April 15, 1997
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/33

10:00 a.m., April 5, 1996

Contents

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman

Executive Directors

A.A. Al-Tuwaijri
M.-A. Autheman

I. Clark
B.S. Dlamini

K.P. Geethakrishnan

J.E. Ismael
D. Kaeser
A. Kafka

H. Mesaki
A. Mirakhor
C. Saito
S. Schoenberg
A.S. Shaalan
E. Srejber

E.L. Waterman
J. de Beaufort Wijnholds

Alternate Executive Directors

S.M. Al-Turki
A. Fayolle
V.J. Fernández
J. Guzmán-Calafell, Temporary

J. Shields

J.C. Martinez Oliva, Temporary
L.M. Cheong
G. Schlitzer, Temporary
G.P. Ramdas, Temporary
J. Prader
V. Rigász, Temporary
D. Saha, Temporary
B.S. Newman
K. Byrne, Temporary

S. Rouai, Temporary
A.G. Zoccali
A. Guennewich, Temporary
Y.Y. Mohammed

V.Y. Verjbitski, Temporary
J.-H. Kang
O. Havrylyshyn
Han M.

L. Van Houtven, Secretary and Counsellor
P. Cirillo, Assistant

Also Present
IBRD: I. Bannon, Latin America and the Caribbean Regional Office. External Relations Department: S. J. Anjaria, Director. Legal Department: R.H. Munzberg, Deputy General Counsel; H. Elizalde. Policy Development and Review Department: J.T. Boorman, Director; T. Leddy, Deputy Director; S.B. Creane, J.P. Pujol. Secretary's Department: M.J. Miller, A. Mountford. Treasurer's Department: D. Williams, Treasurer; D. Gupta, Deputy Treasurer; E. Decarli, L.U. Ecevit, H.G. Jepsen, K.M. Kenney, I. Otker, M.G. Papaiannou, G.S. Tavlas, R.A-M. Westin. Western Hemisphere Department: C. M. Loser, Director; M.A. Da Costa, V. Fichera, J.C. Jaramillo, A.M. Jul, J.G. Mikkelsen, F. van Beek. Office of the Managing Director: S. Sugisaki, Special Advisor. Advisors to Executive Directors: M. Alemán, P. Cailleteau, T.K. Gaspard, G.M. Iradian, R. Kannan, M.F. Melhem, S. O'Connor, Y. Patel, K. Sundara. Assistants to Executive Directors: R.D. Bessone Basto, J.G. Borpujari, A.G. Cathcart, A.L. Coronel, J.A. Costa, D. Daco, J. Dagustun, J.C. Estrella, S. Fukushima, A. Galicia-Escotto, D.S. Hakura, O.A. Himani, O. Issaev, P. Jilek, T.-M. Kudiwu, J.A.K. Munthali, Ng C.S., K. Sakr, Song J., V. Trivedi, L.B.J. van Geest, M. Yiu.

1. FUND LIQUIDITY POSITION AND FINANCING NEEDS—REVIEW

The Executive Directors considered a staff paper reviewing the Fund's liquidity position and financing needs (EBS/96/50, 3/22/96). They also had before them a background paper on revised calculations bearing on the size and distribution of an overall increase in quotas (EB/CQuota/96/4, Sup. 3, 3/11/96).

Mr. Wijnholds made the following statement:

We have already had an opportunity during our quota discussion to speak about the projections for the demand for Fund resources. On that occasion, this chair indicated agreement with the staff projections. I do not see any reason to change my views now.

I would just like to draw attention to the fact that, from the quota documents, I did find interesting the use of an indicator called the drawing propensity ratio. It is not used in the document for this meeting. Perhaps the staff could explain why it found it useful to apply the ratio in the quota papers and not in the paper on the Fund's liquidity position and financing needs. There is also a difference in the geographical distribution of financing and use of resources between the two sets of papers.

I take it that the staff's projection in Table 4 on outstanding Fund credit is in harmony with the projected drawing propensity ratios, but the comparison is difficult. I note, however, that the drawing propensity ratio contains a separate line for transition economies, an element which does not appear in EBS/96/50.

We find the projected development for the liquidity ratio to be worrisome. The liquidity ratio has declined sharply and is rapidly approaching its long-run average of 70 percent. In fact, we are closer to this average than the figure for end-February indicates. Due to several transactions in March, including the Extended Arrangement for Russia, the liquidity ratio has already dropped below 90 percent. The temporary slowdown in the decline in the liquidity ratio that we saw for a while was short lived and no longer offers an accurate description of the situation.

A sharp weakening of the Fund's liquidity ratio, in our view, undermines the Fund's ability to react to any unexpected large demand for its resources. We believe that the Fund is, and should remain, a quota-based institution. Borrowing from the Fund must remain limited to exceptional circumstances. It is in this light that I continue to believe that a level of 70 percent should be the minimum target for the liquidity ratio. By implication, I would feel comfortable with a liquidity ratio that is well above 70 percent normally.

The latest projections confirm our view that we should conclude the discussions on the Eleventh Quota Review rapidly, and I can repeat my preference for a substantial increase.

Mr. Newman made the following statement:

The staff's latest estimates of the Fund's liquidity and financing needs confirm the preliminary information provided during our recent quota discussions regarding the continued trend decline in the Fund's liquidity that one would normally expect during a quota review. We would agree that further declines in the Fund's uncommitted loanable resources to relatively low levels will necessitate a replenishment of the Fund's resources. However, we remain skeptical that maintenance of a 70 percent liquidity ratio provides a meaningful guide to the adequacy of Fund resources or the size and timing of a possible quota increase.

As my colleagues are aware, this chair, among others, has expressed reservations regarding the liquidity ratio concept, especially as it is used in the quota review, as well as the staff's estimates of Fund liquidity. We have had little impact on the debate, however, as the maintenance of a 70 percent liquidity has been used as a central element in decisions in the past few quota reviews. However, we were gratified to note that one of the living legends of the Fund, Jacques Polak, made some of the same arguments in his paper for the recent Fund-sponsored seminar on the future of the SDR. We will be discussing the results of the SDR seminar next week and will have more to say about Mr. Polak's proposals for reform of the Fund at that time. However, for today's purposes it would be useful to recall and elaborate on several points Mr. Polak made regarding the use of the liquidity ratio in the quota context.

First, Mr. Polak argues that the liquidity ratio is misspecified. It measures the Fund's uncommitted loanable resources relative to outstanding liquid liabilities, primarily reserve tranche positions. He notes, however, that reserve tranche drawings have played a declining role in recent years. There has been no reserve tranche use by industrial country members since 1988 and the total amount for the preceding 7 years was only SDR 700 million. A more appropriate specification of the liquidity ratio would be uncommitted loanable resources relative to prospective new commitments. In this context, moreover, some account should also be taken of the availability of the General Arrangements to Borrow (GAB) as a permanent source of supplemental resources.

Mr. Polak also argues that the long-term average liquidity ratio of 70 percent has been used primarily as the basis for large increases in quotas. Like any average, the 70 percent ratio smooths out wide variations in the underlying data but tells us little or nothing about the appropriate size of a quota increase. Normally, one would expect the liquidity ratio to peak after a quota increase and then decline over time as those resources are used to finance increases in outstanding Fund loans. Clearly, a case could be made that a low ratio of available resources to new loan commitments would indicate the need for a quota increase but there is no reason to believe that the average is the appropriate level. As the staff points out, past decisions to increase quotas have occurred when the liquidity ratio was much lower and an average of these ratios might be a more meaningful guide to the minimum levels previous Executive Board's considered acceptable.

Finally, Mr. Polak suggests that the 20 percent adjustment factor used by the staff means that the effective liquidity ratio is actually closer to 90 percent rather than 70 percent. We have long maintained the staff's adjustment factor is excessive and that no additional corrections are required except to account for some minimal working balances to deal with administrative expenses. In developing the operational budget, the staff already undertakes an assessment of a country's balance of payments position and outlook. A 20 percent cut would appear to duplicate the adjustment already implicit in deciding on the operational budget.

We recognize that the concept of uncommitted loanable resources is important in assessing the Fund's ability to enter into new arrangements with members. However, by itself such a measure is inadequate. For example, the staff's projections of new commitments in 1996 are heavily influenced by the recent Russian Extended Arrangement. The probability weighted projection of other new commitments this year and next are relatively modest. However, the Russia loan will be disbursed only gradually over the next 18 months, thus limiting the immediate drain on the Fund's resources. In these circumstances, a full assessment of the Fund's current liquidity position would be better achieved by also having a current cash ratio measure which compares loanable resources with projected net purchases. By this measure, the Fund's current liquidity is strong, with loanable resources more than seven times projected net purchases over the 1996–97 period.

Mr. Mesaki made the following statement:

First of all, I commend the staff's hard work in watching and analyzing the Fund's liquidity position.

I am pleased to report to the Board that repayment of the Fund's borrowing of SDR 3 billion under the 1986 borrowing agreement with Japan was completed on March 29. It is most welcome that the Fund has no outstanding borrowing for the first time since 1974.

Looking at the projections for the Fund's liquidity ratio for 1996 and 1997, one sees that both are higher than those of end-August 1995. I would say that these increases result from the staff's conservative projection as of end-August 1995. At the same time, it is often the case that some purchases are not made on time because of recipient countries' poor program performance. While it would be difficult to calculate this factor numerically, it should be taken into account in the projections.

To strengthen the Fund's liquidity position, I support the staff's view regarding the General Arrangements to Borrow and the Eleventh General Review of Quotas, but I prefer not to go into the details today.

Finally, in light of the uncertainty surrounding the Fund's liquidity position, I welcome the staff's intention to provide us with written reports from time to time.

Mr. Verjbitski made the following statement:

Semiannual assessments by the Executive Board of the Fund's liquidity position are necessitated, in part, by potentially rapid shifts both in members' demand for Fund resources and in the Fund's supply of usable currencies over fairly short periods of time. Thus, updated staff projections might normally be expected to differ from those that were prepared six months earlier.

Having this in mind, I am more inclined to focus attention on the projected liquidity trends rather than on specific levels of various ratios. Although, one might argue that the new staff projections provide a somewhat less pessimistic liquidity outlook for the current year than the previous September 1995 projections, the downward trend in the Fund's liquidity ratio to levels below the Fund's long run average is, nevertheless, clearly manifest, and it needs to be addressed without delay.

In this regard, my authorities' position remains the same as at the time of the previous liquidity review discussion—"the work to increase the Fund's ordinary resources in the course of the Eleventh General Review of Quotas must continue on a fast track and should not be substituted for or delayed by our consideration of various borrowing alternatives." Of course, given the time it takes to implement a quota increase, it would be only prudent to consider, in parallel, different ways of beefing up the existing and establishing new lines of credit that would be available to the Fund in case of emergency.

