DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

March 5, 1997
Approval: 3/12/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/72

10:00 a.m., July 27, 1995

Contents

Executive Board Attendance

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

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
M.-A. Autheman	P. Cailleteau, Temporary
J. Bergo	E. Srejber
L. E. Berrizbeitia	V. J. Fernández
I. Clark	
	Y. Patel, Temporary
	J. Shields
K. P. Geethakrishnan	W. Hettiarachchi
	L. M. Cheong
D. Kaeser	
A. Kafka	
W. Kiekens	J. Prader
Y.-M. T. Koissy	
G. Lanciotti	N. Coumbis
K. Lissakers	B. S. Newman
	M. A. Brettschneider, Temporary
H. Mesaki	T. Oya, Temporary
	M. Daïri
	A. G. Zoccali
S. Schoenberg	
A. S. Shaalan	Y. Y. Mohammed
D. V. Tulin	
E. L. Waterman	J.-H. Kang
	M. Petrie, Temporary
J. de Beaufort Wijnholds	P. I. Botoucharov, Temporary
Zhang M.	Wei B.
	Wang Y., Temporary

L. Van Houtven, Secretary and Counsellor
J. W. Lang, Acting Secretary
S. Bhatia, Assistant
S. L. Yeager, Assistant

Also Present

IBRD: H. M. Codippily, East Asia and Pacific Regional Office; A. Shakow, Operations Policy Office. European I Department: A. Dayal-Gulati. External Relations Department: S. J. Anjaria, Director; C. Hellemaa, H. P. Puentes. Legal Department: R. H. Munzberg, Deputy General Counsel; R. B. Leckow, D. E. Siegel. Policy Development and Review Department: T. Leddy, Deputy Director; S. B. Creane, L. D. Everaert, C. Puckahtikom, J. P. Pujol, J. K. Wakeman-Linn. Research Department: M. Mussa, Economic Counsellor and Director; P. R. Masson. Secretary's Department: C. P. Clarke, A. Mountford. Southeast Asia and Pacific Department: C. M. Browne, M.-H. Duprat, M. R. Kelly, K. M. Meesook. Treasurer's Department: D. Williams, Treasurer; D. Gupta, Deputy Treasurer; G. Wittich, Deputy Treasurer; J. E. Blalock, K. Boese, J. C. Corr, E. Decarli, L. U. Ecevit, D. M. Hicks, I. Otker. Office of the Managing Director: S. Sugisaki, Special Advisor; G. R. Saunders, Personal Assistant. Advisors to Executive Directors: J. M. Abbott, M. Alemán, B. Andersen, A. Chang Fong, R. F. Cippa, A. Cserés, H. Golriz, J. Justiniano, R. Kannan, H. Mori, S. N'guiamba, S. O'Connor, A. V. Vernikov. Assistants to Executive Directors: S. Al-Huseini, S. Arifin, A. G. Cathcart, A. L. Coronel, D. Daco, D. Giga, R. Glennerster, C. M. Gonzalez, A. Guennewich, J. Hamilius, G. H. Huisman, P. Jilek, A. M. Koulizade, E. Kouprianova, K. Kpetigo, N. Laframboise, J. Mafararikwa, Ng C. S., H. Petana, G. P. Ramdas, S. Rouai, D. Saha, K. Sakr, G. Schlitzer, Song J., V. Trivedi, V. Verjbitski, Zubir bin Abdullah.

1. GENERAL ARRANGEMENTS TO BORROW - POSSIBLE ENLARGEMENT

The Executive Directors considered a staff paper on possible enlargement of the General Arrangements to Borrow (EBS/95/117, 7/14/95). They also had before them a background paper on a chronological review of borrowing by the Fund (EBS/95/122, 7/25/95).

The Chairman made the following statement:

> The Executive Board's discussion on July 27, 1995 of the review of the General Arrangements to Borrow will be the first in a series of discussions over the next few weeks that will include not only a discussion on August 2 of the role of the Fund, but also a discussion on August 28 of updated quota calculations and a discussion scheduled for September 7 on an emergency financing mechanism.
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> You will recall that the communiqué of the Group of Seven's (G-7) Halifax summit urged the Fund to "establish a new standard procedure--Emergency Financing Mechanism," and the communiqué then noted that "[t]o support this procedure, we ask the G-10 (Group of Ten) and other countries with the capacity to support the system to develop financing arrangements with the objective of doubling as soon as possible the amount currently available under the General Arrangements to Borrow to respond to financial emergencies."
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> Although these issues have a bearing on one another, I would like to propose that, in connection with the Board's discussion on the General Arrangements to Borrow on July 27, we concentrate on the General Arrangements to Borrow, its extension, and, as appropriate, other forms of Fund borrowing.
>
> Although some members of the Board may see a possible organic link between the General Arrangements to Borrow and an emergency financing mechanism, others may see no such link. I believe that for the good order of our work, it would be appropriate if, at this stage of our discussions, we were to put aside any consideration of an emergency financing mechanism until we have had an opportunity to consider the staff paper on an emergency financing mechanism. In making this proposal, as regards the conduct of the discussion on July 27, I do not wish to presume any conclusion as to whether or not there should be a link between a possible activation of the General Arrangements to Borrow and a triggering of an emergency financing mechanism. There may well be a need to activate the General Arrangements to Borrow in such circumstances, but we could also envisage activation of the General Arrangements to Borrow outside a triggering of an emergency financing mechanism and, indeed, a situation in which an emergency financing mechanism was triggered, but which would not

reasonably call for an activation of the General Arrangements to Borrow. Such issues may be more profitably discussed in September.

Mr. Tulin made the following statement:

I appreciate this opportunity to present our views on the evolving role of the General Arrangements to Borrow and associated borrowing arrangements in the context of the Fund. I commend the staff for preparing two interesting and appropriately detailed papers that provide a good analytical and technical basis for today's preliminary discussion. First, I shall make some general points on matters of principle, before turning to specific proposals on the enlargement and possible modification of the General Arrangements to Borrow, which will be the focus of the second part of my remarks.

On the role of borrowing arrangements in the Fund, clearly, the General Arrangements to Borrow and associated borrowing arrangements constitute a sizable supplement to the Fund's ordinary resources. Together with the latter, they serve to protect the Fund's liquidity against large unforeseen surges in members' demand for balance of payments support. In this context, my authorities view the General Arrangements to Borrow as a helpful contingency mechanism that is definitely better than an ad hoc approach would be in preparing the Fund to deal with crisis situations. Although activation of the General Arrangements to Borrow should continue to be limited to exceptional situations, we attach primary importance to regular reviews of the adequacy of the size of Fund's ordinary resources as the most appropriate and reliable way to buttress the Fund's liquidity in the face of growing or projected demand pressures. Thus, we do not regard borrowing arrangements as acceptable substitutes for the strengthening of the Fund's proper capital base through occasional quota increases. Accordingly, it is important that the Executive Board's ongoing work on the Eleventh General Review of Quotas should not be substituted for, or delayed by, our consideration of proposals related to the General Arrangements to Borrow.

I note that, since their establishment in 1962, the General Arrangements to Borrow have played a useful symbolic role as a detailed framework for large-scale borrowing by the Fund, which has been tested on nine separate occasions of actual use of Fund resources by four industrial country participants with large quotas. Although the General Arrangements to Borrow have not been activated since 1979, the modifications introduced in 1983 to allow the use of the General Arrangements to Borrow for financing transactions with nonparticipants appear today even more appropriate than ever in the present environment of globalized capital markets, encompassing both established and emerging financial markets. The recent Mexican currency crisis has underscored the large scale and speed of potential contemporary balance of payments shocks threatening to impair the international monetary system, which the Fund may be required to forestall in the future. To meet this challenge, in parallel with our other efforts aimed at reviewing the size of Fund's quotas and developing an emergency financing mechanism, it is necessary to maintain the size of the General Arrangements to Borrow and associated arrangements in line with the changed economic conditions and the needs of the Fund's global membership.

I agree with the Managing Director that, at this stage of consideration of the issues relating to the General Arrangements to Borrow, it may be feasible to refrain from becoming very involved in discussions of a possible link to an emergency financing mechanism, pending release of a staff paper on the latter subject. Nevertheless, I believe that it may be useful now to elaborate somewhat on the merits of using the General Arrangements to Borrow for financing currency stabilization funds, which the Executive Board discussed on July 19, 1995. The staff did not have the Directors' guidance on developing this aspect of the future role of the General Arrangements to Borrow while working on the paper, which was issued a few days prior to the Board meeting on currency stabilization funds. Hence, the staff paper, quite understandably, contains only a fleeting reference to the tentative considerations in 1992 regarding the possible financing of a currency stabilization fund by the General Arrangements to Borrow, which did not yield concrete proposals at that time.

Now that the Board has broadly endorsed, in theory, the use of currency stabilization funds in exceptional circumstances, and the staff is finalizing an operational framework pertaining to currency stabilization funds, it is appropriate to look more closely into the possible link between currency stabilization funds and the General Arrangements to Borrow. As in the case of the General Arrangements to Borrow, currency stabilization funds are expected to play a largely symbolic confidence-enhancing role. Furthermore, currency stabilization funds are to be of a revolving short-term nature, which suits the concept of the General Arrangements to Borrow rather well, but is concomitantly distinct from the Fund's traditional forms of balance of payments support. I invite the staff to carefully analyze the advantages and disadvantages of establishing such a link between currency stabilization funds and the General Arrangements to Borrow in the very near term, and if appropriate, make necessary recommendations to the Executive Board. On a preliminary basis, I can point to two specific advantages of using the General Arrangements to Borrow for financing currency stabilization funds.

