His and Mr. Autheman's amendment to the proposal deserve further consideration. We support the proposals, in view of the recent discussions on multilateral debt.

On the issue of the most appropriate method for determining the rate of charge for FY 1996 and thereafter, I can only suggest that we must seek a method that is simple to apply and maintains a rate that is as concessional as possible. I expect that this issue will be appropriately dealt with on the occasion of the forthcoming annual review of the Fund's income position.

Mrs. Cheong made the following statement:

Mr. Wijnholds' statement has outlined the need for the Fund to be prudent in ensuring that precautionary balances are sufficiently high to maintain a strong financial buffer. This assessment is based on recent developments that make it necessary to review the earlier perception favoring a slowdown in the rate of accumulation of precautionary balances. Indications are that the current level of protracted arrears will likely stay with us for a while. The staff has also drawn attention to the greater risk of Fund lending, as two countries will dominate 57 percent of credit outstanding. As the Fund cannot prejudge the credit risk of new borrowers without a "pattern of practice," the appropriate indicator of greater riskiness in the Fund's lending program appears to be the higher concentration ratio, which reflects more resources being lent to fewer countries. In this scenario, a conservative approach is prudent, and several Directors would favor a higher rate of accumulation of precautionary balances.

However, the basic question is whether the risk to the Fund is, indeed, higher because of higher concentration of lending. This chair has stated before that the increased risk is perceived, rather than real, mainly because of probable large lending to countries in similar economic difficulties. This perception ignores the role of conditionality in Fund lending. Any contention that greater lending would raise the risk of Fund lending would be self-contradictory as far as this Board is concerned. This contention would be interpreted as an indication that the Board has doubts about whether the programs will work to turn around these economies. At the same time, even if we can be sure that a program will work, political developments can disrupt program performance. However, as Mr. Tulin has pointed out, the management has a system to ensure that countries can recover over the medium term, through more frequent monitoring, and other means. In this light, the traditional assumption that riskiness

increases with higher lending concentration ratios is not really applicable to the Fund, with its current mode of operations. At the same time, prudent management dictates that the Fund should not subscribe to ad hoc measures, that is, lend large sums, then raise alarms of inadequacy of precautionary balances. If we subscribe to this practice, then we have to think of single borrower limits, and other considerations. Like Mr. Geethakrishnan, I do not feel that these new developments should raise alarm bells or require changes in the way we have been determining increases in reserves. However, I acknowledge that Fund lending is likely to be bigger in each case and, therefore, there is a need for the usual prudence. In this light, it may be best to maintain the current policy on buildup of precautionary balances, and on another occasion, to look at accelerating the buildup in the total resources through an early increase in quota, and other means. We should also, in the near future, examine how to factor in the role of gold in protecting the Fund's financial exposure.

On the method of financing of the precautionary balances, this chair has, in the past, been a strong supporter of burden-sharing and looks forward to more equitable sharing in proportion to quotas. This chair maintains the position that any surcharge, whether accompanied by a rebate or otherwise, should not increase the burden to be borne by existing borrowers under the burden-sharing formula.

On the special contingency funds, we will comment at a later stage, in the light of Mr. Geethakrishnan's latest proposal. I should add that we would, in principle, be supportive of this proposal.

Mr. Al-Tuwaijri made the following statement:

I join other Directors in commending the staff on this highly informative and interesting paper. The staff has made an excellent presentation of all the factors that need to be considered in deciding on the reserve accumulation targets for FY 1996. Table 2 in the staff paper was especially useful.

Based on the data presented in Table 2, the Fund's hidden reserves, and the substantial progress made on the arrears front, a strong argument can be made for reducing reserve accumulation even below the 8 percent option presented in the paper. Indeed, in the latter part of last year, this chair called for an early review of our reserve accumulation targets as indications mounted that we may have reached a comfortable level of reserves.

However, over the past few months, important developments that have a major bearing on our reserve strategy took place. Our

lending activity picked up substantially, the concentration of our loan portfolio rose sharply, and our liquidity ratio declined. All of these developments argue for increasing the current rate of reserve accumulation. The projected decline in the liquidity ratio increases the possibility that the Fund may have to borrow, should it decide to further increase its lending activities substantially. In this connection, I agree with Mr. Wijnholds that a strong reserve accumulation strategy plays an important role in enhancing the institution's ability to borrow.