Having said that, I would like to make several comments on the liquidity assessment exercise per se.

I note that the last review of the methodology used for projecting the Fund's liquidity position and financing needs was undertaken back in April 1990. For those chairs that have not participated in that discussion, some of the methodological aspects of this exercise may appear questionable. Perhaps, the Executive Board may wish to give a fresh consideration to this issue in the not-so-distant future.

Generally, we would favor continued use of the quarterly list of members with sufficiently strong balance of payments positions to determine whether the Fund's holdings of specific currencies are "usable." Perhaps, the same principle could be adopted to determine which individual lines of credit to the Fund (for example, those that may be available under the General Arrangements to Borrow) can be regarded as "usable."

Country-by-country analysis of prospective demand for the Fund's resources could, in our view, be extended also to apply to projecting reserve tranche drawings by the membership. The staff assumed for 1996 and 1997 that about 11 percent of reserve tranches of members which are not included for transfers in the Fund's operational budget could be drawn in each of those years. This assumption may prove difficult to substantiate on a country-by-country basis. It is useful to recall that several industrial countries presently account for a large portion of such reserve tranche positions, while their propensity to draw on these tranches in the near term, as Mr. Newman observed, is, perhaps, close to zero. In fact, many industrial countries, for some reason, prefer to draw down their SDR holdings below the level of their cumulative allocations and pay interest, rather than make interest-free reserve tranche purchases.

Gold remains an important undervalued financial asset of the Fund, which, as a hidden reserve, implicitly strengthens the Fund's liquidity position. Therefore, for illustrative purposes, we would welcome adopting a market-oriented approach to the method of its valuation for the purpose of realistic assessment of the Fund's true liquidity outlook. It is conceivable that the resulting higher value of gold in SDR terms could be prudently adjusted by the same adjustment coefficient as the one applied to reduce the amount of the Fund's currency holdings before it is entered into the calculation of the liquidity ratio.

I would like to point out the need for a very careful interpretation of the data in Table 4 on page 16 of the staff paper. The data on regional distribution of the outstanding Fund credit is based on the IFS regional classification which lists five Asian member countries as developing countries of Europe. As a result, since most of these countries are presently users of Fund resources, the true data on Fund credit extended to the countries in different geographic regions are considerably overstated for Europe and understated for Asia in the staff paper.

Nevertheless, putting these classification reservations aside, it is relevant to provide some historical background information pertaining to the evolution over time of regional shares in total Fund credit outstanding. One would not be excessively concerned about the projected increase in the share of European countries to 38 percent by the end of 1997, if it were also remembered that the share of European countries in the total Fund credit climbed as high as 77.8 percent in 1956 and 75.5 percent in 1970. On average, the share of Europe was at about 56 percent in 1964–71, and at around 43 percent of Fund credit in 1974–78. It is noteworthy that back in those days the Fund did not regard concentration of its credit among a few member countries or within a single geographic region as too risky or requiring accelerated strengthening of the Fund's precautionary balances.

I shall conclude by saying that this chair firmly supports continuation of such a traditional approach, and it is our hope that the Fund's medium-term liquidity concerns can be appropriately addressed through a substantial quota increase, whereas the Fund's policy regarding precautionary balances should remain closely linked to the size of the problem of overdue financial obligations.

Mr. Zoccali made the following statement:

The staff's updated liquidity situation does not seem to pose immediate difficulties for the Fund's ordinary financial activities. At the same time, it is clear that the Fund cannot rely exclusively on new additions to the list of countries whose currencies are included for transfers in the operational budget, clearance of arrears and advance repurchases which recently included the full amount of Chile's indebtedness to the Fund, to counter the projected continued decline in the liquidity ratio, already below 90 percent as noted by Mr. Wijnholds.

Moreover, while it is true that the adjustment factor used to calculate total usable currencies provides some cushion against the uncertainties surrounding potential supply, particularly at a time when a number of creditors are running comparatively large external payments deficits, the projections of underlying demand for Fund credit are exposed, as never before, to the increased vulnerability of both developing and industrial countries to the effects of globalization of financial markets, the constraints on official development assistance and especially strong demands from transition economies.

These factors place significant restrictions on the Fund's margin for maneuver over the medium term and could mean having to resort to borrowed resources relatively quickly and on an ample scale, representing a departure from the accepted principle that increases in resources available to the Fund through borrowing should not be a substitute for quotas. Consequently, we fully support the call for relatively early agreement on issues related both to new borrowing arrangements and increases in quotas and reiterate our preference for a large and predominantly equiproportional increase under the Eleventh General Review to ensure adequate liquidity for the Fund in the medium term.

Finally, while we appreciate the reference in the staff paper to the active consideration being given by the Group of Ten and other countries with a capacity to support the international system in the context of the doubling of the General Arrangements to Borrow, some updating of the status of the ongoing negotiations on the General Arrangements to Borrow and/or New Arrangements to Borrow (NAB) by the Fund's staff or management would be deemed appropriate before the forthcoming Interim Committee meetings.

Mr. Clark made the following statement:

I have no significant disagreement with the staff's estimates of the Fund's liquidity and financing needs for the next couple of years. However, I do wish to make a few comments on some of the underlying procedures used in developing these estimates and in describing them. Specifically, I wish to comment on the forecast errors for usable resources and the probabilities associated with the demand for financing.

The estimates of usable resources are higher than previous estimates, and, as a result, the liquidity ratios for 1996 and 1997 are higher than previously anticipated. This is evident when the estimates for the liquidity ratio are compared with those provided at the end of February for the discussion on the quota increase. Those were 6 percentage points lower for this year and 1 percentage point lower for next.

The current revised estimates were originally published after the quota discussion as a supplement to the initial documentation. Forecast errors, even substantial ones, cannot be avoided, but they should be investigated to ensure they are not systematic.

The staff has conducted such an investigation and has identified three factors contributing to the error: advance purchases by Chile and Hungary; the accession of the Chilean peso to the operational budget; and the clearance of overdue arrears by Zambia. While I would agree that these are purely random factors with respect to the magnitude of useable resources this year, all certainly cannot be considered nonrecurring items, except possibly for the specific members involved.

Advance repurchases and movements into and out of the operational budget occur too often to be considered nonrecurring; indeed, they are supposed to occur regularly. Only the repayment of arrears, which are not supposed to arise in the first place, should be defined as a nonrecurring item. Moreover, these random increases in usable resources at the beginning of the year are sufficient to more than offset the projected large disbursements from the Extended Arrangement commitments to Russia later in the year, which results in the sharp increase in the estimated liquidity ratio at the end of 1996.

While random factors are, by definition, unforeseeable, the large magnitude of these shocks indicates just how wide confidence bands should be around estimates of the Fund's usable resources and its liquidity ratio. To some extent, this justifies the use of the 20 percent adjustment factor in estimating usable resources, which I would suggest could also cover the risk that financing commitments may arise faster than expected, but it also indicates how low these estimates can be on occasion.

Turning to the probabilities and risk factors in the demand for financing, I note that the staff has cautioned us that the projections of commitments for 1997 may be low because of the low probabilities assigned, first, to the prospect of initiating programs for some financially troubled members and, second, to the prospect of completing ongoing program negotiations for some others within the relevant time frame. One implication of this warning is that an explicit risk factor or cushion should be applied to the expected demand for financing. Even though I am not convinced that this is required, since assignment of subjective probabilities likely accounts implicitly for this risk and the adjustment factor on usable resources should also affect this risk, it may be a useful approach under different conditions. For example, this type of projection problem strikes me as a strong candidate for the application of nonlinear probability estimation techniques. Using these techniques, the staff could replace subjective probability assignments with probabilities estimated as functions of a small set of quantitative variables reflecting, respectively, the need for a program and the negotiation interval using the variants of these probability estimates as the basis for a risk factor. The advantage of such an approach is that the probability assignments for financing demand, which are made by the area departments, would be empirically consistent across departments, and the risk adjustment factor, defined as some nonuniform multiple of the estimated probability variances, could reflect special individual circumstances.

It strikes me that such a procedure would more clearly distinguish between the objective probability measures and the subjective considerations surrounding the demand estimates, but it might also have a broader policy value in helping the Board to identify those factors that most affect the likelihood of a member requesting a financing program and the prospect of completing negotiations within a fixed time interval. I would like to ask the Treasurer whether such an approach has been considered in the past and whether he sees any merit in trying it out for the next report.

Mr. Shields made the following statement:

I take the main conclusions of paper as being that liquidity is reasonably healthy now, even after approval of the Russian Extended Arrangement; liquidity will probably (but not certainly) deteriorate over next year or so, but certainly not to levels at which the Fund can be said to be liquid.

We are already embarked on arrangements which are likely to produce a good strengthening of the Fund's financial position through both a quota increase and our intention of enlarging the Fund's borrowing arrangements.

On forecasting issues, I share Mr. Clark's concerns about inconsistencies in approach and possible systematic errors. Just a casual look at recent experience shows a consistent underprojection of liquidity as a result principally of overprojections of purchases.

Projections made each March for the end of the following year are roughly 20 percent too low. (1995 was an exception: the projection made in March 1994 was 25 percentage points too high).

It may be time to look again at methodology—either with a view to simple adjustments or the systematic approach suggested by Mr. Clark.

I sympathize with Mr. Newman's reservations about the adjustment ratio. The adjustment ratio reflects the risk of members being excluded from the operational budget. With greater access to private capital markets for many Fund creditors, the chances of a country being taken off the operational budget may be thought to have diminished over the years. And there are a few countries not now on the operational budget which I would sincerely hope will return before long. A smaller adjustment ratio might therefore be in order which might even go right down to the level of allowing for working balances only.

On the liquidity ratio itself, I share Mr. Newman's sympathy for the views expressed at the SDR seminar by Mr. Polak. I see little justification for the denominator currently used. But even if it is, there is no reason why its decline to its long-run average should constitute a trigger for action to increase usable resources.

Finally, on a technical point, Mexico has indicated that they do not intend to draw on the undrawn balance of their Stand-By Arrangement of SDR 3.3 billion, but footnote 7 on page 3 indicates that only SDR 1.9 billion of commitment are excluded from the amount of undrawn balances likely to be drawn. Two questions: (1) how is the commitment represented by the undrawn balance of Mexico's Stand-By Arrangement treated? And (2) how would a precautionary successor arrangement with Mexico be likely to be treated?

Mr. Al-Tuwaijri made the following statement:

The staff projections indicate that the Fund's liquidity ratio will decline dramatically by the end of 1997. Such a decline would suggest that, by 1998, the Fund liquidity ratio will be about 9 percentage points below its long-term average.

There can be no disagreement that maintaining the Fund's ability to deal with demands of its entire membership should be our paramount consideration. However, there are several reasons to believe that the projected decline in the liquidity ratio should not be a source of as much immediate concern as one may be tempted to assume at first glance.