First, the lenders would receive interest at a full market rate on the actual use of resources borrowed from them by the Fund under the General Arrangements to Borrow without adjustments--reductions--under the decision on burden sharing, whereas this would not be the case should the Fund's ordinary resources be used to finance the same purchases.

Second, the program countries with a currency stabilization fund "window" in their stand-by or extended arrangements with the Fund could be required to pay only for the actual use of currency stabilization fund financing and would not have to bear the disproportionate burden of financing the Fund's operations by paying additional large commitment fees on the significant currency stabilization fund component, which may never be used and may not require a commitment of Fund's ordinary resources.

With regard to a need for further enlargement and modification of the General Arrangements to Borrow, the nature of commitments undertaken by lenders under the General Arrangements to Borrow is such that the Fund can not reliably count on "all-weather" access to the full amount of these Arrangements, as for every drawing of resources by the Fund a prior consent of two thirds of the General Arrangements to Borrow participants representing 60 percent of total commitments is required. Consultations on activating the credit lines under the General Arrangements to Borrow have historically taken from one to five weeks, which may be too long in the present volatile conditions in the capital markets. Besides, the weakening of a General Arrangements to Borrow participant's balance of payments position may preclude the Fund's use of the respective credit line from the outset. In this regard, I note that, for balance of payments reasons, the Fund presently cannot count on the ability to make use of commitments undertaken by all of the participants in the General Arrangements to Borrow and associated arrangements. These features of the General Arrangements to Borrow lead me to three basic conclusions.

First, the usefulness to the Fund of the General Arrangements to Borrow and associated arrangements depends crucially on the strength of their participants' balance of payments position, and, in practical terms, is determined by the fact of inclusion of their currencies for transfers in the Fund's quarterly operational budget. Thus, the staff's proposal to use the quarterly list of members with sufficiently strong balance of payments positions as a basis for a General Arrangements to Borrow-type contingency financing mechanism for the Fund makes sense. Under such an approach, the list of the Fund's potential lenders could be considerably broadened; it would be flexible and would better reflect both the changing debtor-creditor relations in the Fund and members' current ability to contribute to financing the Fund in case of emergency. Importantly, the amount of total borrowing arrangements available to the Fund could be markedly increased without placing an excessive burden on present participants in the General Arrangements to Borrow and associated arrangements. Application of a quota-based principle to the distribution of the total amount of respective commitments among members would appear to be most appropriate in the Fund's context.

Second, as activation of the General Arrangements to Borrow and associated arrangements always requires consideration of the Managing Director's proposals by the Executive Board, the consultations with the General Arrangements to Borrow participants and other lenders could, conceivably, take place within the framework of the Executive Board discussions. It could reduce the period of activating the General Arrangements to Borrow and associated arrangements to, say, 48 hours following the specific request.

Third, although the initiative to double the amount currently available under the General Arrangements to Borrow, endorsed by the Halifax summit of the G-7, contains, like many other prudential decisions, an element of judgment, the proposed increase does not appear to me as excessively large, considering that the last enlargement of the General Arrangements to Borrow took place one dozen years ago. I can certainly support it, bearing particularly in mind our ongoing work on the evolving role of the Fund in the area of capital account convertibility.

Mr. Shaalan made the following statement:

I am in agreement with the conclusion that the relevance of the General Arrangements to Borrow has increased with the increased integration of the world economy and the rise in volatility of capital markets. I also agree that, to be effective in helping to stabilize or impress the exchange markets, the amount of credit available under the Arrangements would need to be substantial. The proposed enlargement of the Arrangements is consistent with both of these conclusions.

In coming to this view at this stage, I do not wish to imply that there is no link between the discussion we are having today and those we will be having on the broader issue of the role of the Fund. I should make it clear, however, that I am of the view that the Fund's financing role must be an integral element of the overall effort currently under way to enhance this institution's capacity to forestall financial crises and to help remedy them effectively when they occur.

There is also an important degree of interaction between the issue of General Arrangements to Borrow enlargement, on the one hand, and the ongoing review of quotas, on the other. As the General Arrangements to Borrow constitute an important supplement to the Fund's own resources, their size and that of the Fund cannot be viewed as completely independent of one another. However, one should keep in mind that, whereas a quota increase expands the pool of resources available to the Fund permanently, a General Arrangements to Borrow enlargement would not. Moreover, as presently constituted, the conditions for activating the General Arrangements to Borrow are restrictive and the procedures for activation are complex and can be time-consuming. It would, of course, be desirable to seek to achieve improvements on both of these fronts, the conditions and procedures for activation. I doubt, however, that the conditions could be relaxed and the procedures streamlined to the point where the resources available under the General Arrangements to Borrow can become as readily usable as the Fund's own resources.

Therefore, I believe that consideration of an enlargement of the General Arrangements to Borrow "should not retard or impair the quota exercise, which is the primary means of strengthening the Fund's resources." This was a point on which the Board was agreed when consideration was being given to enlarging the General Arrangements to Borrow in the early 1980s, and I hope the principles underlying that agreement will continue to be upheld today. This being said, the question arises as to whether some modalities of General Arrangements to Borrow enlargement may not bear too strong a resemblance to a general quota increase. For example, an arrangement whereby all members would agree to lend the Fund a fixed proportion of their quotas, provided their external financial positions are sufficiently strong, would very much look like a quota increase. I would appreciate a staff comment on this issue.

The approach to General Arrangements to Borrow enlargement that is based on drawing up a firm list of potential lenders would seem to be more viable than a generalized approach. The staff describes the list of "other countries," namely countries other than the current participants, presented in the paper before us as illustrative. I have to underscore this characterization, particularly as I do not yet have the benefit of the views of the authorities of a member of my constituency that is on the list. The same goes for the method of distributing the total amount to become available under an enlarged General Arrangements to Borrow, although, I believe, it would be more appropriate to use shares in calculated quotas, rather than shares in reserves, as a distributive key.

On the remaining issues for discussion, the criteria for activating the General Arrangements to Borrow should be the same, regardless of whether the borrowing member is a participant or nonparticipant in the Arrangements. Moreover, I agree with the staff that in the present system of globalized markets, it is difficult to give operational significance to whether a transaction meets the criterion of forestalling or coping with an impairment of the international monetary system. Accordingly, I would be in favor of deleting this criterion.

Finally, I also agree that the procedures for activation should be simplified and focused more directly on the Executive Board.

Mr. Zhang made the following statement:

At the outset, I would commend the staff for its two papers for today's discussion, which I think are both useful and informative. I also welcome the Managing Director's statement on the possible enlargement of the General Arrangements to Borrow. Although I can certainly agree with him that today's discussion should "concentrate on the General Arrangements to Borrow, its extension, and, as appropriate, other forms of Fund borrowing," it has to be recognized that there are certain links between the issue of the General Arrangements to Borrow and that of an emergency financing mechanism. One link is that the activation of the General Arrangements to Borrow might be caused by a triggering of an emergency financing mechanism. Another link is that consideration of the size of the General Arrangements to Borrow expansion is related to the maximum amount of resources that will be made available to member countries through an emergency financing mechanism. We are of the view that as many financial resources as possible should be provided by the Fund through its own resources to deal with member countries' financial crises. This brings me to my second point.

As this chair has stated clearly on other occasions in relation to the General Arrangements to Borrow, as a quota-based financial institution, the Fund should be ready to provide financial assistance to its member countries mainly through its own resources. We must emphasize that consideration of increasing the General Arrangements to Borrow resources should not have a negative impact on the quota increase under the Eleventh General Review of Quotas; neither should the size, nor a timely conclusion, of the quota increase be affected. This is clearly defined in the guidelines for borrowing by the Fund as adopted by the Board in Decision No. 9862-(91/156) on November 15, 1991, which I quote: "Quota subscriptions are and should remain the basic source of the Fund's financing." This principle should be kept in mind by all of us as we proceed with a discussion of the General Arrangements to Borrow issue.

Having said this, we do understand that it is necessary to consider an enlargement of the General Arrangements to Borrow in order for the Fund to play an effective role in assisting its member countries in financial emergencies. I share the staff's conclusions in its paper on the role of the Fund regarding the lessons drawn from the experience with Mexico "that the relatively prompt availability of large-scale financing to support an appropriate adjustment program played an important role both in containing the crisis within Mexico and in limiting its broader contagion effects." Given the enormous scale of capital flows in today's international financial market and its accordingly huge impact on the member countries, as well as on the stability of the international monetary system, it is reasonable for the Fund, in addition to using its own resources, also to consider utilizing resources committed by member countries under the General Arrangements to Borrow. For the reasons mentioned above, an expansion of the General Arrangements to Borrow resources, which should be an adequate amount, needs to be considered in view of the Fund's expected role in responding to financial emergencies.