On balance, and after taking all the above factors into account, I feel that the preferred course of action is to maintain our current rate of accumulation. It goes without saying that, regardless of the reserve accumulation target on which we agree, it is important to also agree, on a permanent basis, to treat both shortfalls and excess in income targets in a symmetrical fashion. This is not only fair but also logical, and should greatly reduce the acrimony in our annual discussions on precautionary balances.

Finally, this chair maintains its belief that the present system of financing the Fund operations serves the Fund well and there are no compelling reasons to change it.

Mr. Saito made the following statement:

I welcome this opportunity to discuss the issues related to the adequacy of the Fund's precautionary balances, and commend the staff for a very useful paper. As was pointed out by this chair during last year's discussion on this matter, the first point to consider is the unique nature of the Fund as an international financial institution. In this regard, the Fund lends only to members that agree to observe macroeconomic conditions consistent with medium-term balance of payments viability, which make the repayment of its external obligations possible. Second, the Fund maintains a preferred creditor status. Moreover, being current in meeting payments to the Fund is usually considered a prerequisite for access to other financial resources. As a result, the risks faced by the Fund seem to be low. Nevertheless, there are countries with protracted arrears, which indicates that some risks exists.

The current policy of precautionary balances follows two criteria: first, precautionary balances should fully cover credit outstanding to members in protracted arrears; and, second, such balances should include a margin for potential exposure to risk related to the outstanding credit to members current in meeting payment obligations to the Fund. As regards the first criterion, the current level of precautionary balances, namely, reserves and SCA-1, are sufficient to cover outstanding arrears and the ratio, reserves plus SCA-1 to outstanding arrears, is expected to remain

over 200 percent, beginning in 1995. The present arrears strategy has proven successful in reducing the number of members in protracted arrears, as well as the total outstanding balance. Moreover, the likelihood that all members currently in protracted arrears will not honor their obligations is low. Therefore, the current level of reserves and SCA-1 seems to offer appropriate protection against the risk of loss arising from an ultimate failure to settle overdue obligations to the General Resources Account.

Similarly, balances in SCA-2 currently exceed the use of GRA resources to finance encashment of rights. Although the aggregate amount of overdue obligations of the three remaining countries eligible to enter into rights accumulation program, if the program is to be further extended after end-April 1995, is substantial in relation to balances in the SCA-2, it appears unlikely to finance any encashment of rights accumulated by these countries from GRA resources. In these circumstances the Managing Director's proposal that further additions to SCA-2 be discontinued seems appropriate. Furthermore, this chair would have preferred consolidating the Fund's existing precautionary balances into reserves, to protect the Fund against all risks. However, given the difficulties in dissolving SCA-2 and adding its balance to SCA-1, this chair could also support a proposal that, in the future, the shortfall in contributions by creditors to SCA-2 would be paid to SCA-1.

Regarding the margin for potential exposure to risk related to total outstanding credit, in 1995 total reserves represent 11 percent of total outstanding credit and are expected to remain at about 9-9.5 percent in 1996 and 1997, despite the sharp increase of Fund credit expected in the next two years. Similarly, the level of free reserves is projected to continue to be about 4 percent of the remaining outstanding credit. Moreover, given the Fund's sizable hidden reserves arising from the undervaluation of the Fund's gold holdings, we view the present level of precautionary balances and their current rate of accumulation as appropriate cover against risk of current and projected increase in outstanding credit, which in any event would continue to be secured primarily by the quality and strength of the agreed adjustment policies. In this context, we do not consider it necessary to increase the rate of accumulation of precautionary balances. By the same token, given the sharp increase in Fund credit and the high degree of concentration of the Fund's portfolio among a relatively small number of members, this chair believes that a reduction in the rate of accumulation of precautionary balances is not appropriate at this time.

Finally, regarding the alternative methods of determining the rate of charge for FY1996, I agree with Mr. Kiekens that this

issue seems to be more closely related to the topic of "reform of the financing of the Fund's operation" than to the "review of the Fund's precautionary balances." From our discussion of the former topic on January 6, it was the feeling of the majority of the Board, that establishing an interim system of financing the operations of the Fund was not appropriate as it might result in a loss of momentum toward reform, thus delaying the introduction of a permanent and more transparent system, mainly the uniform but variable norm. In this regard, this chair agrees that quotas should be the basis for a more effective and equitable mechanism for distributing the Fund's operating expenses among the membership. Moreover, since the Fund's lending activity is linked to its mandate of facilitating the process of international adjustment, additions to the precautionary balances and the cost of deferred charges related to this activity should be shared by the entire membership and not only by the users of Fund resources through a surcharge. However, if a surcharge is to be the condition for an amendment of the Articles of Agreement that sets a uniform but variable norm to share the Fund's expenses, I would be prepared to accept a proposal along the lines suggested by Mr. Berrizbeitia, namely, that the surcharge be small, refundable, and temporary in nature. In any event, setting a surcharge should require a high qualified majority and be constructed in such a way that it acts as a reward for early repayment and good policy performance, not as a penalty for resorting--in a timely manner--to a Fund-supported adjustment program.