First, we have always been very conservative in our assumptions when projecting demand for Fund resources. Thus, the balance of risks points toward a higher liquidity ratio than currently projected. Some Directors, including myself, commented on this issue in the context of our discussion of quotas, and I need not repeat these arguments again today.

Second, when the current access limits were established, it was agreed that the increase would be effective for a period of three years, subject to annual reviews. Thus, unless the Board decides otherwise, access limits would revert back to their original level in 1997.

Third, current discussion on providing the Fund with higher amounts of resources under borrowing arrangements should place the Fund in a better position to cope with large and unforseen demands on its resources. This is not to suggest that borrowing arrangements are a substitute for quota-based resources. However, it does suggest that we may need to be less concerned with what might be transitory fluctuations in the liquidity ratio.

Mr. Shaalan made the following statement:

I share the concern expressed by Mr. Wijnholds and other speakers regarding the falling trend in the Fund's liquidity ratio. The projection of a liquidity ratio of about 61 percent by the end of 1997 is possibly on the optimistic side since no exceptional use of Fund resources or additional financing associated with a major financial crisis has been factored in the projections. Moreover, and as the staff rightly points out, while liquidity ratios have fallen to low levels in the past, the expectation was then that impending quota increases and Fund borrowing would soon follow. The situation is, however, a little different today since a consensus is yet to emerge concerning the Eleventh General Review of Quotas.

We should, nonetheless, feel encouraged by the active consideration that is currently being given by the potential contributors to the doubling of resources under the General Arrangements to Borrow, and welcome an early and positive conclusion of this issue. It goes without saying that the Fund liquidity projections also call for an early conclusion of the quota review and that, as generally agreed, a quota increase and the eventual new credit lines to the Fund be considered as supplementary rather than substitute resources.

Mr. Guzmán-Calafell made the following statement:

The likely evolution of the Fund's liquidity position over the next couple of years is a source of concern. The staff is projecting a decline in the liquidity ratio to 61 percent by the end of 1997, a figure not only below its long term average but also representing the lowest level recorded by this indicator since 1983. These projections are particularly worrisome for several reasons. First, the decline in the liquidity ratio may restrict the ability of the Fund to respond to members' demands, in a moment when the globalization of the world economy has increased substantially the exposure to risks and, therefore, the potential demand for Fund resources. Second, the projections are based on assumptions which can be considered conservative, particularly as far as the future demand for Fund resources is concerned; in this respect, I am not surprised to see that commitments for both 1996 and 1997 have been adjusted upwards with respect to the projections prepared for our previous liquidity review. Third, in view of the sensitivity of the projections to changes in the assumptions used, the decline of the liquidity ratio can be significantly faster if the demand for Fund financing increases more rapidly than expected, a possibility which cannot be considered remote.

The fall in the liquidity ratio projected for 1996 and 1997 underlines the urgency to substantially increase the Fund's financial base. The proposals to increase the resources available under the General Arrangements to Borrow are a welcome step. But, as has been stressed repeatedly by this and other chairs, the conclusion of the negotiations leading to a prompt and substantial increase in quotas under the eleventh general review is the central measure to be taken in this regard. On the other hand, it cannot be overemphasized that to decide on the size of the quota increase, we must be guided by the objective of providing the Fund with the resources needed to meet the challenges ahead. It is our view that this objective calls for a doubling of the present quota level.

Mr. Han made the following statement:

I would like to commend the staff for the concise paper prepared for today's discussion. We fully share the staff's analysis on the demand of the Fund resources and appreciate the staff's reasoning on the number of inherent uncertainties. However, the level of future demand for Fund resources could be significantly higher in light of the Fund's role in the last two years in assisting member countries in external sector difficulties.

The Fund should be prepared to assist members experiencing exchange rate crises which could potentially be caused by the increased volatility of the international capital market. While it is encouraging to see that the total of uncommitted and adjusted resources registers some SDR 2.7 billion higher than the level at the end of October 1995, the Fund's stock of usable resources declined by SDR 1.7 billion during the period between August 1995 and February 1996. Furthermore, it is noticeable that, after taking into account the Extended Arrangement for Russia and the transactions expected to take place during the month of March, the Fund's uncommitted and adjusted resources are expected to decline from SDR 40.2 billion at the end of February to about SDR 33 billion by end-March this year. As a result, the Fund's liquidity ratio is expected to fall sharply in March and decline to 61 percent by the end of 1997, reaching its lowest level since late 1983. Judging from the staff's suggestion of a stronger impact of new commitments on the degrees of the Fund liquidity ratio from additional commitments, we see clear concern over the deterioration in the Fund's liquidity position in the period ahead.

I take note of the uncertainties cited by the staff in projecting the supply of the Fund's usable resources. The inclusion of currencies of some relatively large developing and industrial countries in the operational budget gives rise to the possible shortfall of funds available to the Fund in the case of unfavorable developments with their balance of payments. It is appropriate for the staff to continue regularly monitoring the change of the adjustment factor.

As for the demand for Fund credit, in light of the growing volatility of the financial markets associated with the domestic imbalances and the short-term international capital flows out of increasingly liberalized currency regimes, we cannot rule out the likelihood that some unexpected use of the Fund's resources will occur. The fact that the projected demand for 1996/97 is SDR 4 billion higher than the projection six months ago shows exactly how possible arrangements for members with relatively large quota shares can change the picture of the Fund's liquidity ratio. This is confirmed by the probability adjustment projection made by the staff for the remainder of 1996, of which six new Extended Arrangements could account for as much as three-fourths of the total SDR 10.6 billion under the Fund's stand-by and Extended Arrangements.

We are concerned that the fall in the liquidity ratio is being projected at a time of relatively strong demand for the Fund's resources over the medium term. The Fund is also expected to assist its members in cases of financial emergency, especially when systemic implications are involved. I would like to reiterate our position that the Fund's resources and liquidity could be effectively addressed through a timely quota increase. As for the Fund borrowing from its members, we consider that all members participating in a borrowing arrangement should be placed on an equal footing.

Mr. Schlitzer made the following statement:

The updated estimates provided by the staff do not provide reasons, in our view, for being particularly concerned about the Fund's liquidity position in the next couple of years. In fact, the Fund's liquidity ratio is not expected to depart significantly from its benchmark level of 70 percent through end-1997.

The staff points out that the liquidity ratio has, on several occasions in the past, fallen greatly below this level, to as a low as 30 percent in the periods immediately preceding a quota increase. I also wish to note that the stock of usable resources used to compute the liquidity ratio is already adjusted downward by a precautionary factor of 20 percent.

This said, the decline in the liquidity position should be carefully monitored. The uncertainty about future supply and demand of Fund resources is high, as pointed out by a number of Directors, and, hence, any significant deviations from the official projections should be promptly submitted to the Board's attention.

I have one remark on the staff projections. In the conclusion it is stated that "the projections of demand in 1997 may be somewhat conservative" (page 11). This seems to suggest that the staff has some extra information indicating that demand could be even higher in 1997. I wonder, therefore, why this has not been incorporated in the projection exercise.

I note with satisfaction the addition of the Chilean peso to the operational budget. Adding other currencies to the list of those included in the operational budget would help further strengthen the Fund's liquidity. The staff, however, seems to express pessimism in this regard, even in a medium-term perspective, and I would appreciate some comments on this point.

Mr. Schoenberg made the following statement:

The Fund's present liquidity position and the prospects for the near future do not look particularly worrisome. At present, the liquidity ratio stands at some 90 percent, well above the historic long term average and even the projected ratio of 61 percent at the end of 1997 is still substantially higher than its lowest levels in the past. In order to correspond over time to the historical average the actual liquidity ratio has to drop, of course, for a substantial period of time below the average.

The demand for Fund credit in 1996 and 1997 taken together is now being projected to be SDR 4 billion higher than assumed at the occasion of the last liquidity review six months ago.

Though I am aware of the difficulties of projecting the demand for Fund resources I would not exclude, however, that staff's estimations concerning the demand may well prove to include a substantial "safety margin" similar to earlier projections for the demand for ESAF resources.

As far as we can see two main conclusion can be drawn from the projected trend in the Fund's liquidity. First, there is little room for new facilities or generous exceptional financial support during the next years. And second, the declining trend in the liquidity ratio underlines the desirability of a timely conclusion of the present quota review.

Until the next quota increase enters into force, the Fund has to do with the resources available. Unlike the staff, we would not draw a direct link between the projected development of the Fund's liquidity position and an enlargement of the borrowing arrangement available to the Fund. The General Arrangements to Borrow (or NAB) are designated to cover a major unexpected demand for Fund resources, not an expected increase. Borrowing arrangements are an instrument for bolstering the Fund's resources in exceptional circumstances.

Mr. Dlamini made the following statement:

As noted in the staff paper, the Fund's liquidity position has been on a declining trend since December 1994 when the ratio reached an all-time high of about 169 percent. The ratio is expected to fall to about 61 percent by end-1997.Although this is significantly higher than the low of 31 percent which was registered just before the quota increase under the Eighth General Review, it compares unfavorably with the long-run average liquidity ratio of 70 percent. In the absence of any increase in the Fund's resources, the decline in the ratio is likely to continue over the medium term. In this regard, I endorse the staff's view regarding the need for an early conclusion of the Eleventh General Review of Quotas and the new borrowing arrangements..

The staff paper, as on previous occasions, provides useful information on the regional distribution of the Fund's lending activity as shown in Appendix Table 4. In this regard, I note a rising trend of outstanding Fund credit to the European countries, many of which are transition economies. This is a welcome development in view of the expected high demand for the GRA resources by these countries to address the increasing imperatives of economic reform. However, in the case of Africa, the projected demand for Fund credit during 1996 and 1997 appears to be on the conservative side as the outstanding Fund credit to the region is to remain broadly unchanged at its 1995 level. I consider that past commitments may not adequately reflect the effective demand of many countries in the region as they were influenced by a host of factors, including the protraction of program negotiations. It has to be noted that many of these countries are in weak external positions and, in view of that, require substantial external resources. In particular, their reliance on Fund resources is likely to be heavy in view of their limited access to private capital markets and the expected low level of bilateral ODA flows. Without the compensatory financing from cooperative institutions such as the Fund, these countries are likely to face severe adjustment and import restraints. Indeed, inadequate financing may put at risk some of the vital reforms which these countries have to make. Therefore, the extent of Fund's response to these countries' challenges needs to be more than what is reflected in the staff projections.

Mr. Prader made the following statement:

In view of our recent discussions on this subject, I have just a few brief comments.