On the issue of the size of the enlargement of the General Arrangements to Borrow, we fully support the staff view that "any consideration of an increase in the size of the General Arrangements to Borrow should not be regarded as a substitute for an increase in quotas under the Eleventh General Review." In our view, it is probably appropriate to increase the General Arrangements to Borrow credit lines up to the size of 21 percent of the total quotas in 1983, an increase to about SDR 30 billion. As recognized by the staff, the presumption of a need to double the current size of the General Arrangements to Borrow is made at the upper end of likely demand for Fund resources.

On the issue of new participants to the General Arrangements to Borrow, we believe that it is desirable for as many member countries as possible to be included in the enlargement of the General Arrangements to Borrow. Accordingly, the minimum amount of commitment, namely SDR 100 million, could be lowered, for example, to SDR 50 million. Could the staff comment on such a proposed scenario?

On the issue of the treatment of new participants, I join the other Directors in stressing that all participants should be treated equally in terms of rights and obligations. There should be no difference in status, like first-class citizenship for current General Arrangements to Borrow members and second-class citizenship for new participants. Therefore, we cannot support the proposed associated arrangements for new participants. A new General Arrangements to Borrow arrangement that would include both current and new participants would probably be more practical and feasible.

With respect to procedures, we agree with the staff that they should be streamlined so that the Fund can activate resources quickly in response to financial emergencies. Taking this into account, an umbrella-type General Arrangements to Borrow, which covers both current and new participants, has obvious advantages in terms of efficiency to activate the resources. Under the current General Arrangements to Borrow or the proposed associated arrangements, the procedures are too complex and time consuming.

On the method of the distribution of credit lines among the General Arrangements to Borrow participants, we are in favor of using their shares in calculated quotas as an indicator.

Finally, on the issue of other forms of Fund borrowing, the staff correctly emphasized in its paper that "the Fund so far has borrowed only from official resources and overwhelmingly from members or their monetary authorities." We firmly believe that borrowing from official sources has many advantages. There is every reason for the Fund to continue to continue such policies. As a cooperative intergovernmental financial institution, the Fund can always rely on its members in terms of mobilizing resources. This can be done through either a quota increase or direct borrowing from member countries. Fund borrowing from official, rather than other, sources is always less costly.

Mr. Clark made the following statement:

I would like to commend the staff for its useful examination of the issues related to the role of the General Arrangements to Borrow. As the paper notes, both the Interim Committee and, more recently, the G-7 in its Halifax communiqué, have remarked on the need for such a review. However, as you know, we at the Fund are not the only group that is actively examining options for enlarging the Fund's borrowing agreements. The Group of Ten (G-10) Deputies have also undertaken similar preliminary studies, and I would like to begin with a few comments on this procedure, as I understand it, to help put some perspective on our own deliberations.

Following the G-7 summit in mid-June, the G-10 Deputies met in Paris on July 12 to discuss the implications of the summit. At that meeting, they decided to create an ad hoc working group to examine proposals regarding an enlargement of the General Arrangements to Borrow. The working group is chaired by Mr. Thomas Bernes, the Canadian Acting Deputy, and comprises members of the G-10 countries represented at about the deputy level in both the finance ministries and the central bank. Their first meeting was held on July 18 in Toronto, and it was attended by members of the Fund staff as observers. I might add that Mr. Bernes met with the Managing Director just this week, and with the staff to describe the results of that meeting. A broad range of possibilities were identified in very general terms, all of which have some appeal in specific aspects, and some of which are outlined in the staff report. The working group is directed to prepare a report outlining the advantages and disadvantages, as they perceive them, of all the proposals. The group will reconvene in early September to finalize the report for presentation at the G-10 Deputies meeting in Rome later that month. The G-10 Deputies will probably report to their Governors on this topic in preparation for the Annual Meetings in October.

As you can imagine, the working group is interested in our discussions today as a means to obtain some perspective from the Board, and the Fund, on its requirements for an enlarged borrowing arrangement, either along the lines of the General Arrangements to Borrow or along other lines. In this latter context, the proposal in the staff report for a quota-based borrowing facility that involves all members--or at least those included in the operational budget--has great appeal, and I would like to ask the Chairman whether the staff could prepare a paper that would provide further details on how such an operation might actually work. Of course, as the staff report emphasizes, any new borrowing arrangement cannot be perceived as a substitute for a quota increase as the primary means of increasing Fund resources. Aside from the fact that the Fund must remain a quota-based institution to maintain its integrity and cannot, therefore, risk being perceived as a credit-based institution, reliance on exceptional borrowing arrangements to finance normal loan operations is simply bad financial practice.

My own view is that while the Fund's liquidity position is sufficient to meet the normal demands for resources, there is little flexibility to respond quickly and adequately to the exceptional borrowing needs of more than one or two members in the event of some severe shock to the system. The paper provides some examples of such events that illustrate the Fund's potential need for borrowed funds, although I submit some of the more extreme illustrations, which feature demands for large stand-by arrangements at the same time that creditors are drawing extensively on their reserve tranches, do beg the question as to which members would be in a position to lend such funds. Nevertheless, the evidence is persuasive that a doubling of the current value of the General Arrangements to Borrow, which would restore the Arrangements to relative levels comparable to those following its last enlargement in 1983, is warranted.

As for delving into the specific modalities of any new arrangements, as suggested in the report, I believe that this is simply too early in the process. The more general properties and functions of any expanded arrangement must be thoroughly considered before focusing on the specifics of any such arrangement. For example, a discussion on the activation procedures, which are described as "complex and somewhat cumbersome" for the existing General Arrangements to Borrow, does seem premature. One might add that there is no empirical evidence that they are excessively cumbersome and complex, because they have not been put to the test since 1983. Also, I agree with the Managing Director and Mr. Tulin that it may be premature to discuss the form of any structural links between an enlarged General Arrangements to Borrow and an emergency financing mechanism. But, I submit that it is equally premature to discuss the relationship with a currency stabilization fund as well.

Extending his remarks, Mr. Clark noted that he had recently learned about the history of relations between the G-10 and the Fund. Both Mr. Kafka and Mr. Van Houtven had written articles on the subject, and the biography of Per Jacobsson by his daughter described in detail the early years of the relations between the G-10 and the Fund, which were often marked by some degree of dissension. He was hopeful that Mr Jacobsson's successor would be successful in maintaining harmonious relations between the G-10 and the Fund.

Mr. Fernández asked whether there was any further information on the Toronto meeting of the working group of the G-10.

Mr. Clark remarked that the discussions of the working group had been very preliminary, and participants had only begun considering a number of options regarding borrowing by the Fund.

Mr. Mesaki made the following statement:

I welcome today's Board discussion on the General Arrangements to Borrow. Before making specific comments on the suggested points for discussion in the staff papers, I would like to make clear the basic position of my authorities on the General Arrangements to Borrow.

In light of the experience of the Mexican crisis, the G-7 countries proposed at the Halifax summit to establish an emergency financing mechanism to deal with financial crises with systemic risks, which is considered important by the Managing Director, as noted in the press release issued on June 16. I would emphasize that the G-7 proposal to double the amounts currently available under the General Arrangements to Borrow was clearly intended to support the emergency financing mechanism, as stated in the Halifax communiqué. Although, from the viewpoint of the good order of our work, I can understand the Managing Director's request to put aside any consideration of an emergency financing mechanism at today's Board discussion, from the standpoint of substance, I attach the utmost importance to the link between the General Arrangements to Borrow and an emergency financing mechanism. I believe that, to ensure a fruitful discussion on the General Arrangements to Borrow, it is crucial for management and the staff to give higher priority to an emergency financing mechanism, and to make their best efforts to reach a conclusion as quickly as possible.

Regarding the first question on whether the criteria for activating the General Arrangements to Borrow for participants and nonparticipants should continue to be different, I believe that it is important to provide incentives to potential participants to join the new arrangement, irrespective of its modality. To this end, I prefer maintaining a distinction between participants and nonparticipants and continuing favorable treatment for participants.

With regard to the alternative approach, which proposes that countries included in the Fund's operational budget be lenders, I am concerned that this proposal could discourage the impetus for an early conclusion of the Eleventh Quota increase.

In addition, I am also concerned that periodic changes of participants, which is an important characteristic of the alternative approach, would cause some problems for the following reasons.

First, we should bear in mind that there are many member countries that require parliamentary approval for making a lending agreement with the Fund. I am afraid that quarterly changes in participants could put a considerable and unexpected burden on participants and complicate the process of concluding lending agreements.

Second, a lack of unity among participants may require the Fund to take the trouble of confirming participants' intentions to lend to the Fund individually. This means that the alternative approach does not have the collective relationship among participants that has contributed a great deal to the effective functioning of the General Arrangements to Borrow.

In sum, I believe that it would be more rational and effective if the Fund conducted consultations with a group of fixed participants.

Regarding whether Table 8 in the staff paper is a reasonable basis for further consideration with members, I would say that consideration based upon Table 8 seems premature at this stage. I believe that a formal discussion at the Board in this regard should be preceded by consideration within the G-10 on new participants and the modality of an enlarged General Arrangements to Borrow, and should also be preceded by informal contacts with the candidates on their willingness to participate. So far, the G-10 has not agreed on this issue because of the preliminary nature of the discussion; therefore today, I am interested in hearing the views of other Directors who represent countries that are expected to participate in the new arrangement.