In conclusion, let me summarize our position as follows: we consider the present level of precautionary balances and its current rate of accumulation as appropriate to cover against the risk of current and projected increases in outstanding credit. Therefore we do not see the need to either increase or decrease the rate of accumulation of precautionary balances, at this time. In relation to the method of determining the rate of charge, this chair favors the introduction of the uniform but variable norm as an alternative to financing the operating expenses of the Fund, and considers that additions to the precautionary balances should be shared by the entire membership and not only by members using Fund resources, through a surcharge.

Mr. Autheman said that he could endorse the conclusion of the staff, which had been supported by almost all previous speakers, that the current rate of accumulation of precautionary balances was appropriate and should be maintained. It was interesting to note that the more such issues were discussed, whether precautionary balances or the financial structure of the Fund, the clearer it became that the present system worked well.

Some speakers had questioned whether the uncertainties related to the sharp increase in the concentration of Fund credit called for an acceleration in the pace of accumulation of reserves, Mr. Autheman recalled,

in spite of the diminishing measured risk of arrears and the fact that the Fund's preferred creditor status had never been seriously put at risk in its 50-year history. There were two dangers in such an approach. First, the Fund should be careful not to take the initiative of questioning its preferred creditor status by hinting that the Fund was entering into a new risk by extending a high level of credit to Mexico, the Russian Federation, Ukraine, and others, a move that many chairs had argued strongly for. In fact, throughout the Fund's history, the only challenges to its preferred creditor status had been related to cases of major political disruptions, whether civil war or international conflict. It was dangerous to assume that some important members of the international community, which had cooperated closely with the Fund and had agreed on rather tough conditionality, would be ready to consider such a breach of confidence. It was appropriate, of course, following the unprecedented use of the exceptional circumstances clause, that a special confirmation of the Fund's preferred creditor status be given on the basis of a report by the Legal Department. He would be reluctant, however, to support a recommendation to accelerate or increase reserves owing to unfounded concerns that the Fund's preferred status could be challenged.

The second danger in the proposed approach lay in the anesthetic nature of precautionary balances, Mr. Autheman remarked. In the past, the French chair had supported the view that the Fund should not hold any specific precautionary balances, a view that the German chair had also supported for a long time. That point should not be disregarded. It was clear that the greater the level of precautionary balances, the greater the danger that the Fund would accept more risk than would be advisable. In that context, he would caution against entering a vicious circle in which the Fund supported high access on the basis of strong conditionality only to demand higher reserves because the underlying rationale for granting higher access had in fact been political, or otherwise not related to the sound working of the institution. There was some merit in keeping reserves low enough to keep the Board under strong pressure to act every day with great caution.

Several speakers had mentioned the existence of the Fund's hidden reserves, namely, gold, Mr. Autheman observed. He was disappointed to learn that management intended to circulate a paper on that issue. Indeed, in matters concerning gold, it was always prudent to err on the side of caution and not on the side of laxity. It was clear, moreover, that those anxious to open the debate about the role of gold in the Fund were interested less in the thrift aspects than in the potential for spending. In his view, the best approach would be to maintain the long-held practice of not discussing the issue of gold.

On SCA-2, Mr. Autheman commented, it was too early to decide on the disposition of those balances, as all options had not been explored. In his view, the issue whether SCA-2 should be used to strengthen GRA reserves or ESAF reserves remained open and should be examined.