First of all, on the basis of the projections presented in today's staff paper on the Fund's liquidity, we agree with the staff that a relatively early decision is called for on issues connected with the quota review, as well as with the old General Arrangements to Borrow, the so-called New Arrangements to Borrow, or for that matter the even more newly proposed Standing Arrangements to Borrow (SAB). Given the degree of uncertainty connected with forecasting the future demand for and supply of Fund resources, the staff is certainly right to err on the side of caution. But while we recognize the need for caution, the staff should take care to ensure that their scenarios are not too sensitive to changes in the assumptions. For example, the staff assumes that "there seems to be only limited flexibility to add significantly to the list of countries included in the operational budget at this time, so that it may be expected that an increase in the Fund's usable assets is likely to be relatively small over the medium term."

We could agree with this assumption in the short run, but are more optimistic over the medium term. We think it reasonable to expect that as the transition economies continue to graduate from the Fund's financing and their currencies become convertible and their reserves reach significant levels, it is likely that some of these successful countries' currencies will be added to the list of currencies usable by the Fund. This would represent a modest but certainly not insignificant contribution to the Fund's liquidity. Likewise, on the demand side, even though some transition countries may continue to need Fund resources for a longer time, it is not unreasonable to suppose that as a growing share of the transition countries gains access to private capital markets, their need for Fund financing will permanently decrease.

Finally, I would like to be quoted in the summing up as among the few or the many who support the use of more scientific methods of forecasting the Fund's liquidity as suggested by Mr. Clark.

Ms. Srejber said that she agreed with Mr. Wijnholds and Mr. Shaalan. A substantial overall quota increase was necessary, and the Fund should remain a quota-based institution. She also agreed with Mr. Schoenberg that there should not be a direct link between the Fund's liquidity and the borrowing arrangements, since those arrangements were for unexpected events.

Mr. Geethakrishnan made the following statement:

I endorse the staff's assessment of a sharp and steady decline in the Fund's liquidity ratio. As far as the demand for the Fund's resources is concerned, I think we will have to take any demand that is made with a small pinch of salt, since it is not an area in which one can be accurate. When one looks at the funds that we had to extend to Russia, one should remember that the issue was debated over a period of two or three years. On the other hand, when one looks at what happened in Mexico, we were definitely taken by surprise. Therefore, it is not possible to be very precise.

At the same time, when we also look at the regional distribution shown in the paper, we see that one of the basic factors in this projected demand is a sharply declining trend in the demand for resources of the Asian countries. I am looking forward to the day when the Asian countries will no longer rely on Fund resources. This also underlines the fragility of the overall estimation process, because the number of countries in that region is so large that even a couple of countries facing sudden challenges could upset the whole outlook.

The decline in the liquidity ratio is taking place at a time of a strong growth in demand for the Fund's resources. Without going into details, I would like to be counted among those chairs that feel it is futile to try to predict exactly such demand because of the inherent uncertainty. At the same time, we do not seem to be able to succeed in deciding between any of the methods that are identified for augmenting the resources base of the Fund. These measures take some time to put through and, if we are faced with a major crisis in the near future, we might not be equipped to handle it as we have done in the past. I would urge everyone to work toward a quick and substantial increase in quota with a large equiproportional element in it.

Mr. Waterman made the following statement:

Although I sit next to Mr. Wijnholds, I really have not absorbed his anxiety as yet, but there is value in having a few worriers to keep us up to the mark. To my mind, the liquidity ratio looks reasonably high. It is expected to decline a little over time, but that is not surprising given the stage we are at in terms of the quota discussions. To my mind, it looks like something we can certainly live with for the time being.

On a point of detail, it might have been useful to have the figuring extended to cover 1998, if not beyond. More generally, we remain strong supporters of the Fund being a quota-based institution, and also believe changes to the General Arrangements to Borrow arrangements can play a useful supporting role, particularly in meeting the exceptional and unexpected demands that Mr. Schoenberg referred to. We would not argue that the immediate liquidity outlook by itself warrants early conclusion agreement on either of those fronts.

Mr. Saha made the following statement:

> We would like to commend the staff for its continued work on the complex issue of assessing the Fund's financial position. Overall, we believe that factors with potential bearing on the Fund's financial position in the near term, have been appropriately weighted and thus, the selected ratios, as indicated at page 15 of the staff paper, give a fairly good picture of the institution's financial situation. Nonetheless, as the potential supply of the Fund's usable resources is subject to considerable uncertainties, and the demand on Fund's resources remains strong in the next coming years, developments in the Fund's liquidity position should continue to remain under close scrutiny by the staff and the Board should be informed at an early stage about significant changes that could affect the Fund's financial position. Indeed, the sharp projected deterioration in the Fund's liquidity ratio is a cause for concern. Therefore, in order to strengthen the institution's resource base in the near future, we join previous speakers in their call for an early completion of the Eleventh General Quota Review. Here, this chair would like to reiterate its support for a substantial quota increase.

Mr. Autheman made the following statement:

> I am in broad agreement with the conclusions of this report, which basically confirms the conclusions of the previous one. I take note that, as usual, Mr. Williams is cautious. He tends to overestimate future commitments and to underestimate usable resources; but, keeping in mind what happened with Mexico, this caution does not seem inappropriate.
>
> I was intrigued by Mr. Newman's attempt to revive a past legend. Of course, the liquidity ratio has strange features, since we do not expect many members to draw on reserve tranches, but it has been a convenient tool to measure one thing which is very important for members, which is the liquidity of our claims on the Fund. We could use other ratios. The fact is that between 1994 and 1996 the liquidity of the claims of members on the Fund has been sharply declining. Since the Fund is financed by reserves which have to remain liquid, I think we have to be very cautious. I have no anxiety, but I think it will soon be time to act.

Mr. Rouai said that, in view of the uncertainty associated with the globalization of international capital markets and the declining trend in bilateral financing, there was a need for an early and substantial increase in quotas.

Mr. Kaeser made the following statement:

> We agree with the staff that the demand for Fund financial resources is very likely to remain strong over the medium term. However, the projected fall in the liquidity ratio from 108 percent now to a mere 61 percent at the end of 1997 does not at present leave us overly worried about the Fund's ability to meet its future obligations. Even taking into account the possibility of several large drawings in the coming year, the liquidity ratio will still remain close to its long-run average. Therefore, we see no need in taking quick corrective

action. The ongoing work on increasing the Fund's usable resources deals sufficiently with the liquidity concerns raised in the paper.

We are well aware of the uncertainties involved regarding future resource use and the probability that the current projections may underestimate the actual amount of purchases made. The liquidity ratio is thus an indicator to be monitored carefully to make sure the Fund has the necessary financial clout to fulfill its role. Although the expected gradual decline of this indicator will somewhat limit the Fund's options in the event of an unexpected and large drain on its resources as in the Mexican crisis, we would like to emphasize that such exceptional circumstances should not represent the basis for calculating the regular financing needs of the Fund.

Important steps are being taken to counter the decline in the Fund's resource base. The current work on the Eleventh Quota Review indicates the willingness of members to proceed with a strengthening of the Fund's resources. In addition, the enlargement of the General Arrangements to Borrow will provide additional resources under exceptional circumstances. In our view, a quota increase of 60 percent would be adequate to adjust the Fund's resource base to economic realities and preempt a liquidity problem over the medium term.

Mr. Ismael noted that he shared the concern of many other Directors about the expected decline in the Fund's liquidity ratio and the need for an early conclusion of the quota review. He also agreed that the General Arrangements to Borrow should not be directly linked to the Fund's liquidity position.

The Treasurer said that he agreed with Mr. Shaalan that the staff estimates had not included any possible exceptional use of the Fund's resources, and that, perhaps in the future, the Board and the staff might want to take that into account. It was not just a matter of accommodating another Mexico, which the Fund could do, but rather of incorporating the increasing scope and power of international capital markets. Mr. Shields had mentioned that the growth of those markets would reduce the demand for the Fund's resources, whereas Mr. Shaalan had expressed the opposite opinion. Nevertheless, the issue of the potential for market instability on the demand for balance of payments financing merited closer scrutiny.

Mr. Clark's suggestions for further research were useful, but the staff had already conducted research along the lines suggested by Mr. Clark, the Treasurer noted. The Treasurer's Department had been preparing for quite some time a paper on projecting the demand for Fund resources through analytical means, but it was getting ever longer, and the results were getting ever poorer. However, the staff would revisit the issue because it was important to have a quantitative framework in which to place the area departments' estimates. The staff, however, had not been too far off in its own estimates on projecting the demand for Fund resources about a year and a half into the future: on average since 1988, the staff had been about 15 percent on the high side. If the example was extended back six months, then the staff would have been only about 10 percent off. The staff had been reasonably good at predicting the countries that would request Fund resources; the problem was predicting the timing of the negotiation of such demands and the level of access. There was a correlation between those elements: usually, the longer the negotiations continued, the higher the access demanded. The issue surrounding that correlation could be proposed for a Board seminar, but the analysis of that correlation could not be the main approach used in determining the Fund's liquidity or the evolution of the Fund's usable resources.

The liquidity ratio had come back into prominence as a result of the recent seminar on the future of the SDR, the Treasurer remarked. There were two aspects to the liquidity ratio that had been raised by Directors. One, raised by Mr. Autheman and Mr. Wijnholds, was that the liquidity ratio was the amount of liquid assets that the Fund possessed to meet its liquid claims. From that aspect was derived the idea that the Fund must have at all times a sufficient amount of usable assets to meet the possible encashment of the reserve tranche positions of its members. The ability to meet those commitments had been a major element in the willingness of members to make resources available to the Fund. The second aspect of the liquidity ratio was that it was the result of two disparate trends—the demand for Fund resources and, more important, the supply of usable resources in the Fund. The trend of the usable resources, rather than the liquidity ratio, was driving the discussions on the quota review and on the General Arrangements to Borrow.

While the General Arrangements to Borrow and the New Arrangements to Borrow were in principle for emergency use, they might be called upon in other circumstances as well, the Treasurer remarked. Mr. Newman had correctly pointed out that the most recent reserve tranche drawing by an industrial country had been in 1987, and that for eight years previous to that the total drawing had amounted to SDR 800 million. However, if he had gone back one more year, he would have encountered the major reserve tranche drawing by the U.S., which had to be financed by the General Arrangements to Borrow because the Fund had not had sufficient deutsche marks and Japanese yen to meet that particular claim. It was not clear whether that case had been an emergency, but it was clear that the Fund could not have said that the General Arrangements to Borrow resources could not have been used for that purpose.

Mr. Newman asked whether that example proved that the General Arrangements to Borrow were available for Fund-specific situations in which the Fund's resources needed to be supplemented and, therefore, the General Arrangements to Borrow resources should be taken into account as a usable resource in estimating the liquidity ratio, or that the Fund should be sufficiently large to take account of all unforseen circumstances.