Finally, I would like to reiterate that immediate priority should be given to developing a financing arrangement as soon as possible to double the amount currently available under the General Arrangements to Borrow. I am open-minded on the modality of the new arrangement to achieve this goal.

The Chairman asked Mr. Mesaki to elaborate on his comment relating to doubling the resources of the General Arrangements to Borrow.

Mr. Mesaki stressed that, owing to the preliminary nature of the discussion, his authorities were willing to consider various options. However, they were doubtful about the feasibility of the alternative approach suggested by staff, namely, the possibility of the Fund borrowing from those members whose currencies were included in the operational budget. He would like to hear the views of other Directors on the modalities of new borrowing arrangements. His authorities considered that the discussion of an emergency financing mechanism should be given immediate priority, and a doubling of the Arrangements should be considered in that context.

Mr. Waterman made the following statement:

There is much discussion and reflection under way with regard to this issue. As we are not at the point where we can discuss very specific proposals, my comments will be relatively general in nature. However, I would hope to convey some of the flavor of what is important to us in terms of the detail.

We start from the basic position that the Fund is a quota-based institution, and that this should be the main underpinning of its normal activities. At the same time, I recognize that the Fund is not in a position to foresee all the potential demands that will be placed on it in the future, particularly at short notice. There is a case, therefore, for the Fund and its members to be in a position where they can put together substantial additional financing for crisis situations with systemic implications, particularly when liquidity is tight just before a quota increase is effected. But in saying that, I would put the emphasis on the unforeseeable nature of the situation that has to be addressed and an inability to address it in the normal way, particularly given available resources. I would not see such a special arrangement extending to normal Fund lending, nor to providing assistance to currency stabilization funds or, more particularly, a ruble stabilization fund as Mr. Tulin's statement might suggest.

In principle, the existing General Arrangements to Borrow has the potential to perform a role in a crisis but, given its modalities, it is obviously difficult to activate quickly even for G-10 members and, for most practical purposes, it seems irrelevant for other potential users.

So while we put the emphasis on the eleventh quota increase, we also recognize that a case can be made for some additional support mechanism to be used in a clearly defined set of circumstances when a crisis occurs; I believe that discussions on the preferred nature of a mechanism needs to be discussed and progressed.

There are many options available as to how the existing General Arrangements to Borrow could be reformed to play a role in crisis situations, so one needs an open mind. One would be to reform the General Arrangements to Borrow with the existing membership with increased financing. An alternative is to have a broader arrangement involving a larger number of countries. If there is to be an expanded grouping, there would need to be some flexibility on membership of the group.

The position of this constituency, like others, will obviously depend on the detail. But I do not rule out the largest members of this constituency being prepared to play a role in an expanded arrangement, if that were the wish of the membership more generally. But, as I say, I think we would be looking for the purposes of the arrangement to be reasonably tightly defined, and we would expect that the decision-making processes would be democratic, in the sense that all contributors would have a chance to have their say on making any facility operational. That is, I do not think it would be acceptable to have an arrangement that would have a structure involving, say, the G-10 members speaking with one voice and other new members effectively being given a very limited say in decision making.

We recognize the importance--if such a support mechanism is to have any practical value--of structuring it in such a way that it can be made operational on relatively short notice. Management would certainly need to be confident that this was the case, and that they could rely on the relevant countries coming to a decision very quickly. So there is a balance to be struck between the scope for management to act quickly, and with some flexibility, and the safeguarding of the interests of potential contributors by ensuring adequate consultations. Clearly the existing General Arrangements to Borrow do not achieve this balance. The membership more generally has a keen interest in any

Arrangements as it is the Fund that takes on the credit risk if the facility is used.

Finally, I will repeat that while we can only talk in broad terms at this stage, I can say that the largest members of this constituency are likely to be prepared to play a positive role in the development of an expanded facility on the broad basis I have outlined. I would emphasize again, however, that we believe that the Fund's main functions need to be supported by an appropriate quota increase. We would not see any specialized arrangement impacting on either the timing or the size of the quota increase. In that regard, it is also important, in coming to any conclusion on that front, that members take account of the broader role that countries play in supporting mechanisms such as we are discussing.

Mr. Tulin remarked that in his statement he had not suggested establishing a link between a ruble stabilization fund and the General Arrangements to Borrow. He requested that Directors exercise caution in interpreting his remarks because of the problems that could be created by misinterpretation, particularly if the Board discussions were somehow leaked to the public.

Mr. Schoenberg made the following statement:

I welcome the presentation of a well-written staff paper providing us with the history, the functions, and the potential elements of a further development of the General Arrangements to Borrow and, therefore, with a useful basis for further discussions on that subject.

At this moment, we are at quite an early stage of the discussion on a possible enlargement of the General Arrangements to Borrow. As a large number of consultations and negotiations will take place over the coming months--both in this Board, in other bodies, and among participating and interested countries--and as decisions on major aspects of changes to the General Arrangements to Borrow can be expected to be taken outside this institution, I would like to offer only a few general remarks on some of the key features likely to be dealt with in these negotiations, and in particular on the purpose, the size, and the method of financing of a revised General Arrangements to Borrow.

The purpose of the General Arrangements to Borrow is--and should remain--to forestall or cope with an impairment of the international monetary system, that is, in order to activate the General Arrangements to Borrow there must be a systemic risk, and in order to cope with that risk the Fund's resources need to be supplemented. So, depending on how the purpose of, and access to, the proposed emergency financing mechanism will be defined, we would not necessarily see a link between an enlarged General

Arrangements to Borrow and the emergency financing mechanism. I would like to stress that, at this stage, we are open-minded in this regard. If the emergency financing mechanism would be considered open to all members, including smaller members, and if a small country came under sudden pressure in financial markets, then probably the two basic features of the General Arrangements to Borrow--systemic risks and the need to supplement the Fund's resources--would not be fulfilled. If the membership would see a link or a need for an enlarged General Arrangements to Borrow to finance in every case the activation of the emergency financing mechanism, then probably a fundamental redesign of the General Arrangements to Borrow would be necessary. In this context, I also welcome the staff's statement and that of other Directors, like Mr. Shaalan, who have stressed that an enlargement of the General Arrangements to Borrow cannot be a substitute for a quota increase. Like Mr. Clark and Mr. Waterman, I also believe that the drawing of a connection between the General Arrangements to Borrow and currency stabilization funds would be premature at this stage.

Regarding the desirable size of the General Arrangements to Borrow, I submit that there is no analytical solution to that question. The specific purpose of the General Arrangements to Borrow renders the search for objective criteria for determining precisely the right size of the General Arrangements to Borrow--other than historical relationships--impractical. Above all, however, the appropriate size of the General Arrangements to Borrow depends crucially on how effectively the Fund's surveillance will operate in the future and, particularly, how well the surveillance process will function as an early warning system, on the amount of the Fund's own resources, that is, on the size of the next quota increase, but also on other factors, like, for instance the possible introduction of internationally agreed "work-out" arrangements.

This notwithstanding, I have no objections to the Board proceeding, for the time being, on the basis of a working assumption of a doubling of the size of the General Arrangements to Borrow, as suggested by the G-7 and by the staff.

Regarding the financing of an increase in the General Arrangements to Borrow, it is important to note that the G-7 Halifax communiqué does not call explicitly for a doubling of the size of the General Arrangements to Borrow, but rather for the development of financing arrangements effectively doubling the amount currently available under the General Arrangements to Borrow. This objective could be achieved by increasing the amounts financed by existing participants, by extending the General Arrangements to Borrow or a similar arrangement to other participants, by developing new instruments through which both present and additional Fund members could lend to the Fund and through which the objective of doubling the reserves available could be reached completely outside the General Arrangements to Borrow, or by an indeterminant number of combinations of these three alternatives. The staff has discussed some of these options in its paper. More are possible and imaginable, and should also be evaluated. We generally favor the integration of non-G-10 countries into the responsibility of dealing with international financial crises. Like Mr. Waterman, I believe that new participants to financing arrangements in favor of the Fund should probably be offered adequate incentives, particularly in terms of the right to have a say in the activation of the financing mechanism.

Before we can discuss more thoroughly specific options, however, management should sound out the preparedness of non-G-10 countries to participate in financing arrangements in favor of the Fund under various options and report to the Board on such explorations. I believe that only then can this Board confidently discuss the staff's last question raised in the paper, namely, whether a distribution of contributions as illustrated in Table 8 of the paper is a reasonable basis for further consideration. As the General Arrangements to Borrow is a voluntary exercise, and as any increase in the financing arrangements should be a voluntary exercise, prospective members may also wish to know first in what kind of arrangement they are expected to participate. In this context, I would also like to raise the presumption that drawing too wide a circle of countries potentially participating in the Arrangements might, in the end, prove counterproductive. The Fund requires a certain degree of confidence that the countries that would be called upon if a need were to arise would actually be in a position to deliver. Insofar, one might need to contemplate thoroughly what degree of financing assurances could be offered by countries that are actual or potential users of Fund credit, or by IDA-eligible countries.

Finally, as to the staff's other two questions, at this stage, we see no need to change the activation criteria for participants in the General Arrangements to Borrow and for nonparticipants, respectively, nor do we see a compelling need to change the procedures for activating the General Arrangements to Borrow. As far as we can see, those rules have worked well in the past. At least, no proof has been presented to the effect that they are inadequate.