With respect to the reform of the financing of the Fund, his views were well known, Mr. Autheman said. The reasons for his reluctance to modify the existing system were well illustrated in the results of the simulations contained in the staff paper. According to Column 2 of Tables 4 and 5, in FY 1996, the share of debtors in financing the general costs of the Fund under the present system, assuming continued accumulation of precautionary balances, would be 29.9 percent with an SDR interest rate of 6 percent and 21.7 percent with an SDR interest rate of 7 percent; according to Column 5 of those Tables, the corresponding share would be 28.9 percent and 28.7 percent, respectively, under a system based on an adjustable uniform norm, without a surcharge--itself a questionable assumption. Before recommending changes, therefore, it would be useful to recall one of the great merits of the present system, namely, the protection that it afforded debtors vis-à-vis increases in interest rates; he suspected that that aspect, which had been overlooked in the past, would be examined with greater interest in the future.

Mr. A. R. Ismael made the following statement:

The Fund, being a financial institution, needs to take protection against risks. However, unlike other commercial institutions, the Fund's financial transactions are very specialized in nature, and these transactions are effected with sovereign member nations. Therefore, the type of financial risks faced by the Fund are not the same as those faced by other financial institutions. Hence, in coming to a decision as regards the adequacy of the Fund's precautionary balances, one must not rely solely on quantitative factors but on other qualitative factors as well, some of which pertain to the unique characteristics of the Fund. Among these are the Fund's preferred creditor status, the level of hidden reserves relating to its holdings of gold, and the extension of credit to members only on the basis of a strong adjustment program. Because of the requirements of such programs, which require the implementation of measures specific to each country to address the cause of the imbalances, a method of risk assessment has not been necessary. Moreover, it is not clear what purpose such an exercise would serve, since all members are charged the same rate of charge. In any case, there is already an implicit assessment of risks at the time of program negotiation, when the conditionality and measures to be taken are tailored specifically to each case, which, by the way, is the primary safeguard for Fund resources.

A major argument for precautionary balances has been the existence of arrears to the Fund by a relatively few members. However, experience has shown that even in the most protracted case, no country has refused to completely honor its obligations to the Fund. Civil disturbances and political difficulties have generally been the cause for the accumulation of arrears, and as the domestic situation has improved, those countries have

re-established relations with the Fund. More recently, we have developed an arrears strategy, which has been quite successful in reducing overdue obligations to the Fund.

Looking at the quantitative indicators, we share the assessment of Mr. Shaalan and Mr. Dlamini regarding the positive trends shown by these indicators, which reinforce our view that precautionary balances have reached a comfortable level. From Table 2 of the staff paper, we find that the Fund's reserves and balances in SCA-1 will be more than double the amount of credit outstanding to members in protracted arrears. Table 2 also indicates that the level of precautionary balances covers approximately 10 percent of credit outstanding and that credit in arrears as a proportion of credit outstanding has consistently declined, while the level of precautionary balances has increased significantly and covers approximately 10 percent of credit outstanding. All of these factors point to the fact that the Fund can safely consider a reduction in the accumulation of precautionary balances. In this regard, we can support a reduction in the addition to reserves from 5 percent to 3 percent. However, should conditions change, we would be willing to reconsider these levels.

As regards the SCA-2, we support the proposal to discontinue any further addition to this account for the reasons stated in the staff paper. We do not favor adding the balance to SCA-1, but would prefer to redistribute the balances as provided for in the decision to create the SCA-2. However, I have noted Mr. Geethakrishnan's proposal for use of SCA-2 for debt reduction for the poorer members, or even to use the amounts to augment ESAF resources, as suggested by Mr. Autheman. While it is true that we need to study these proposals in more detail to make sure that there are no legal barriers to them, I can say that the proposals are very interesting and we could favor such an approach for the use of the SCA-2.

On the determination of the rate of charge, as the details of any modification have yet to be agreed upon, we are of the view that we should maintain the present system of computing the rate of charge.

Miss Chang Fong made the following statement:

We would also add our commendations to the staff for the clarity and focus of the presentation and analysis of the relevant issues in the staff paper.

There is no gainsaying the fact that Fund credit has increased substantially and is expected to increase relatively rapidly over the next two years. The increase in concentration to

a few borrowers and geographic concentration are some factors that others have already noted as additional risk indicators that, considering the recent history of overdue obligations by members, have heightened concerns about the level of risk being added to Fund credit.

We are of the view, however, that the measures that the Fund has taken incrementally over the past decade have served to place the Fund in a reasonably comfortable position, notwithstanding the recent surge in credit, as the ratios provided in the staff paper illustrate. We do not, however, underestimate the risk that sudden additional shocks can pose for the financial position of the Fund, but the frequency of review of the subject, such as the one we are having today, will give us opportunities to take timely and appropriate action, as in the past.