The Treasurer answered that both possibilities needed to be considered, and that was one of the goals of Board reviews.

The propensity-to-draw ratio that had been used in the March 1996 supplement to the analysis in the quota review paper was not used in the liquidity review, because that ratio was more appropriate as an estimation of resource needs over the longer-term 1998–2002 period, the Treasurer noted. It would be difficult to extend the liquidity ratio on a country-by-country basis beyond an 18–24 month period, and the staff was reluctant to do so, unless the Board asked the staff to reconsider the value of the propensity-to-draw ratio.

The geographic classification used in the supplement to the quota review paper was different from that used in the liquidity review because of the long-run nature of the quota review exercise, the Treasurer said. The shorter-run liquidity review exercise relied on the classification of *International Financial Statistics* because the latter provided a wide geographic breakdown of countries that better allowed the staff to avoid identifying the projections for individual countries.

The 20 percent adjustment factor used by the staff to reduce the level of usable resources took into account three considerations, the Treasurer commented. First, it took into account the need to cover the immediate liabilities of the Fund to a member in its own currency, rather than in SDRs. While most countries, because of the burden-sharing arrangements, chose to be remunerated in SDRs, some received remuneration in currencies, and any changes in the burden-sharing arrangements might alter that mix. Second, the adjustment factor reflected the need for working balances because, under the Articles of Agreement, members had a right to draw a specific currency. The U.S. reserve tranche drawing was an example of that. Third, there were countries the currencies of which were included in the operational budget but which had a weaker balance of payments and reserve positions than others, and therefore it would be imprudent to include all those currencies as part of the usable resources.

While the Fund's gold was taken into account in the context of the precautionary balances, it was not taken into account in assessing the Fund's liquidity position because use of gold would require the approval of 85 percent of the total voting power and of all members' legislatures, the Treasurer explained. Therefore, while it was a major underpinning of the Fund's financial position, its usefulness in the liquidity position should not be overstated.

Currently, the arrangement with Mexico was being treated as precautionary, as indicated by the Mexican authorities, and the staff was not projecting any further drawings under it, the Treasurer commented.

The estimate for the demand for Fund resources for 1997 was considered low by the staff because some of the countries in the list of likely recipients of Fund resources had been assigned low probabilities of reaching agreement on Fund support, and a low level of access, the Treasurer remarked. However, that was subject to change, and the next Board review would likely show a higher total than the SDR 7.1 billion projected for commitments under arrangements for 1996. For 1997, based on the latest projections, it was likely that commitments under arrangements would be higher than the projected SDR 6.9 billion.

The estimates for the Enhanced Structural Adjustment Facility (ESAF) were included in the data for the interim period at SDR 1 billion per year, which was consistent with the staff report on ESAF operations that had been discussed by the Board in March 1996, the Treasurer noted. There was also a small potential use in the event that there was some blending between the ESAF and the use of the General Resources Account, but that figure was subject to change.

Mr. Newman said that he recognized that the purpose of the liquidity ratio was to ensure that the Fund could meet potential calls on liquid liabilities. However, in the context of the quota reviews, it had served the purpose of trying to assess the potential demand for Fund credit, and the Fund's ability to meet that demand. A liquidity ratio designed for that purpose would presumably be a ratio of uncommitted available resources to prospective new commitments, which would be a more meaningful ratio than the current liquidity ratio. The staff should consider a true liquidity ratio in terms of a cash ratio, which would consider how much the Fund would actually have on hand to finance purchases. The staff had included such a ratio in previous reviews, but not at present. The cash ratio in the current staff report did not relate to new purchases, but only to an outstanding stock of liabilities. Also, the paper did not contain a commitment ratio, in terms of the ratio of available uncommitted resources to new commitments.

The Treasurer replied that the staff could examine alternative measures of liquidity, although in principle he did not see how a cash ratio like the one proposed by Mr. Newman would be preferable for the Fund. The possible encashment of reserve tranche positions could not be ignored in assessing the liquidity position. Furthermore, future commitments were already included in the liquidity ratio per se.

The Acting Chairman made the following concluding remarks:

> The discussion today on the Fund's liquidity position and financing needs in the period to end-1997 has basically amplified the recent discussion of the Executive Board on the demand for Fund resources in the context of consideration of the size of the overall increase in quotas under the Eleventh Review. The staff's projections were broadly endorsed by Directors, though some Directors felt that the staff had overestimated the future demand for Fund resources, while some others noted that estimated demand in the period ahead did not include exceptional use of Fund resources by any member.
>
> Directors noted the sharp deterioration in the Fund's liquidity position over the span of only 15 months from a peak liquidity ratio of 169 percent at end-1994 to less than 90 percent at end-March 1996. They also noted the projected fall in the liquidity ratio to about 60 percent by end-1997.
>
> Many Directors believed that recent and prospective trends in the Fund's liquidity position were worrisome, while others believed that the present and prospective position was comfortable, and that the staff's projections were too conservative. In that context, it was suggested that it would be timely to review the factors included in the calculation of the liquidity ratio. Some Directors also thought it useful to re-examine the methodology followed in projecting the demand for Fund resources, and, in particular, to develop a probability analysis against which to assess the staff's projections of the demand for and supply of the Fund's resources.
>
> The downward trend in the Fund's liquidity position has a direct bearing on the timing of the conclusion of the Eleventh General Review of Quotas, and many speakers stressed the importance of bringing that review to a timely conclusion. Directors also noted and welcomed the active consideration that is being given by the Group of Ten countries and other countries with the capacity to support the international financial system as regards the doubling of the amount of resources currently available under the General Arrangements to Borrow. It is, of course, agreed that an increase in resources available to the Fund under the new borrowing arrangements is not a substitute for an increase in quotas.
>
> The Board will continue to monitor closely the evolution of the Fund's liquidity position.

2. ELEVENTH GENERAL REVIEW OF QUOTAS—DRAFT REPORT TO INTERIM COMMITTEE

The Executive Directors considered the draft report of the Executive Board to the Interim Committee on the status of the Eleventh General Review of Quotas (SM/96/80, 4/2/96).

Mr. Ismael made the following statement:

> While I appreciate the need for the report to be brief, its brevity should not be at the expense of omitting important issues that will affect future discussions on the Quota Review. The Eleventh Quota Review is one of the most important issues facing the Board this year and next, and I feel that the report should attempt to be more representative of discussions that have taken place to date. I would like to make some suggestions to the draft report.
>
> On the size of quota increase, I would prefer that the first paragraph on page 3 be amended to accord more importance to the urgency of an early conclusion of the Eleventh Review rather than accord emphasis to the General Arrangements to Borrow as a means to resolve the liquidity position, as the present draft implies. Therefore, a proposed redraft could read as follows: immediately after the first sentence on page 3, that is, page 3, second line, before the sentence starting with "some Directors," insert the following: "Executive Directors clearly indicated that early agreement on the Eleventh Quota Review is critical to address the liquidity position. Although there were divided views on the level of the liquidity ratio that would be comfortable for the Fund's operations, there was broad support that the Fund's size should err on the conservative side by allowing for a reasonably large quota increase. Directors were also agreeable that General Arrangements to Borrow resources are only to supplement, and not to substitute, for a quota increase and that early decisions on the quota increase should not be related to current discussions to double the General Arrangements to Borrow and to expand its membership."
>
> On the distribution of quota increase, I propose to amend (ii) of paragraph 3, on page 3, as follows: instead of "the size of the equiproportional element," have it read, "the decision on how far this Eleventh Review should adjust for relative economic positions." Also, add an additional sentence at the end of the first paragraph: "Many Directors viewed that a high selective increase is important in order to ensure that the Eleventh Quota Review continues the process of adjusting quota shares to reflect relative economic positions of members, as has been partly achieved in the last two reviews.
>
> On the last sentence on page 3, which starts with "Directors were of the view that," insert the following sentence after that: "Directors were of the view that, in considering amendments to allow for basic votes, practices in the AsDB and other regional development banks should be considered. However, all Directors recognized that this issue should not . . ."

Mr. Martinez Oliva suggested that paragraph 3, on page 3 of the draft report, be amended to read: "On the various illustrative methods to distribute the selective element of an increase in quotas, most Directors expressed their preference in favor of a method that be transparent and simple and one that facilitates a more rapid consensus in the Quota Review."

Mr. Shields said that if paragraph 3 were amended, it would be important to include the fact that some chairs had not yet decided whether there should be a selective quota increase. Also, the final line and a half of the current page 3 could be deleted so that the line would end with, " . . . appropriate to provide for ad hoc quota adjustments."

Mr. Al-Tuwaijri said that he supported Mr. Shields's comments regarding the distribution of the quota increase. If the Board mentioned the selective increase, then there should also be a sentence saying that most Directors supported an equiproportional increase.

Mr. Newman asked the Chairman whether, given the fact that the Board was sending the Interim Committee four extensive concluding remarks on the discussions of the Board, it was necessary to include a cover summary, which might be quite long.

The Chairman said that the need for brevity needed to be reconciled with the need to present the Board of Governors with an informative document.

Mr. Clark agreed with Mr. Newman that perhaps a cover summary was not necessary.

Mr. Prader said that he was in favor of a quota increase; however, for reasons similar to those outlined by Mr. Newman, he did not favor changing the proposed text.

Mr. Fernández agreed that the text should not be amended.

Mr. Newman said that he was prepared to support the present text.

Mr. Verjbitski said that he could support the proposed report as it stood. However, the final part of the second line of the second full paragraph on page 2 should be deleted, so that it ended with the words: " . . . few members having relatively fast long-term growth rates and declining shares in calculated quotas." Otherwise, the sentence would ignore the result that a country with a growing GDP and relatively stable current receipts under the present formulas could have a lower quota. In the case of Russia, as Mr. Tulin had explained, the use of nonmarket exchange rates to increase the size of the GDP in SDR terms would lower its calculated quota.

The Treasurer suggested that, instead of deleting the final part of that sentence, it could be revised to include the words: " . . . which in some cases may arise from . . ."

Mr. Mesaki said that he could generally endorse the existing text, but that, in the second line of page 3, the particular reference to the General Arrangements to Borrow was not included in the concluding remarks, and might be deleted.

The Chairman said that he shared Mr. Mesaki's view. In fact, there was a contradiction between the first and second lines on that page.

Mr. Autheman noted that he was in favor of Mr. Newman's proposal not to add anything to the proposed report; however, several elements could be deleted. He could support the suggestion made by Mr. Mesaki and the Chairman. Also, in the beginning of paragraph 3 on the distribution of quotas, the word "most" should be deleted, since no one had challenged the point that the choice of method would depend on the size of the quota increase and the size of the equiproportional element.

Mr. Mirakhor and Mr. Shaalan said that they agreed with the proposal of the Chairman and Mr. Mesaki.