Mr. Zoccali made the following statement:

As outsiders to the G-10 proceedings, we have found the staff's explanations of General Arrangements to Borrow issues extremely useful and would welcome new information emanating from those deliberations as it develops. I will thus offer some very preliminary comments regarding the G-7 recommendation on the General Arrangements to Borrow.

This chair agrees with the general proposition that the Fund should avail itself of every opportunity to enable it to more effectively fulfill its role in the international monetary system, particularly now that universal membership is a reality. In that regard, however, "conditions of widespread convertibility and greater freedom for short-term capital movements" no longer apply to a reduced group of industrialized countries.

An increasingly integrated world economy, dominated by globalized financial markets, underscores the need for better equipped and less compartmentalized access to Fund financing than when the General Arrangements to Borrow were established--or last modified in 1983--if it is to credibly attempt to "forestall or cope with an impairment of the international monetary system." Although we agree with the Managing Director that it would be premature to discuss now the link between a possible activation of the General Arrangements to Borrow and a triggering of an emergency financing mechanism, we consider such a mechanism long overdue and look forward to discussing the forthcoming staff paper on the subject. At the same time, we continue to see merit in pursuing the link between an emergency financing mechanism and an SDR allocation.

Very briefly, on the issues raised in the paper, as it currently stands the General Arrangements to Borrow represent a potentially hollow response to a sudden change in market sentiment affecting large quota members resulting from its relatively small size, the essentially nonbinding character of the credit commitments, and its complex and nonuniform activation procedures.

At this stage, suffice it to note that we fully agree with the staff's view that for the credit arrangements of the General Arrangements to Borrow to be effective, even as a supplementary financing mechanism, the available amounts would need to be substantial in relation to the size of capital flows and the potentially heavy demands from large quota countries that could occur in the face of a sudden change in market sentiment. An increase of the amount under the General Arrangements to Borrow must not, however, be viewed as a substitute for a substantial Fund quota increase. In fact, agreement early in 1996 on a permanent addition to the Fund's ordinary resources under the Eleventh General Review of Quotas should be part of our understanding in this regard, to ensure that Fund borrowing remains a supplementary form of financing its operations.

In addition, as implementation of a new quota increase is still a long way off and only a portion of the available amount could reasonably be expected to be called on a particular occasion, the callable increase should be sufficient to allow the Fund to finance potentially concurrent drawings under both reserve tranche and large-scale arrangements without seriously depleting its usable resources. While a doubling of the General Arrangements to Borrow as proposed by the G-7 would raise the size to about two thirds of the original size in terms of quotas of participants, it is clear that potential needs are clearly larger than they were in 1962. As noted by Mr. Schoenberg, however, the appropriate size has no optimum analytical formula.

As to maintaining a fixed list of permanent lenders to buttress the Fund's liquidity, the current approach would seem to be unnecessarily restrictive, particularly when usability would in fact depend on the lender's relative external financial strength at the time of activation. In this regard, while we consider useful the staff's elaboration of the notion of "capacity to support the system" to develop financing arrangements, which includes present General Arrangements to Borrow participants and 20 other countries, we are more sympathetic to the notion of an even broader list of potential lenders to the institution, to be reviewed periodically. In this regard, we share the concerns expressed regarding too frequent changes, for the reasons expressed by Mr. Mesaki.

Finally, on the criteria for activating the General Arrangements to Borrow for participants and nonparticipants and the procedures involved, the implication of my earlier remark is that they should be substantially democratized, to use Mr. Waterman's term, if the General Arrangements to Borrow under current or broader Arrangements is indeed to serve as an international back-stop facility. The 1983 decision to extend the General Arrangements to Borrow to nonparticipants is based on asymmetrical decision-making and activating procedures that run contrary to the Fund's principle of uniformity of treatment, and suggest that current General Arrangements to Borrow procedures remain geared to respond essentially to G-10 requests. In light of the recent Mexican experience, we are somewhat skeptical of the Fund's ability to tap General Arrangements to Borrow resources to respond to future emergencies involving nonparticipants in a timely and adequate manner, and would view this as an essential condition for broader participation. In this regard, the approaches mentioned in the staff paper deserve further consideration.

Mr. Daïri made the following statement:

We welcome this preliminary discussion on the enlargement of the General Arrangements to Borrow and support the Chairman's approach to today's deliberations. However, like Mr. Shaalan, we consider that, at the end of the discussions on all relevant issues, the Fund should be in a position to offer a comprehensive and integrated strategy to deal with the new international environment.

On the issue before us today, we reiterate our position that quotas should remain the principal source of Fund financing. In this connection, our preference is for the Board to reach a broad consensus on an increase in quotas under the Eleventh General Review before adopting a decision on the enlargement of the General Arrangements to Borrow. In addition, in view of the rapid changes in creditor-debtor positions, we support further staff work on a mechanism based on a longer list of potential lenders to the Fund. We are attracted not only by the added flexibility of such a mechanism, but we consider that such an approach will help reinforce the cooperative character of this institution. With regard to proposals made by the staff, our preliminary position is as follows: in view of the increasing volatility of capital movements and the globalization of financial markets, we see merit in enlarging the General Arrangements to Borrow, as a backup to the Fund's ordinary resources; we can support a doubling of the General Arrangements to Borrow to an amount of SDR 34 billion. In order to emphasize the cooperative nature of the Fund, our preference is for enlarging the General Arrangements to Borrow by including additional countries. We have an open mind regarding the criteria used by the staff to add 20 countries and to distribute the new credit arrangement, although our preference is for a broader and more flexible mechanism which could potentially include every member that meets the criteria. Finally, we can support the amendment of the criteria for activating the General Arrangements to Borrow in order to eliminate the distinction between participants and nonparticipants. We support also the staff proposal to introduce simplification in the procedures for activating the Arrangements to bring them in line with the procedures currently followed under the Fund's quarterly operational budget.

Ms. Lissakers made the following statement:

Quotas and borrowing arrangements have traditionally played complementary roles in financing the Fund. We continue to believe that quotas should serve as the principal source of the Fund's permanent resource base for use in meeting ordinary balance of payments financing needs. At the same time, borrowing remains a valuable means of augmenting resources to deal with specific situations of an extraordinary nature.

In this context, the General Arrangements to Borrow plays a unique role as the only permanent borrowing arrangement available to the Fund. The General Arrangements to Borrow has been a useful instrument, both as a source of financing and as a vehicle for cooperation among members. We believe it should be retained as the principal source of borrowed funds. However, the international financial system has changed significantly since the 1983 revision of the General Arrangements to Borrow and it is both necessary and desirable to consider how the Fund's borrowing capacity might be enhanced. The staff paper for today's discussion raises three sets of interrelated issues which I will seek to address: the size of an expanded permanent borrowing arrangement and the distribution of country participation; the purpose and structure of a permanent mechanism; and procedures for activation and decision making.

With regard to size and participation, the appropriate size of the Fund's borrowing arrangements is as much a matter of judgment as it is quantification. The objective is to have in place credit lines that will be widely seen as credible in terms of enhancing the Fund's ability to deal with extraordinary financing demands. The staff paper demonstrates clearly that, by almost any test, the Fund's borrowing capacity has declined relative to the world economy, globalized financial markets or Fund quotas.

The staff paper suggests that a doubling of the amounts now available under the General Arrangements to Borrow would go far to restoring the Fund's borrowing capacity to the levels following the 1983 increase. We believe that a doubling is a reasonable objective although the overall size will depend in the final analysis on the willingness of members to lend.

We would also agree that the larger countries with strong current and prospective financial positions should be the prime source of funds. Clearly, the current General Arrangements to Borrow participants will have to play an important role in any augmentation of the Fund's borrowing capacity. However, a wider range of countries are now able to assume greater responsibility commensurate with their increased role in the world economy and the benefits they derive from a stable international economic system and a financially strong Fund.

The staff paper provides some useful background information that is suggestive of those countries that might be in a position to participate. This information will, I hope, stimulate discussion as we carry this debate forward. At this stage, however, it would appear premature to settle on hard and fast criteria regarding potential lenders and the distribution of credit lines. It might be more productive to begin with an informal process involving consultations between management and individual members to determine the level of interest in participating in new lending arrangements. In this context, today's Board discussion is an important opportunity to hear the views of non-G-10 countries, which will help to shape how the Fund should proceed.

With regard to purpose and structure, as I noted earlier, we believe that Fund borrowing is best suited to meeting the Fund's resource needs to deal with specific, yet exceptional situations. I understand the Managing Director's request that we refrain from discussing today the possible modalities of an emergency financing mechanism, particularly the relationship to expanded borrowing arrangements. Suffice it to say that my authorities believe that an emergency financing mechanism involves the kind of extraordinary situation that is best addressed through recourse to borrowed resources. We will, of course, consider carefully management's proposals regarding a possible emergency financing mechanism and look forward to a Board meeting on this issue in September.

The existing General Arrangements to Borrow provides a useful base upon which to build a larger borrowing arrangement. There are, of course, a number of approaches that might be considered enumerated in the paper, including expansion of the General Arrangements to Borrow through increased contributions by existing participants and/or the addition of new members; additional associated borrowing arrangements; a new parallel mechanism in which current and prospective lenders would participate; and some arrangement that would link the existing General Arrangements to Borrow to a supplementary arrangement. Clearly the eventual structure will have to be one that appeals to both current General Arrangements to Borrow participants and potential new lenders. At this juncture, we have reached no firm conclusions, although we do believe that the General Arrangements to Borrow, as it is presently constituted, represents a useful instrument independent of any expanded borrowing arrangement and, therefore, should be continued.