At the present time, the Fund is accumulating reserves, excluding SCA-2, at a rate of 5 percent a year of the existing reserves, that is 5 percent each for the net income target and the SCA-1. Against the background created by more recent events, we are prepared to consider deferring consideration of slowing down the rate of accumulation and would support continuation of the present rate of accumulation under the present system.

In addition to the creation of reserves, greater emphasis could be given to the conditions under which we extend credit and to the strengthened surveillance procedures as advocated by Mr. Kiekens and Mr. Waterman. In a similar vein, an assessment of risk should be an integral part of any decision on creating new facilities such as the short-term financing facility.

In the context of the proposed reform of the financing of the Fund, we are prepared to support the proposition that debtors should contribute some additional portion of the reserves needed to cover the risk posed by credit to themselves, in addition to what might be payable under a clean quota-based system, but as we noted previously, 50 basis points would exceed the rate of contribution that is now required of them and as the staff notes on page 15 of the staff paper, they would, under the present system, fully finance the entire addition to precautionary balances. Enough has been said about the uniqueness of the institution and its cooperative nature. A premium no higher than the 25 basis points suggested by Mr. Clark in his statement would seem more appropriate. Short of finding a mechanism to refund debtors under the new system, we would suggest that the proposed amendments provide for varying the premium. We reiterate that we would not favor any interim mechanism to change the financing structure of the Fund.

With regard to the fate of the balances in the SCA-2, which, on the basis of our discussion this morning, would be a longer-term prospect, we have no objection to the retention of those balances by the Fund after the specific reason for the account's creation disappears. This will clearly strengthen the Fund's financial position at a factor far higher than would apply under present circumstances. There is also clearly a great deal of merit in the notion that it might be politically less difficult to retain those balances than to seek additional resources should the need arise for supplementary resources. We would therefore also have no objection to adding the shortfall on the SCA-2 to other reserves.

Mr. Wei made the following statement:

We welcome this discussion on the issues relating to precautionary balances. The staff paper offers a candid illustration and analysis of the issues, which are both very useful in helping us to find an acceptable solution to the issue of deciding the adequacy for precautionary balances.

Our view on the Fund's present precautionary balance system remains unchanged, namely, that the level of precautionary balances has been adequate in terms of covering the Fund's exposures to members in protracted arrears. Even more encouraging is the fact that loans outstanding to members in arrears are expected to decline, which could reduce the need for the accumulation, at their current fast pace, of precautionary balances. Despite the large expansion in credit outstanding, the level of precautionary balances currently covers approximately 10 percent of credit outstanding. Given the unique nature of our institution, the Fund's financial security should rely mainly on a well-designed economic adjustment program and timely and frequent reviews of program implementation. Therefore, we share the staff suggestion that a modest reduction in the pace of accumulation of precautionary balances is warranted. We can support the proposal that the annual net income target rate, starting from FY 1996, be adjusted downward from 5 percent of reserves to its original level of 3 percent of reserves.

On SCA-2, we can agree that the accumulation in this account should be refunded to contributors. However, we are very interested in both Mr. Geethakrishnan's proposal to use the money for debt-reduction purposes for the poorest countries and in the proposal made by Mr. Autheman.

On the issue of surcharge, as is known to the Board, this chair is against imposing the surcharge on borrowing members, and our views on this matter remain unchanged. One of our reasons, which should be emphasized, is that if any risk occurs because of the Fund's lending program, the risk is a matter for our

institution and it relates to all members. Consequently, it is fair that the risk should be shared by the whole membership.

In this connection, let me confirm our position on the proposed new financing system for the Fund. We could support the quota-based variable uniform norm because we believe the new system is transparent, more predictable, and simpler. However, our support is given based on two understandings. First, under the new system, except for the cost of using the resources, which should be carried by borrowing members, all other costs should be shared among all members, based on quotas. Second, given the adequacy of the existing precautionary balances, the current pace of accumulating such balances should be slowed down somewhat.

Mr. Tulin said that he would not like to convey the impression that his chair was against a further accumulation of precautionary balances and, therefore, did not support the principles of the Fund's prudent lending policy. On the contrary, he would not rule out the possibility that a situation could emerge in which an increase in the rate of accumulation of precautionary balances became necessary, but he could agree to such a decision only after a thorough analysis of the level and nature of risks to which the Fund was exposed had been undertaken. It was tempting to misinterpret the nature of the risks facing the Fund. In assessing the adequacy of precautionary balances, it was important to differentiate between general lending risk, concentration risk, liquidity risk, and many other forms of risk. Indeed, precautionary balances were, by their nature, often viewed as a medicine to be applied against all possible diseases.