Mr. Newman noted that Mr. Mesaki's concern could be addressed by reversing a portion of the sentence so that it read: "Some Directors also noted that the amount of resources currently available under the General Arrangements to Borrow was a relevant consideration in this regard, and that there were ongoing discussions on doubling the amount." The final sentence would remain, and it might be suitable to add a reference stating that an increase in the General Arrangements to Borrow should not be a substitute for a quota increase.

The Chairman said that he was reluctant to associate the Fund's liquidity position with the issue of expanding the General Arrangements to Borrow, particularly since they had not been activated in 18 years. He asked the Board to adopt the proposed text without amendment, for which there was a broad majority.

Mr. Verjbitski asked whether the amendment proposed by the Treasurer was maintained. He recalled that it would be factually incorrect to say that the use of market exchange rates to convert GDP into SDR equivalents was the only reason for a decline in quota shares.

The Chairman said that he had sympathy for the amendment; perhaps the Board could accept that single amendment.

Mrs. Cheong suggested that paragraph 3 should be amended to delete the contradiction regarding the General Arrangements to Borrow issue.

The Chairman said that Directors could explain to their respective Governors the apparent contradiction regarding the General Arrangements to Borrow issue.

The Board agreed to submit the report on the General Review of Quotas, as amended, to the Interim Committee.

The Chairman said that the Board would be informed on the details of the General Arrangements to Borrow negotiations before the Interim Committee meeting in April 1996.

3. EL SALVADOR—1995 ARTICLE IV CONSULTATION; AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1995 Article IV consultation with El Salvador and the midterm review under the 14-month Stand-By Arrangement for El Salvador approved on July 21, 1995 (EBS/96/42, 3/13/96). They also had before them a statistical appendix (SM/96/68, 3/20/96).

The staff representative from the Western Hemisphere Department made the following statement:

> Competitive auctions for stabilization and government bonds were started on March 11, 1996, and, on March 21, the government submitted legislation to the Assembly to eliminate the tax exemption on interest earned on stabilization bonds, that will be considered by April 15. The placements of stabilization bonds for the first quarter of the year were in line with the program.
>
> Also on March 21, the government submitted draft legislation to the Assembly authorizing the issue of a 25-year bond to document C 1.4 billion of central bank losses stemming from the assumption of nonperforming loans from the state commercial banks, and to budget C 100 million in 1996 to compensate the central bank for the elimination of the tax exemption on interest earned on stabilization bonds. These two measures also will be considered by April 15.
>
> Total imports were 5.8 percent lower in the period January–February 1996 than in the corresponding period of 1995, with imports of consumption goods (including vehicles) down by 9.6 percent. Total exports (excluding maquila) were 5 percent larger in January–February 1996 than in January–February 1995, while net exports of maquila were up by 18.3 percent. The trade deficit for the first two months of the year amounted to $216 million, compared with $427 million envisaged in the program for the first quarter of 1996. Commercial banks reduced net foreign borrowing by $4 million from end-December 1995 through March 22, 1996, compared with $15 million of additional borrowing envisaged in the program. El Salvador observed the international reserve target for end-March 1996 with a margin of $11 million.

Mr. Fernández made the following statement:

> I would like to thank the Fund's management and the staff for its work on El Salvador's economy and convey to them the appreciation of my authorities for their support and advice during the discussions in relation to the 1995 Article IV consultation and midterm review of the 14-month Stand-By Arrangement. As it was stated on the July meeting in which the Executive Board of Directors approved this arrangement, my authorities are treating the arrangement as precautionary.
>
> On developments during 1995, real GDP grew by 6.3 percent in 1995, maintaining the momentum of strong growth since 1992. My authorities expect a real GDP growth of 5.0 percent in 1996. December 1995 year on year inflation was 11.4 percent. Core inflation, however, is estimated at 8 percent in 1995, a rate more in line with the disinflationary progress of the previous two years. Annual average consumer prices fell from 10.6 percent in 1994 to 10.2 percent in 1995. February–March 1996 data show that inflation represents a 11.2 percent increase year on year, but a strong deceleration is expected in the next few months. The 7 percent December 1996 target is achievable.

The deficit of the nonfinancial public sector (NFPS), excluding grants, amounted to 0.9 percent of GDP in 1995 compared with 1.6 percent in the program. For 1996, the NFPS deficit is programmed to decline further to 0.4 percent of GDP, sustaining the momentum of further fiscal consolidation.

In 1995, total bank credit accelerated and the credit to the private sector increased by 32.5 percent compared with 24 percent during 1994, due to an extraordinary expansion of private consumption and investment in the first semester. Commercial banks borrowed heavily abroad to satisfy this credit demand. To control the credit expansion starting in August 1995, the central bank raised reserve requirements on public sector deposits and reimposed a 10 percent reserve requirement on foreign borrowing by commercial banks. The colón remained stable in nominal terms relative to the U.S. dollar during 1995, at the rate of C 8.75 per $1; however, the colón appreciated in nominal effective terms.

Net international reserves increased by $147 million in 1995, an amount lower than the $172 million programmed, in part due to a balance of payments outcome weaker than expected. Coffee exports were less than projected due both to lower international prices and lower domestic production (bad weather conditions).

My authorities are in general agreement with the staff appraisal. Nevertheless, regarding monetary and exchange rate policies, my authorities have a slightly different view from the staff.

In regard to monetary policy and inflation, concerning the staff assessment on pages 16 and 17, linking an insufficient tightening of monetary policy with the acceleration of inflation in 1995, my authorities would like to note the following. First, it is true that the financial system borrowed heavily from abroad to finance a strong expansion in private domestic demand. Extraordinary factors not expected in advance were responsible for this strong expansion in private consumption in the first part of 1995. This behavior of the private sector made the monetary policy efforts ineffective to keep credit tight. With the benefit of hindsight, monetary policy was insufficiently tight in this period. However, in the second part of the year, a 10 percent reserve requirement on financial system external borrowing was reimposed, at the same time that the factors behind a strong private consumption receded. Second, interest rates on thirty-day CEMs moved up from 8.9 percent in January 1995 to 14.5 percent in December. Other interest rates, such as short-term lending rates and deposit rates, also moved up from the early Spring to the end of the year. December rates were 20 percent and 16.8 percent, respectively, compared to a 11.4 percent consumer price increase. Third, other tightening measures such as the increase in the reserve requirement on public sector deposits, were taken. Fourth, on evaluating the overall monetary conditions in 1995, it is also worth noting that the effective exchange rate appreciated. In sum, the overall assessment of monetary conditions in 1995 can be, then, characterized as a moderately tight monetary policy, taking into account the stance of the first and second semesters.

On the other hand, the staff's statement linking the December 1995 year on year consumer price index to the weak stance of monetary policy in 1995, ought to take into account the following. First, inflation increased to 11.4 percent reflecting, in part, the effect of the adjustment of the value-added tax rate from 10 to 13 percent in July, the bad weather on food prices, and the effect on consumer prices of the strong adjustments in public utility rates (water, domestic telephone tariffs, and electricity). My authorities' estimation of the "core inflation" for 1995 is about 8 percent, as pointed out previously.

Recent data for the first months of 1996 point to a trend deceleration in credit to the private sector, and also a deceleration of external borrowing of commercial banks. My authorities maintain the 10 percent reserve requirement on external borrowing by the financial system, and have lifted the 1995 increase in reserve requirement of public sector deposits.

On exchange rate policy, let me indicate that my authorities attach great importance to the maintenance of a stable value of the colón vis-à-vis the U.S. dollar. There is a long historical tradition and political support for this currency stability. As pointed out in Paragraph 28 of the Memorandum of Economic and Financial Policies, my authorities plan to continue with their present exchange rate policy of limiting the variation of the colón with respect to the U.S. dollar in an effort to reduce perceived exchange risk, achieve international low inflation levels, and permit lower interest rates on loans in domestic currency, as well as in dollars.

They are well aware that to reach that target not only monetary policy must be consistent with the exchange rate target, but fiscal and wage policy must play a very important role too. My authorities agree with the staff that these two former policies are so far consistent with the stability of the exchange rate and plan to keep them so in the future. Of course, the external competitive position of the Salvadoran economy needs to be kept under permanent view. At present, they do not have great concerns about the evolution of the real effective exchange rate which has been very stable in the last three years. Inflation differentials with partner countries are expected to be reduced in the next coming months, when the effects of once and for all 1995 factors disappear, and when present tight financial policies produce the expected results. Exports of nontraditional products and net maquila exports have been growing very strongly in 1995 and recent data for the first two months of 1996 show continuation of this increase. At the same time, imports, especially of consumption goods, have strongly decelerated as expected.

On fiscal and structural issues, my authorities are in general agreement with the staff appraisal. The staff report contains a detail and accurate description of measures taken and prospective measures to be implemented on the fiscal and structural area. My authorities are taking courageous political decisions for downsizing employment in the public sector. They also will move decisively ahead with the privatization agenda in 1996.

Let me finish by indicating that the ultimate goal of my authorities is to significantly improve health and education services at the same time that poverty is reduced. A necessary condition to achieve this goal is domestic financial stability. Structural reforms and continued efforts to modernize and make more efficient the public sector is also important.

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

Despite some slippages in the second half of 1995, the last eight months have seen commendable progress under the Stand-By Arrangement, especially in the area of structural reform. The 1996 program seems appropriately aimed at all the issues that deserve priority attention. There are a few potential obstacles to its implementation. These include the low level of domestic savings and investments; the possibility that social stability could deteriorate; and the continuing fragile balance of payments position and the economy's vulnerability to external shocks.

Let me turn first to the low level of domestic savings and investments. The imbalance between gross investment at 19 percent of GDP and gross savings at 14 percent is certainly not very conducive to long-term growth. The staff's medium-term outlook foresees a gradual decline in El Salvador's use of external savings over the next six years as the domestic savings-investment gap narrows. While it can generally be expected that private savings will respond more strongly with the implementation of more and more structural measures moving the economy toward market mechanisms, Table 3 on page 3 of the Statistical Appendix shows that three successive Stand-By Arrangements between 1991 and 1995 accomplished very little in terms of promoting private sector savings. It could be argued that this is due to last year's excess consumption, but the bottom line is unless there is a substantial increase in the contribution of private savings to the growth of the economy, it is very unlikely that El Salvador will be able to sustain its present growth rate over the medium term without significantly harming its external position.

The second potential obstacle is the possible deterioration of domestic social stability. The government's efforts to control public expenditure are highly commendable. In time, the increased efficiency of public finances, combined with the ongoing restructuring of the public enterprise sector and the planned privatization drive, should certainly enable the government to shift a larger share of social spending to such areas as health and education. But even though such a goal is worth sacrifices, the government must not try to achieve it too quickly. Reports that the public protests were more frequent in 1995 may be a sign that the authorities can expect public opposition to its reform plans to intensify as more citizen groups are hit. The success of the government's overall agenda depends on maintaining the social consensus needed to support the necessary economic reforms.