We note the staff's suggestion of yet another approach in which all members would establish supplementary credit lines with the General Arrangements to Borrow that would be activated at the discretion of management. Calls could be made, however, only on countries that were included in the Fund's operational budget at the time financing is required. I must say that we share many of Mr. Mesaki's concerns about the practicability of this approach. In many respects, this proposal is similar to an automatic augmentation of quotas for creditor countries but without the additional rights associated with increased financial commitment to the institution and without safeguards to protect individual creditors. I think that Mr. Mesaki rightly pointed to the necessity for cohesion and certainty about the availability of resources, and a clear identity and cooperative relationship among the members whose resources would have to be tapped perhaps on a very speedy basis. It seems to us that this would not in practice be workable, even though it has a certain democratic appeal perhaps, as noted by Mr. Clark. In view of the complexity of starting from the bottom to develop an entire new mechanism, we would prefer to build on what is already available.

As the staff paper notes, the procedures for activation and decision making under the General Arrangements to Borrow reflect the unique role that the arrangement plays in the Fund and, more generally, in the international monetary system. The staff argues, however, that the current procedures are extremely cumbersome and should be streamlined. For this purpose, they suggest that the activation criterion of forestalling or coping with an impairment of the system should be eliminated because it is difficult to implement operationally in a globalized financial market. This provision is, however, intimately related to the fundamental purpose of the General Arrangements to Borrow. It seems that criteria for activating an expanded borrowing arrangement will also need to reflect the basic purpose of the arrangement. I would note moreover that the proposal to use the General Arrangements to Borrow to finance a currency stabilization fund for Russia suggests that the present language may be more robust and provide greater operational flexibility than the staff now believes.

The General Arrangements to Borrow also requires that the Managing Director find that there is an inadequacy of resources before making calls on the General Arrangements to Borrow. This reflects the role of the General Arrangements to Borrow, originally envisaged as a financial backstop for the Fund rather than a regular source of financing. A new expanded borrowing arrangement, which might have other purposes, could require a change in this provision.

Finally, I share the staff's concern that the consultation and decision-making procedures will need to be improved in order to permit the new arrangement to be mobilized quickly in a world of fast-paced capital flows. We need to recognize, however, that while the procedures may appear complex on paper, they provide the consultation and safeguard mechanisms which are necessary in dealing with major financial shocks. Consequently, any new arrangement will also have to make provision for prior consultations and measures to safeguard the interests of individual creditors. This is obviously an issue to which we will need to return at a later date.

Mr. Kaeser made the following statement:

Like many colleagues, I would like to stress that a quota increase should remain the main mechanism for raising the Fund's financial resources. Nevertheless, I thank the staff for the excellent documentation prepared for today's discussion. This documentation goes far beyond what can be called a review of the General Arrangements to Borrow, but I have to say that I cannot yet give you the position of the Swiss authorities concerning the question of doubling the size of and enlarging the General Arrangements to Borrow. This issue is currently being discussed among the members of the G-10, and the Swiss authorities prefer to reserve their position until the G-10 completes its work on this issue. Switzerland wishes to look very carefully at this issue because its participation in the current General Arrangements to Borrow is relatively high and reaches, in a manner of speaking, the level of the G-7.

The Swiss authorities hope, however, that today's discussion will alleviate the decision-making process in clarifying different questions, such as the need for an increase in the borrowing capacity of the Fund, as the best means to do so and last, but not least, as to how nonmember countries of the G-10 wish to be integrated in a borrowing scheme. As to the need to double the borrowing capacity of the Fund, I think that it has not yet be fully demonstrated. Anyway, under the present General Arrangements to Borrow activation procedures, I wonder if such a doubling would not represent mere window dressing. Mr. Tulin in his very interesting statement expresses the view that the General Arrangements to Borrow could play a useful role in financing currency stabilization funds. But if such funds are eventually established, this would not justify a doubling of the borrowing capacity of the Fund.

It is clear that the decision concerning the future of the General Arrangements to Borrow will depend to a large extent on the way in which "countries with the capacity to support the system" wish to be integrated in the borrowing scheme. In this respect, I think that the decision making for allowing the Fund to draw on exceptional resources for nonparticipants should not be as burdensome as in the General Arrangements to Borrow, but not too easy either.

Finally, I think that the staff should study carefully with different banks consortia the option of borrowing on the private capital market. If surveillance can not prevent a major crisis to occur, we will have to face a recycling problem, and it is by far not sure that such a crisis will lead to a sizable increase in the reserves of the countries in strong balance of payment position.

Extending his remarks, Mr. Kaeser said that the crisis of the twenty-first century would be one of recycling funds from countries with inflows of funds to those countries with capital flight.

The Chairman asked Mr. Kaeser whether he would elaborate on his comment that doubling the resources of the General Arrangements to Borrow would be mere "window dressing."

Mr. Kaeser recalled that, during the Board discussions on the Mexican crisis, a number of Directors had expressed the view that the crisis was not systemic in nature. As one of the conditions for activating the General Arrangements to Borrow for non-G-10 members was a possible impending systemic crisis, a doubling of the resources of the Arrangements for use by non-G-10 members was nothing but "window dressing," because G-10 members would have difficulty agreeing that a crisis facing a non-G-10 member was in fact systemic.

The Chairman wondered whether the implication was that, in order to finance crises such as the Mexican crisis, it would be necessary to change the procedures for activating the General Arrangements to Borrow.

Mr. Kaeser remarked that his personal view was that it would be preferable to introduce a new arrangement that would coexist with the current General Arrangements to Borrow, which should remain a borrowing arrangement of the last resort. The new arrangement--designed along the lines suggested by the staff--could have activation procedures that were less cumbersome than the current General Arrangements to Borrow. However, the rules for mobilizing the resources should not be too lenient.

Mr. Shaalan asked Mr. Kaeser to explain why disagreement about whether a crisis was systemic had a bearing on whether the resources under the General Arrangements to Borrow should be doubled.

Mr. Kaeser said that his personal view was that, as there had been no agreement in the Board about the nature of the Mexican crisis, it was unlikely that G-10 Directors would agree if a similar case were presented to them in the future. As it was unlikely that the General Arrangements to Borrow would be activated for use by a non-G-10 member, he considered that doubling the resources of the Arrangements would be mere "window dressing."

He had also mentioned that the staff should explore the possibility of borrowing from private capital markets, Mr. Kaeser noted. The problem in the twenty-first century would be one of recycling funds from financial markets where there were abundant funds to those areas where there was a shortage. Although a number of Directors had expressed reservations about borrowing from markets, the staff should explore the option in conjunction with the World Bank.

The Chairman remarked that in an environment of globalized markets, the Fund in order to remain relevant must be attuned to possible ways to lend to members faced with a crisis. Instead of borrowing from markets, as and when the need arose, the Board was considering a structured system, under which the Fund could lend to members according to agreed rules and procedures. It was extremely important that those members from whom the Fund may borrow should have the ability to provide the necessary resources to the Fund. Currently, 2 of the 12 members that had lending or associated lending arrangements with the Fund under the General Arrangements to Borrow were not in a position to lend, and a further 2 members had only limited foreign exchange reserves for lending to the Fund. It was in that context that the staff had suggested that, instead of a fixed list of members that would lend to the Fund, those members whose currencies were included in the operational budget--which was drawn up quarterly to include those members with the strongest reserves position--should be listed as potential lenders.

Mr. Schoenberg remarked that money lay where investors' confidence lay. As long as polices were sound, resources would flow in. Although such a mechanism might be imperfect, it was important not to lose sight of the principle that sound policies were essential.

The Chairman responded that a basic tenet of the Fund was that quotas constituted the financial base of the institution and would only be supplemented with borrowing in exceptional circumstances. Furthermore, he agreed that sound policies by borrowing members were essential and stressed that the Fund only provided resources under the condition that appropriate policies would be adopted. However, the Fund also needed to have the option to borrow, and in order to do that, it was important that potential lenders have strong external financial positions, and, currently, some G-10 members did not have sufficiently strong reserves to enable them to lend to the Fund.

Mr. Kiekens made the following statement:

> Today we are discussing borrowing by the Fund, and in particular the possibility of increasing the amount of the General Arrangements to Borrow and of including additional participants in these arrangements.
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> In order for the Fund to borrow, it needs to find lenders who are willing to enter into an agreement with it. As the Fund's decision-making organ, the Executive Board can only make decisions having to do with the Fund's role as a borrower. I will therefore intervene primarily as a member of the Board and not as a representative of a potential lender, although as requested by Mr. Clark, Ms. Lissakers and Mr. Mesaki, I will also attempt to clarify the position of Austria as a possible member of an enlarged borrowing arrangement. By the same token, the Fund as the borrower must allow the consortium of present lenders and any potential new lenders to establish their positions before final

negotiations between the Fund on the one hand, and lenders on the other, can be successfully concluded. As Mr. Schoenberg stressed, finally, our decision about the amount of what is necessary under General Arrangements to Borrow and borrowing arrangements can finally be determined by the implementation of an orderly work-out mechanism.