He disagreed with the assumption that a general increase in the Fund's claims on debtor countries argued in favor of a high rate of accumulation of precautionary balances, Mr. Tulin remarked. In financial institutions, the capital base, rather than precautionary balances, was normally raised to offset the risk of higher lending. He was not suggesting that the Board should consider instead a quota increase, which was a political issue. Rather, he intended only to recall the generally accepted principles of financial analysis and risk assessment. Similarly, liquidity risk was not best addressed by increasing precautionary balances, which were generally built up to protect against overdue payments, or so-called bad loans.

In other words, Mr. Tulin continued, he would certainly like to protect the financial integrity of the institution. In his view, however, the size and pace of accumulation of precautionary balances required further study. The issue was closely related to the broader issue of the reform of the financial structure of the Fund. In that regard, he agreed fully with Mr. Newman's observation that it was difficult to separate consideration of the level of precautionary balances from their financing. In sum, the general apprehension about the dangers associated with higher lending should not substitute for a thorough and cool-tempered analysis of the situation.

As a final observation, Mr. Tulin commented, it might be useful to draw a parallel between the Fund's approach to precautionary balances and that of private institutions. In credit institutions organized in the form of joint venture companies, partnerships, and cooperatives, it was generally the management and staff who tried to convince the shareholders or their representatives to increase contingency reserves and precautionary balances, often at the expense of the shareholders' return on equity. In the Fund, however, the approach was somewhat different, which illustrated the unique nature of the Fund as a multilateral financial institution. In spite of the unique nature of the Fund, his chair took a very conservative position on the need for precautionary balances, and he would not want to initiate an increase in the rate of accumulation of precautionary balances unless fully convinced by the staff.

Mr. Schoenberg remarked that while he fully agreed with the views of many speakers that the strength of programs supported by the Fund should be the primary safeguard for the Fund against losses, there were limits to that approach. The reality was that, with respect to the transition economies, for example, both the concentration and the amount of credit involved constituted a substantial risk for the Fund. Indeed, Fund-supported programs for the largest transition economy had run into deadlock three times in the previous two years. Moreover, the fact that the balance of payments gap for those countries could not always be closed by the Fund alone could only be viewed as a sign of the risk of Fund lending in that context, a burden that needed to be spread on more shoulders. By the same token, recent lending by the Fund to emerging economies, particularly Mexico, and the prospect of a quick-disbursing facility--which could be activated on short notice and with corresponding conditionality--would certainly create new risks for the Fund with respect to both the volume and nature of lending. In fact, it was somewhat surprising that some Directors who were particularly in favor of a short-term financing facility, with potentially low conditionality, were stressing the strength of Fund-supported programs as a major safeguard against the risks to the Fund.

The Chairman commented that the quality of the programs supported by the Fund could not be the sole means of addressing concerns about risk. As he had stated on previous occasions, an excellent program covering a period of three years, for example, could leave the Fund exposed to a risk during the remaining period in which repurchases were made. For that reason alone, it was necessary to maintain adequate cover against risk and strong surveillance.

Mr. Shaalan stated that, without prejudice to Mr. Geethakrishnan's still evolving suggestion, he was very much interested in Mr. Schoenberg's view that the 3:1 ratio in the financing of SCA-2 could be restored by refunding to debtors part of the SCA-2 balances, subject to the determination that the refunded amounts were not needed. That view was of particular interest in the light of the fact that there did not appear to be enough support for a net income target of 3 percent in FY 1996.

Mr. Wijnholds remarked that he had not expected Directors to agree with all of the rather explicit views contained in his statement, although the discussion was encouraging nonetheless. He was particularly pleased to note the sense of realism on the part of a number of Directors. In that respect, it was notable that several Directors from borrowing countries had been supportive of continuing the present buildup of reserves, a view that was based on their recognition that the situation currently facing the Fund differed from that one year previously, when views among Directors had clearly diverged. In the light of the discussion, therefore, he would be willing to support an increase in the Fund's precautionary balances to 10 percent of total credit outstanding, and he would not push for a slightly higher pace of accumulation.

The Chairman welcomed the gesture of Mr. Wijnholds to join the broad consensus of the Board.