Third and last, let me mention the continued fragility of the balance of payments and El Salvador's vulnerability to external shocks. The 1995 widening of the current account deficit shows that the balance of payments remains one of El Salvador's principal weaknesses. The staff's medium-term balance of payments projections foresee improvement in El Salvador's sensitivity to coffee prices. However, the degree to which the current account depends on private transfers will remain unacceptably high. Indeed, the expected level of private remittances seems itself to be a little too optimistic. Besides domestic stability, both economic and political, there are exogenous factors, for example the immigration policies of host countries, that affect private transfers. In any event, the stability of private transfers cannot be taken for granted and changes in North American immigration policies could have significant effects on El Salvador's balance of payments.

This being said, we have no problem, given the overall good performance under the current program and the corrective actions already taken, in supporting the proposed decision, including the request to waive the nonobservance of certain performance criteria.

Mr. Saito made the following statement:

Since the end of the civil war in 1992 El Salvador has come a long way, GDP growth has been above 6 percent per year, inflation has been halved and the fiscal deficit substantially reduced from their 1992 levels. Although I commend the authorities for these achievements I wish to note that policy slippages during 1995 are of concern. Most of these achievements took place between 1992 and 1994 while, in 1995, there was a clear deterioration on the inflation and the external fronts. Nevertheless, since the authorities have taken corrective actions and the 1996 program aims at correcting the policy slippages of 1995, I can support the proposed decision including the authorities request for waivers.

I am in a broad agreement with the staff appraisal so I will just make a few comments on some specific issues.

On the exchange rate regime, the staff points out that the 1995–96 program was designed under a scenario that envisaged the implementation of a currency board system or the complete dollarization of the economy. The authorities even announced in early 1995 their plan to completely dollarize the economy. However, the plan was never implemented. In this connection I have three questions for the staff: Was the level of dollar coverage of the monetary base appropriate or sufficient to provide an adequate support to a currency-board style exchange rate arrangement? How did markets react to the non implementation of the new arrangement? How was credibility affected?

Regarding external sector developments, the significant deterioration of the current account in 1995 is of concern. In this regard, the real appreciation of the colon and the expansion of domestic credit contributed to the rise in imports, particularly of consumer goods. Regarding exports, although in 1995 prices were favorable, the relatively high dependence on primary commodity exports, such as coffee, constitutes a constraint to the sustainability of the balance of payments in the medium term. To reduce the external vulnerability, the authorities should increase their efforts to diversify El Salvador's exports.

On monetary policy, I share the staff's view that during 1995 it was not sufficiently tight, and that the announced plans to dollarize the economy, brought about an acceleration of credit to the private sector. The latter prompted an expansion of the private consumption that not only contributed to widening the external current account deficit, but also pushed inflation beyond programmed levels.

Regarding structural issues, I welcome the efforts aimed at improving the public finances and the efficiency of the public sector management. In this regard, the elimination of the Ministry of Planning and the restructuring of the customs administration are steps in the right direction. Moreover, the reforms introduced to create a more competitive framework in the financial system through the modification of the banking system law are particularly welcome.

Regarding 1996, I welcome the authorities program aimed at correcting last year's slippages, through stronger fiscal adjustment and a tightening of monetary policy. In this regard, the programmed reduction of the overall deficit will contribute to lower inflationary pressures as well as to increase national savings. Regarding monetary policy, I welcome the introduction of market-determined interest through competitive auctions for stabilization and government bonds. However, I am not convinced that the reimposition of reserve requirements on the financial system external borrowing is effective to reduce the amount of this type of borrowing or to provide adequate incentives to the financial institutions to attract domestic savings. Reserve requirement alone will only reduce external borrowing in the very short term, since they are easily circumvented through off-balanced sheet transactions and by borrowers' direct access to the international markets. Staff comments are welcome. Finally, I share the staff's view that in light of the real appreciation of the colon in recent years, the authorities need to monitor closely the impact of exchange rate policy on external competitiveness.

With these remarks, I encourage the authorities to strictly adhere to the program and wish them every success in their difficult endeavors.

Mr. Ramdas made the following statement:

Since 1992, the Salvadoran authorities have made remarkable progress in strengthening the economy. Although there were slippages in 1995, there was ample evidence of the authorities' resolve in continuing the reform process. As noted by the staff, significant gains were attained in structural reforms and real GDP growth, public savings, and the overall balance of the nonfinancial public sector were in line or better than in the program. For 1996, the authorities aim for a stronger fiscal adjustment than in the original program and a further tightening of monetary policy.

The experiences of the past year suggest that the authorities would need to pay increased attention to monetary policy and the external sector, while continuing to adhere to the structural reform agenda and maintaining a tight fiscal stance. We are in broad agreement with the recommendations made by the staff and would add only a few brief comments related to monetary policy and export competitiveness.

Regarding monetary policy, we encourage the authorities to develop indirect instruments of monetary control in order to gain increased flexibility in monetary management. This involves moving to more market-determined interest rates. In this connection, we welcome the planned competitive auctions for stabilization and government bonds. Also, as the authorities seek to tighten policy, it could become expedient, given the experiences of 1995, to take further measures to dissuade the financial system from offsetting monetary policy by resorting to foreign borrowing.

We are pleased to note in the staff's update the reduction in commercial banks' net foreign borrowing. We can appreciate the authorities' desire to maintain a stable exchange rate at this time in order to encourage desirable private capital inflows and, in this regard, commend the authorities' intent to keep wage adjustments in the public sector below projected inflation. We have also noted the improvement in the external performance in early 1996, mentioned in Mr. Fernández's opening statement.

Notwithstanding these developments, the authorities should monitor the impact that the exchange rate is having on export competitiveness and be prepared, if necessary, to take appropriate actions to preserve competitiveness. With steadfast implementation of the program, the revised medium-term outlook for El Salvador is expected to remain favorable. Finally, we support the proposed decision and wish the authorities every success.

Mr. Guennewich made the following statement:

We regret that the very promising economic policies of 1994, which had begun to produce tangible results, were not strongly built upon in 1995. Obviously, the authorities cannot be blamed for some external developments, like the lower volume of coffee exports caused by bad weather. It seems, however, that the insufficient tightening of monetary policy, which is well controllable by the authorities, led to the nonobservance of three performance criteria. In view of the fact that the arrangement is of a precautionary nature and that the targets were not missed by too much, we can agree to the proposed waivers and support the proposed decision.

I generally support the staff's assessment. I have only two brief comments. One concerns exchange rate policy, where I fully support the staff's endorsement of a more flexible exchange rate approach. The second issue concerns the introduction of determined interest rates through competitive auctions. I would welcome the staff's comments on whether this new system has been introduced and whether it is working as planned.

Mr. Fayolle made the following statement:

Let me first commend the Salvadoran authorities for the positive achievements during 1995, in particular the continued high level of growth and the good performance in the fiscal area. That said, I would like to make some brief comments on four issues.

On inflation, I can agree with the staff that the main reason for the deterioration in inflation in 1995 lies with monetary policy during the first part of the year. In 1996 the authorities have to be ready to tighten monetary policy if the level of inflation continues to remain higher than anticipated by the program. However, I have some difficulty in understanding Mr. Fernández's comments that the higher level of inflation is related to the increase in the level of the value-added tax. I can assume that the impact of this appropriate measure was indeed taken into account in the forecast the staff presented to the Board earlier.

On exchange rate policy, it seems to me that there is disagreement on this issue between the staff and the authorities. Like Mr. Guennewich, I have some difficulty in understanding the staff's specific recommendations. Could the staff be more specific about its recommendation to the authorities? The recent economic developments described in the staff representative's statement circulated this morning indicates some improvement in the external area. Does this change the staff's point of view on the exchange rate system in El Salvador?

Like Mr. Rigász, I share the concerns on the worrisome decrease in the private savings rate during 1995. The main reason mentioned in the staff report is an increase level of consumption, but is this a sufficient explanation for such a decrease given the high level of growth, and what are the authorities' intentions for reversing this trend?

I would like the staff to comment on the state of the banking sector. I would, in particular, like to know whether banks are competitive enough in this country.

Finally, I can support the proposed decision, but I am concerned about the slippages registered regarding the noncompliance with many quantitative targets of the program. The supplementary staff report indicates that the target for net international reserves at end-March has been met. I would also like to know whether other quantitative performance criteria were met at this time.

Ms. Byrne made the following statement:

El Salvador's authorities continued to perform well under the precautionary stand-by program in 1995, particularly in terms of maintaining the pace of real GDP growth, managing public finances conservatively, and implementing structural reforms. Nevertheless, the coincidence of policy slippages on the monetary side and the effects of bad weather on coffee production led to a re-acceleration of inflation, deterioration in the external accounts, and a real effective appreciation of the colon. As a result, the December 1995 performance criteria for net domestic assets, net international reserves, and contraction of external debt were missed, and certain targets for the 1996 economic program have had to be revised to accommodate these slippages.

I am in broad agreement with the staff's analysis of El Salvador's fiscal policy record and structural reform effort in 1995. The authorities are to be commended for balancing the need to increase peace-related expenditures and public investment with the necessity of fiscal restraint in the context of the current exchange rate policy. Despite conflicting priorities, the out turn for public finances was better than programmed. The pace of structural reforms was accelerated and significant progress was attained last year. Passage of the obligatory government employment reduction program is particularly noteworthy, and the financial position of public enterprises was restored to balance, a better result than programmed. We are also pleased that the process of privatization in the financial sector will be completed this year.

I would like to focus my comments on the lapse in monetary policy witnessed in 1995 and its effects. The out turn for inflation and the balance of payments last year, as well as the weaker outlook for 1996, are exactly the results one would expect when policy makers choose the exchange rate as the nominal anchor and then fail to maintain credible policies on both the monetary and fiscal fronts. The monetary policy slippage and attendant loss of credibility reduced the anchor's potential benefit for reducing inflation and stabilizing the real economy. Indeed, inflation actually increased, the exchange rate appreciated in real effective terms by 7 percent, and the current account deficit widened last year.

Given the ongoing difference of opinion between the authorities and Fund staff over El Salvador's exchange rate policy, and the authorities' repeated insistence that they are committed to an exchange rate anchor because of the importance they attach to exchange rate stability for private capital inflows, a number of observations appear warranted.