I would like to emphasize the very preliminary character of these discussions. As was made clear during our discussion of the work program and acknowledged in the Chairman's introductory statement of July 24, 1995, today's discussion is only the first in a series that will cover quota calculation, the role of the Fund in the present environment of globalized financial markets and nearly universal freedom of capital movements, emergency financing mechanisms, and "orderly adjustment procedures for debts in foreign currencies," an item that I still consider to be an integral part of this series of discussion, and which may be an important element in judging the desired amount of lending undertakings by members under the General Arrangements to Borrow.

This being said, I would now turn to the formal subject of today', board agenda. From the Fund's standpoint, and at first glance, there seem to be considerable attractive advantages connected with the idea of devising simpler, perhaps even automatic, procedures that the Fund can use to make drawings against the line of credit it maintains with its important members, with the idea of centering these procedures more directly in the Executive Board and conforming them to those used in the case of the Fund's quarterly operational budget.

Attractive as these advantages are, however, it is also true that the more closely we make the lenders' commitments under borrowing arrangements resemble the commitments involved in accepting a quota increase, the harder it becomes to justify the General Arrangements to Borrow as an exceptional source of financial resources for the Fund that is distinct from the subscription by the members of their quotas.

I would therefore argue that the specific procedures of the General Arrangements to Borrow--which reflect its basic purpose--should be respected, and that our consideration of an increase in amount of the General Arrangements to Borrow should not be permitted to delay our work on the Eleventh General Review of Quotas. So my first reflection is: first, surveillance, then quotas and then borrowing.

I insist that the General Arrangements to Borrow still fulfills an important role distinct from that of quotas. I also recognize that, under any of the various ways of measuring it, the relative size of the existing borrowing arrangements has greatly diminished, both in comparison with the Funds' ordinary resources and in comparison with the size of the financial flows occurring in today's globalized markets. In order to preserve the General Arrangements to Borrow's effectiveness as an instrument for forestalling or coping with impairments of the international monetary system, or for supplementing the Fund's resources when the stability of the international monetary system is threatened, it seems justified, as a working hypothesis, to consider substantially increasing, or even doubling, the present amounts. A more definitive judgment will, of course, depend on our conclusions concerning the role of the Fund and perhaps also the Eleventh Quota increase. At this stage, I would just like to stress that today, more than in the past, members can finance their balance of payments needs via access to the financial markets. The ultimate purpose of the Fund's surveillance is precisely to preserve its members' access to the markets and thereby limit the need for the Fund to intervene with its own resources. The fact that the General Arrangements to Borrows have not been activated since 1983 is largely explained by the pursuit of relatively good macroeconomic policies by the General Arrangements to Borrow and other important members, and hence their continued access to the financial market, an outcome to which the Fund's surveillance has doubtless contributed.

I admit that the criteria for activating the General Arrangements to Borrow for participants and new nonparticipants could be reviewed. The distinction between an "impairment of the international monetary system" and "a threat to the stability of the international monetary system" is not clear cut and the establishment of either condition involves considerable judgment. However, it remains true that activation of the General Arrangements to Borrow should remain exceptional and should be limited to cases in which it is necessary to supplement the Fund's resources.

The distribution of increases in the credit arrangements among existing General Arrangements to Borrow participants and potential new participants should be based on an appropriate set of indicators to determine the relative financial strength of each lender. For this purpose, relative quota shares are apparently the most appropriate indicator, especially following their adjustment for the latest developments in the world economy. They are, however, not the only possible criteria, and in fact the present distribution among the current participants in the General Arrangements to Borrow is based on other criteria as well, such as the member's external reserve position.

Using external reserves as a sole criterion would lead to an inconsistent and unsustainable distribution. For example, on the sole basis of gross external reserves, Mexico would be expected to contribute up to 83 percent of Canada's contribution, 87 percent of the Netherlands' contribution, 125 percent of Belgium's contribution, and almost double Sweden's contribution. Obviously a country's strength is far better expressed by its position as a supplier or user of net international capital flows, as illustrated for example in Chart 32 of the latest World Economic Outlook.

Finally, it is clear that enlarging the General Arrangements to Borrow will not only require an acceptable distribution of shares among the lenders, but also an acceptable decision-making process. Ms. Lissakers has rightly pointed out that various approaches are possible and under consideration in the G-10 working group.

My Austrian authorities wish to make especially clear that they attach great importance to a distribution among lenders of shares that reflects the changes in countries' relative economic positions, their financial strength in the world economy, and the need to participate in the decision-making process according to their financial participation. It follows from this that, for Vienna, the prevailing rules need to be changed. In fact the Austrian position is much in line with what Mr. Waterman had to say about the position of the largest countries in his constituency. My Austrian authorities also stress the need for an understanding about the Eleventh Quota Review that will provide options for adjusting members' quota shares to their financial contributions under Fund-related operations and arrangements.

Mr. Wijnholds made the following statement:

In order to strengthen the Fund's safety net mechanism to deal with emergency situations, I consider it appropriate to substantially increase the amount of credit available under the General Arrangements to Borrow. As the size of the General Arrangements to Borrow has fallen considerably, in relation to both quotas and reserves, a doubling would seem acceptable. However, I would like to emphasize from the outset, as others have done, that increased credit lines for the General Arrangements to Borrow cannot be viewed as a substitute for an increase in members' quotas under the Eleventh General Review.

As to the design of an increase in credit available under the General Arrangements to Borrow, my Netherlands authorities would be quite prepared to accept a doubling of the General Arrangements to Borrow within the current group of participants. They see some practical advantages in this, namely, the rapidity of decision making and the simplicity of continuing with the same group of countries that have a long track record of cooperation on international financial issues.

However, to the extent that enlargement of the current General Arrangements to Borrow contributions were to fall short of the desired overall increase, it should be considered whether the remaining gap can be filled by other countries. Two possible approaches have been put forward.

First, the staff has suggested the establishment of credit lines with all Fund members, to be activated on the basis of their inclusion in the operational budget. Such an approach clearly has advantages as well as drawbacks. One advantage of such an approach would be its flexibility and the absence of partially arbitrary and static criteria for participation in credit arrangements. At the same time, careful attention should be paid to the conditions for activation, in order to ensure that the use of these credit arrangements is limited to exceptional circumstances in which the Fund faces an inadequacy of resources; otherwise the mechanism would, in fact, become a substitute for a quota increase.

A second, and perhaps more realistic, approach is to invite a number of countries to contribute the rest of the envisaged enlargement of the General Arrangements to Borrow--the "rest" meaning what has not been taken care of by the existing members, in view of the fact that I am talking about a doubling. This could be done either by way of individual borrowing arrangements or as a new group arrangement next to the current General Arrangements to Borrow. It would be logical to select these countries primarily on the basis of their reserve positions and their recent inclusion in the operational budget, as these are the most relevant indicators of members' financial strength. When looking at the countries mentioned in group A and B, in Table 8 of the staff paper, these indicators, combined with members that have already shown interest in a borrowing arrangement with the Fund, indeed produce a list of members that seems meaningful. I am also sympathetic to the idea of adding a number of financially strong or potentially strong countries from Latin America--group C--as well, and I would go somewhat further to add some from the group of countries in transition to this list, in order to provide an even more appropriate geographical balance of the membership. As to the individual contributions of countries, I would find it most appropriate to relate these to quotas. An approach of this kind would place the enlarged General Arrangements to Borrow squarely within the Fund. This would in my view be clearly preferable to the creation of a separate body or entity to coordinate the functioning of an enlarged General Arrangements to Borrow. I would envisage the Executive Board playing a central role in this process.

The specific conditions and procedures for activating a new, enlarged credit arrangement would have to be discussed later, as these would be dependent on a number of factors such as the relation between the current General Arrangements to Borrow and the second borrowing mechanism, as well as on the modalities of a possible emergency financing mechanism, and there may be an organic link there with the General Arrangements to Borrow, to be discussed in September. However, at this stage I would say that my authorities are not in favor of deleting the words "in order to forestall or cope with an impairment of the international monetary system" from the decision on the General Arrangements to Borrow. First of all, although this formulation was originally intended as a reference to balance of payments problems in a reserve center, it is broad enough to generally apply to exceptional circumstances, thereby retaining its relevance today. Second, deleting this formulation might give the wrong impression, namely, that any purchase by a participant would automatically be financed by General Arrangements to Borrow resources instead of through the General Resources Account.

Extending his remarks, Mr. Wijnholds noted that he was not in favor of changing the wording of the decision of the General Arrangements to Borrow because it was important to retain certain safeguards, particularly if the Arrangements were enlarged.

Mr. Koissy made the following statement:

Today's discussion on the paper before us is about a possible enlargement of the General Arrangements to Borrow. This is in response to the G-7 Halifax summit communiqué, which has proposed doubling the total amount currently available under the General Arrangements to Borrow and associated borrowings.

An enlargement of the resources of the General Arrangements to Borrow is to be seen in the broader context of the future role of the Fund in a rapidly changing world economic environment, particularly during periods of severe financial crisis.