The Treasurer said that the present discussion had provided the staff with sufficient guidance to prepare a paper for Board discussion in April 1995 on the Fund's income position and the rate of charge in FY 1996. It was less clear, however, how the staff should proceed with SCA-2.

With respect to the call from a number of Directors for a more formal framework for risk assessment, the Treasurer continued, it was useful to recall that the staff had in fact prepared a paper for Board discussion along those very lines in March 1994. A central element of that paper was a proposal that the Board undertake a risk assessment on a country-by-country basis, in particular for the post-program period, a point emphasized in the present discussion by the Chairman in responding to the remarks of Mr. Schoenberg. In that March 1994 paper, the staff had devised an illustrative three-category approach to classifying countries and determining what could be considered a reasonable level of precautionary balances for each category. In the course of the Board discussion on that paper, the Board had rejected the proposed approach and the underlying framework. The issue had emerged again a few weeks previously with the suggestion of the Managing Director that the Board continue to consider how it might conduct a risk assessment for the post-program period, an idea that was at the heart of Mr. Tulin's observations during the present discussion.

In comparing the Fund with other multilateral institutions, the point had been made by Mr. Geethakrishnan and others that a number of multilateral development banks had much higher reserve ratios than the Fund, the Treasurer commented. It should be noted that those institutions had a high level of reserves as much for the provision of income as for prudential purposes, including the need to satisfy market perceptions. In terms of provisioning against the risk of loss, however, the level of protection was far higher in the Fund. While provisioning in the Fund currently amounted to about 10 percent of total credit outstanding, the corresponding figure for the World Bank, for example, was 3 percent. In addition, while the Bank might be able to draw on its total reserves to cover a loss if necessary, provisioning in the Fund was automatic and, therefore, the full amount of

precautionary balances was available to the Fund; moreover, as noted by Mr. Tulin, the Fund's capital was also available in the event of a write-off. In that sense, the current level of the Fund's precautionary balances, at about 10 percent of total credit outstanding, was sound and compared very well with the multilateral development banks.

On a point of clarification, the Treasurer said, the staff would be in a position to recommend that part or all of SCA-2 balances be refunded only after one particular member that had completed a rights accumulation program had begun to make--or had completed--repurchases in the General Resources Account, and provided no further eligible member encashed its rights in the General Resources Account. Thus, as he had noted in commenting on Mr. Geethakrishnan's suggestion, it was the disposition of the surplus in SCA-2, not necessarily the full amount of those balances, that was under consideration at present. The SCA-2 had a continuing role to play in protecting the Fund against the risk of nonpayment by those countries that had successfully completed a rights accumulation program and were using GRA resources.

A somewhat more technical issue had been raised by Mr. Rouai in asking whether the accumulation of reserves should be based not on the previous year's level, as at present, but on the average level over a number of years, the Treasurer recalled. Such an approach would, of course, have the effect of lowering the rate of accumulation of reserves. For many years, however, the Fund had followed a particular method of accumulating reserves, which, although relatively slow initially, had begun to generate sizable amounts and remained a sound basis for future accumulations. In reviewing present practice, therefore, it might be useful to focus on the end result rather than the means of achieving that result: if the Board wished to lower the rate of accumulation of reserves, that issue should be taken up explicitly.

The Deputy General Counsel recalled that he had noted in responding to Mr. Fukuyama's question that it would be possible to examine alternative uses for SCA-2 balances that were no longer needed, but that the determination of need would not be made with reference to the particular needs of creditors or debtors. In deciding on a reduction in those balances, therefore, the relevant criterion was whether the balances themselves were needed.

On the references made by some Directors to the Fund's preferred creditor status and the staff's ongoing work in that regard, a few points of clarification were in order, the Deputy General Counsel considered. He would not characterize the staff's work in the context of the recent agreement between Mexico and the United States, to which Mr. Newman and others had alluded, as dealing exclusively with the Fund's "preferred creditor status." Rather, the staff was studying the relevance for the Fund of certain arrangements that had been agreed between parties outside the Fund in the context of the recent financing package between Mexico and the United States.

In that context, the Deputy General Counsel continued, the staff had been in touch with the authorities of Mexico and the United States in order to gain an understanding of the details of those arrangements, which was a time-consuming process, given the large volume of documentation involved. Before returning to the Board with a precise answer, the staff would want to be sure that it understood the issues fully and would want to consult further with the authorities of both countries. The staff expected to be in a position to inform the Board of its findings at the time of the first review under the stand-by arrangement for Mexico, which was tentatively scheduled for March 29, 1995.