The selection of the exchange rate as the nominal anchor does not, in and of itself, bestow the credibility needed to attract private capital inflows, nor does it automatically guarantee the convergence of domestic and international inflation rates and exchange rate stability. The true anchor of exchange rate–led stabilization is found in the authorities' willingness and ability to maintain adequately tight fiscal and monetary policies. Previously, this chair has commended the Salvadoran authorities for demonstrating that they could and would take determined action to adjust fiscal and monetary policies, when needed, to support the exchange rate objective. Their record on fiscal policy in this regard is clear. Just as clear, however, was the observation contained in El Salvador's 1994 Article IV review, that strong private demand was keeping inflationary pressures high and that prospects for continued strong private capital inflows and a windfall from higher prices for coffee exports would require a tightening of monetary policy in order to meet the program's objectives in 1995. If the authorities insist on maintaining the current exchange rate policy, they must be more vigilant on the monetary front before they can expect to reap the credibility dividend. It would be helpful if the staff could elaborate on its view that the authorities should be prepared to consider greater flexibility in the exchange system.

We welcome the steps the authorities have taken to tighten monetary policy. The introduction of a system of market-determined interest rates for all maturities of government bonds through competitive auctions will facilitate open market operations and enhance the central bank's control over the monetary base. Improving the return on domestic assets will be helpful in promoting domestic saving and offsetting the expected declines in official and private transfers. The imposition of reserve requirements on financial sector foreign borrowing is understandable in light of developments last year, but we trust that this is a temporary measure, given the potential counter productivity of protracted capital restrictions. The recent reduction in reserve requirements for demand deposits seems inconsistent with the authorities' stated commitment to a tighter monetary stance, and we would be interested in staff's views on this point.

The staff representative from the Western Hemisphere Department said that, given the developments in 1995, the staff recommendation at the time of the discussions with the authorities had been to allow the exchange rate to float, in order to determine its appropriate level. The authorities had argued against that, stating that they believed that many of the factors that had resulted in the deterioration of the external current account in 1995 had been temporary in nature. Also, measures being implemented in 1996, especially on the structural front, would contribute to support the present level of the exchange rate. In the end, the staff had been convinced that introducing a flexible exchange rate might raise expectations of a depreciation, leading to damaging speculative attacks. Consequently, it was agreed that the staff would monitor developments in the external sector closely, and, if the rate of growth of imports did not decelerate as envisaged in the program during the first two months of 1996, then discussions were to be reopened. During January–February 1996, export growth had remained strong, while imports had declined in absolute terms. Therefore, the staff accepted the authorities' decision to maintain a fixed exchange rate, particularly in view of the introduction of market-determined interest rates through competitive auctions for stabilization and treasury bonds on March 11, 1996.

The coverage of the monetary base by international reserves had been 63 percent in 1994, and it had been projected to increase to about 77 percent in 1995, the staff representative noted. In the event, it had gone up to 75 percent, a cover that was not sufficient to move to dollarization or even to a currency board. An appropriate cover for such a move would be over 110 percent. The authorities had shelved plans for dollarization, and at the time of the discussions questions had been raised, particularly by the banks, about why such an important piece of the economic program as presented by the government in early 1995 had not been implemented and what were the implications for the attainment of the objectives of the program. The decision not to dollarize, however, had not had a major impact on the general public or on the credibility of overall government policy.

The competitive auctions for government bonds had been in place for three weeks, the staff representative noted. Despite the fact that bids had fallen significantly short of the amounts offered, the staff was satisfied that the new system was off to a good start, especially taking into account the learning curve that could be expected as the authorities moved away from the previous system of fixed interest rates.

The increase in the value-added tax, as well as the adjustment of the public tariffs, had been taken into account by the staff in the projections for inflation, the staff representative remarked. The increase in the value-added tax rate might have had a slightly larger impact than had been anticipated, and, therefore, could have contributed to the higher than projected inflation rate.

The banking sector was not suffering from a problem of competitiveness, nor a problem of soundness, the staff representative said. The spread between lending and deposit rates was about 4–5 percentage points.

The imposition of reserve requirements on foreign borrowing by commercial banks was a temporary measure, the staff representative agreed. There had been a 10 percent reserve requirement through April 1995, which had been removed at the time of the announcement of the dollarization. That requirement had been reimposed in September 1995. Foreign borrowing needed to be monitored closely, in order to determine whether to increase the requirement temporarily, although currently no change was anticipated. The staff believed that such a temporary measure was appropriate, in order to allow other measures, such as the introduction of market-determined interest rates and fiscal reforms, to take hold.

The latest information on performance criteria showed that the net international reserves target and the net domestic assets target had been met, the staff representative said, but only incomplete information was available.

Mr. Fernández said that he was surprised that the German chair had implied that, since the Stand-By Arrangement was intended as precautionary, a more flexible approach to compliance with program targets was acceptable. The authorities were serious about complying with the performance criteria of the program.

The authorities would not welcome a more flexible exchange rate regime because that essentially meant devaluation, which would have a high cost for the private sector, Mr. Fernández continued. There was much debt in dollars in both the private and public sectors, and devaluation would hurt the political credibility of the President, who had strongly supported exchange rate stability. The issue of dollarization and currency boards had begun to be discussed in late 1994, when some advisers in the Ministry of Finance and academics had begun thinking about how the Salvadoran economy could meet the challenges of globalization, freer trade, and modernization. However, there had been political difficulties surrounding such potential changes. Dollarization could occur either de jure, by declaring the dollar legal tender, or de facto, through the increased use of the dollar by banks and other economic agents. However, it was contradictory to substitute the national currency with the dollar and, at the same time, strengthen the national currency through tight fiscal and monetary policies. The stability of the exchange rate with respect to the dollar was considered important by the authorities, and they would work toward, inter alia, lowering the inflation differential and interest rates. The exchange rate rule was sending a positive message regarding fiscal and wage policies to economic agents. A more flexible exchange rate would send negative signals regarding fiscal and wage policies.

The inflation rate in 1995 had been affected not only by the value-added tax, but also the poor weather conditions and the strong adjustment of some utilities prices, Mr. Fernández noted. The authorities believed that core inflation, taking into account the one-off factors of 1995, was about 8 percent, which was consistent with the decelerating trend in inflation, which was expected to continue in 1996. That showed that there was no link between monetary policy expansion and inflation in 1995, and that monetary policy had not been too loose. However, monetary policy could have been considered inappropriately loose, ex post, because of the large increase in consumption and investment in the private sector. It had been difficult to offset commercial banks' behavior of borrowing heavily abroad to satisfy that expansion in domestic credit.

Having the colón fixed to the dollar in nominal effective terms caused the colón to move in the same direction as the dollar vis-à-vis other currencies, Mr. Fernández pointed out. That, and not inflation differentials, had been the main reason for the minor appreciation of the colón. That appreciation had not caused a deterioration in the balance of payments. Exports had continued to increase strongly, while imports had declined substantially, signaling that the boom in imports in 1995 had been linked to the strong consumption of the first quarter. The balance of payments position was correcting itself. The reduction in inflation and the implementation of strong financial policies supported the real effective exchange rate at its current level and the competitiveness of the economy.

The boom in consumption and investment in the first quarter of 1995 had been partly associated with a problem of confidence and with receipts from coffee exports, but it had been a one-time phenomenon, Mr. Fernández concluded.

The Acting Chairman made the following summing up:

> Executive Directors were in agreement with the thrust of the staff appraisal. During 1995, economic activity had continued to expand at a fast pace, fiscal performance was better than programmed, and substantive progress was made on structural reform. However, the external current account deficit widened, and pressure on domestic prices intensified.
>
> Directors therefore welcomed the commitment of the authorities to correct macroeconomic policy slippages, and the actions already taken to bring the program back on track. They underscored the need to keep a tight rein on credit, and for continued improvements in public sector savings to achieve the program's objectives, especially for inflation. Directors supported the strengthening of indirect instruments of monetary control through the move to market-determined interest rates with competitive auctions for central bank and government bonds. They saw the need to reduce the incentives that make it attractive for commercial banks to borrow funds abroad to lend domestically. They noted that that undermines the effectiveness of monetary policy instruments and increases the exchange risks of financial institutions.
>
> In the fiscal area, Directors welcomed the implementation of the employment reduction program, the efforts to control expenditure and restructure public enterprises, and the new impetus given to the privatization program. They noted that cutbacks in expenditure should be complemented by further improvements in tax administration and limits on wage increases.
>
> Keeping in mind the evolution of the real effective exchange rate, Directors urged the authorities to continue to monitor closely its impact on external developments. In that regard, they welcomed the authorities' efforts to maintain wage increases in the public sector below the inflation target.

Directors expressed keen interest in El Salvador's exchange rate policy, and emphasized the need to maintain export competitiveness.

Directors emphasized the importance of strengthening El Salvador's savings performance in order to maintain the recent record of rapid growth, as well as to reduce the fragility of the balance of payments, which remains very vulnerable to external factors. Directors welcomed the continuation of the close relationship between El Salvador and the Fund.

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

The Executive Board took the following decision:

1. El Salvador has consulted with the Fund in accordance with paragraph 3 of the Stand-By Arrangement for El Salvador (EBS/95/107, Sup. 1, 7/25/95) and paragraph 4 of the letter dated June 12, 1995 from the President of the Central Reserve Bank, the Minister of Finance, and the Minister of Economic and Social Development of El Salvador, in order to review performance under the program, set performance criteria for end-March and end-June 1996, and reach understandings regarding the circumstances in which purchases can be resumed under the arrangement.

2. The letter dated March 11, 1996, with its annexed memorandum and tables, from the President of the Central Reserve Bank, the Minister of Finance, and the Minister of Foreign Affairs of El Salvador, shall be attached to the Stand-By Arrangement for El Salvador, and the letter dated June 12, 1995, and its annexed memorandum and tables shall be read as supplemented by the letter dated March 11, 1996 and its annexed memorandum and tables.

3. Accordingly, the limits, targets, and ceilings for end-March and end-June 1996, referred to in paragraph 3(a) of the Stand-By Arrangement shall be as specified in Tables 1, 2, 3, 4, and 5 annexed to the letter dated March 11, 1996.

4. The Fund decides that the review contemplated in paragraph 3(c) of the Stand-By Arrangement is completed and that no further understandings are needed for the resumption of purchases under the arrangement.

Decision No. 11239-(96/33), adopted
April 5, 1996

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/32 (4/3/96) and EBM/96/33 (4/5/96).

4. ANALYTICAL ASPECTS OF DEBT PROBLEMS OF HEAVILY INDEBTED POOR COUNTRIES—PUBLICATION

The Executive Board approves the proposal to publish a paper, prepared jointly by the staffs of the Fund and the World Bank, entitled "Analytical Aspects of the Debt Problems of Heavily Indebted Poor Countries" (SM/96/23, 1/31/96) as set forth in EBD/96/39 (3/21/96).

Adopted April 4, 1996

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/96/51 (4/2/96) is approved.

APPROVAL: April 22, 1997

REINHARD H. MUNZBERG
Secretary