The Chairman made the following concluding remarks:

This has been a useful discussion, and several matters have now been clarified. I will organize my concluding remarks around the three main issues: the rate of accumulation of the Fund's precautionary balances in the coming year, the future of SCA-2, and burden sharing and the mechanism for setting the rate of charge for FY 1996.

First, regarding the amount of additions to precautionary balances for FY 1996, Directors recalled the fairly widespread agreement in the Board last year that precautionary balances had reached an acceptable level. Nevertheless, most Directors considered that the recent evolution of Fund credit, and taking into account developments in international financial markets, had resulted in markedly changed circumstances and had, on balance, increased the Fund's exposure to risk. These Directors, therefore, saw good reasons for the Fund to maintain and, in the view of some, even to increase the rate of accumulation of precautionary balances. While this view was not shared by other Directors, today's discussion suggests that, in its broad majority, the Executive Board would find it inappropriate to reduce the accumulation of reserves, and prefers to retain the net income target of 5 percent of reserves at the beginning of the year as well as to place the same amount to SCA-1--that is, to accumulate precautionary balances equivalent to 10 percent of reserves. These indications will guide the staff in the preparation of the review of the Fund's income position and the rate of charge for FY 1996, which is scheduled for April 14.

Second, concerning the special contingent accounts, these accounts serve as a first line of defense should the Fund ever have to recognize a loss. We must have that in mind. The SCA-1 provides protection against any kind of nonpayment of overdue repurchases, while the purpose of SCA-2 is to meet the risk associated with purchases from the General Resources Account that finance the encashment of rights by members that have been in protracted arrears. While there seemed to be broad support for the view that further additions to SCA-2 should be discontinued

after the end of the current financial year, it was also generally agreed that the shortfall in payments by creditor members of approximately SDR 130 million owing to the floor to the remuneration coefficient should be made up by creditors. Many of you held that this amount should in the future be added to SCA-1 rather than SCA-2, in view of the broader availability of balances in SCA-1 to cover the risk of loss, but others linked such a shift to a merging of the two accounts. The staff shall prepare a draft decision, but I remind you that this decision requires 70 percent of the voting power.

A number of Directors favored, or could go along with, the merging of SCA-1 and SCA-2. While a few Directors have indicated that they could not support a merger of the two accounts, I suggest that we keep this question open for the moment. Apart from the possibility of using SCA-2 to protect the General Resources Account, we have today listened with great interest to Mr. Geethakrishnan's proposal to use the resources no longer needed in SCA-2 to strengthen the financing of our support for the poorest countries, in particular those overburdened with debt, including multilateral debt, and also, as suggested by Mr. Autheman, to strengthen the ESAF. This is a different approach than we have been contemplating thus far, and its feasibility would need to be examined in the light of the legal systems of individual members. We should return soon to the further consideration of these issues.

Third, in the paper before you today, the staff has provided calculations that show the implications of moving toward financing the Fund on a quota-based system with most or all of the general expenses being burden shared. However, it is clear that for FY 1996 the Board prefers to continue with the present system of burden sharing and of determining the rate of charge on the use of Fund resources. Accordingly, the staff's proposals as regards the rate of charge in FY 1996 shall be prepared in accordance with the practices followed in recent years.

Looking further ahead, most of you reaffirmed your view that we should proceed with the consideration of an amendment of the Articles that would permit the adoption of a uniform but adjustable norm to make sufficient unremunerated resources available to the Fund to cover agreed general expenses. The staff is proceeding with the preparation of the draft of an appropriate amendment of the Articles for your consideration. The Board has thus renounced any kind of transitional regime, and prefers instead to move directly to the adoption of the necessary amendment to allow for the establishment of a uniform but adjustable norm. I suggest that we return to this matter soon after the spring meeting of the Interim Committee.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/23 (3/13/95) and EBM/95/24 (3/15/95).

2. JOINT AD HOC COMMITTEE ON ARRANGEMENTS FOR ANNUAL MEETINGS - WORK PROGRAM

The Executive Directors approve the work program for the Joint Ad Hoc Committee on Arrangements for Annual Meetings as set forth in EBD/95/33 (3/7/95).

Adopted March 13, 1995

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and an Advisor to Executive Director as set forth in EBAM/95/38 (3/10/95) is approved.

APPROVAL: May 16, 1996

LEO VAN HOUTVEN
Secretary