The staff paper has provided a thorough review of the Fund's experience with the General Arrangements to Borrow and associated borrowing arrangements since 1962. We note from the staff paper the main elements that led to the revision and the modification of the Arrangements in 1983. The arguments used by the Executive Board and the G-10 on that occasion to justify an enlargement of the Arrangements in 1983 remain valid in today's world economic environment. Another enlargement has become necessary because, as the staff paper correctly states, the increasing integration of the world economy--in particular, the volatility of capital flows in emerging capital markets--can now affect the balance of payments positions of many countries at the same time.

The possible enlargement of the General Arrangements to Borrow raises a number of issues that must be addressed. First, we must provide a rationale for an increase in credit arrangements available under the Arrangements at this time. Second, we must suggest the appropriate size of the increase that would be required for the Fund to continue to be effective in responding to requests by countries confronted with financial crises. Third, we have been asked to express our views on the criteria and procedures that govern the activation of the Arrangements for both participants and nonparticipants.

Although we recognize clearly the need to increase the amount of credit arrangements available under the General Arrangements to Borrow, we are not in a position to suggest the precise magnitude of such an increase. However we agree with the staff that the increase would need to be substantial for the Fund to be able to meet potentially large demands from member countries. Consequently, we welcome and support the G-7 proposal to double the amounts of resources available under the General Arrangements to Borrow, which is a step in the right direction.

However, we would like to stress the view already expressed by other Directors, namely, that an increase in the General Arrangements to Borrow should not be considered a substitute for an increase in quotas within the framework of the Eleventh General Review of Quotas. As the staff rightly pointed out, an increase in quotas is needed, inter alia, to provide the Fund with resources commensurate with the financing needs of its members.

Regarding other issues, we are of the view that the procedures for activating the General Arrangements to Borrow should be simplified, and that the same criteria for its activation should be applied to both participants and nonparticipants.

Mr. Fernández made the following statement:

We welcome today's discussion on borrowing by the Fund and thank the staff for two excellent papers on this matter. We would like to share with you what should be considered preliminary views on the matter.

My authorities are willing to participate, in principle, on an existing or on a new borrowing arrangement on the basis of the following principles.

All lenders must be treated with equal footing--this means, essentially, that a distinction between first class and second class members of the arrangement would not be acceptable.

Moreover, the procedure to activate the borrowing arrangement ought to be simple, not cumbersome and not time-consuming. At the sane time, the borrowing arrangement ought to be used by any Fund member. In this regard we share the criticism of the staff's paper on present procedures for activating the General Arrangements to Borrow.

Negotiations on a borrowing arrangement and on the increase in quotas ought to proceed pari passu. Any agreement on the increase in the size of the General Arrangements to Borrow, or on a new borrowing arrangement, should not be regarded as a substitute for an increase in quotas under the Eleventh General Review. Quota subscriptions are, and should remain, the basic source of the Fund's financing. Borrowing should only be of a supplementary or bridging nature in exceptional circumstances.

Extending his remarks, Mr. Fernández noted that his personal view was that the consultations regarding enlargement of the General Arrangements to Borrow should be democratic, open, and transparent.

Ms. Lissakers observed that the discussions on enlarging the Arrangements would be transparent and open and potential participants would be consulted. The Board's discussions were part of the open consultation process. At the same time, there would be parallel discussions among the G-10 members themselves about a possible enlargement, but the intention was to make the whole process as open as possible.

Mr. Fernández said that he welcomed Ms. Lissakers's comments and hoped that her views were shared by other G-10 members as well.

Ms. Srejber made the following statement:

At the outset I would like to welcome today's discussion as well as the staff papers and the Managing Director's statement. We have a clear mandate from the Interim Committee to examine the issues related to borrowing by the Fund from members and, in particular, the role of the General Arrangements to Borrow; in October we have to provide the basis for a review by the Committee of progress in, inter alia, strengthening Fund surveillance and financing.

This is indeed a rather challenging task, not least because all the issues are interrelated. Therefore, I see clear advantages in proceeding very cautiously when we discuss more specific subjects related to this process, in order to ensure that all elements are appropriately addressed before we try to express more firm and final views. For a number of reasons, this is particularly so for the issues at hand for today's discussion.

First, this chair holds the view that borrowing by the Fund from both capital markets and member countries should be approached with great caution, for the reasons given by the Managing Director prior to our discussions on the Fund's financial resources (EBM/95/28, 3/24/95 and EBM/95/29, 3/27/95).

Second, while the sequence of our initial discussions on the various themes connected with the future role of the Fund may be of secondary importance in the end, it seems that we are now following a strategy that resembles the building of a roof, and certainly not an insignificant one, without having a clearer view on the size and organization of the house that should be beneath it. Thus, it would be rather difficult, and somewhat illogical, to express firmer views on a specific financing element before we have a clearer view on the appropriate future role of the Fund, including on the future potential financing needs.

Third, and closely related to this, we should avoid a tendency to focus excessively on the now presumably positive experience from the Fund's financial involvement in Mexico, and on the risks of "similar" cases in the future, as the main basis for our considerations. Instead, what is perhaps the most important effect of the Mexican case deserves to be emphasized, namely, the "positive contagion effects" of some correction of unsustainable developments in emerging markets, increased awareness of the risks associated with continued unsustainable policies in many member countries, and the strengthening of Fund surveillance provoked by the Mexican case. Through an over-reliance on the financing side, the focus could too easily be taken away from these very valuable lessons and instead give rise to moral hazard problems that would underscore the risks of bailouts and arm twisting of central banks and undue financial involvement of the Fund. In any case, there needs to be a proper balance between adjustment and financing when the Fund is involved. I welcome the opportunity to return to these important issues next Wednesday in connection with our discussion on the role of the Fund's financing and its interactions with adjustment and surveillance.

Fourth, as the Managing Director has pointed out in his statement, the issues related to General Arrangements to Borrow and to an emergency financing mechanism clearly have a bearing on one another. While I can support putting aside any emergency financing mechanism considerations until we have had an opportunity to consider the forthcoming staff paper, there is obviously a need to clarify the relation to the emergency financing mechanism at some stage. I would also like to express my hope that some further light will be shed on the relation to the ongoing deliberations on an international debt adjustment mechanism.

Fifth, notwithstanding the need for careful analysis and deliberations on the proper role of the Fund, I would like to emphasize that this chair finds that the primary means for strengthening the Fund's resources is and should continue to be quota increases. This was also, as Mr. Shaalan refers to, emphasized by this Board when it was discussing General Arrangements to Borrow issues in November 1982, partly in response to the financial crisis of the 1980s--the debt crisis. The Board agreed on another important point as well, namely, that any new or additional borrowing arrangement, irrespective of its modalities, "should not retard or impair the quota exercise." I find it appropriate to emphasize this once more in the current circumstances, as we are in part responding to what some have called the first financial crisis of the twenty-first century. Thus, care should be taken that any increase in the General Arrangements to Borrow does not retard or impair the Eleventh General Review of Quotas, and to ensure that the General Arrangements to Borrow plays only a supplementary financing role for the Fund. As had been said by this chair on previous occasions, we find that there is a strong case for a substantial quota increase, even with no major reformulation of the Fund's financing role. Accordingly, I would find it appropriate to give priority to the Eleventh General Review of Quotas and then, depending on the conclusions drawn on the future proper role of the Fund, conside- the various alternatives of other financing mechanisms.

The final reason is that further Fund deliberations might benefit from the ongoing General Arrangements to Borrow considerations in other fora, as was the case in the 1982-83 discussions.

Against this background, I would like to emphasize that the view of this chair on the future role of the General Arrangements to Borrow is of a preliminary nature at this stage. Several issues have to be clarified, and I would find it appropriate if further deliberations on the General Arrangements to Borrow to a considerable degree were to await some further guidance from our forthcoming discussions on the future role of the Fund.

Nevertheless, I will try to provide a few considerations on the main issues for discussion on the General Arrangements to Borrow, namely, the criteria and procedures for activating the General Arrangements to Borrow, and the potential broadening of the Arrangements.

In the staff report, the criteria and procedures for activating the General Arrangements to Borrow are reviewed and the staff has provided some considerations on how these criteria and procedures could be changed. At this stage of the discussion, and based only on work done so far, it is to early to hasten to any conclusion on this issue. The criteria could be further reviewed if this would prove necessary when our discussions developed. An examination could be made of the possibility of activating the arrangement in the General Arrangements to Borrow for financing emergency assistance in combination with financing out of the Fund's regular resources, and of alternative financing modalities and combinations of them.

On the scope of General Arrangements to Borrow, the staff describes an alternative approach that leads me to wonder whether in doing that we would be close to reinventing a form of quota system. Other chairs have pointed to problems with such an approach. This chair is also skeptical about changes that would lead to a globalization of the Arrangements, inter alia, as this will necessarily slow down the decision-making process. Furthermore, it would be necessary to have liberal opt-out rules, which would make it difficult to judge the amount of resources actually provided by the Arrangements. However, we would be open for discussions on how a more limited increase in the number of countries having an arrangement of this kind with the Fund could be developed. I would think that the non-G-10 countries in my constituency might share many of Mr. Waterman's views with regard to the modalities of any new Arrangements. Establishing some kind of a list could be one avenue worth exploring during the further deliberations, but several other issues have to be analyzed and carefully judged as well before we come to any conclusions. Although the illustrative calculations in Table 8 are interesting, we are not in a position to offer firm views on what should constitute the basis for the distribution of increases until other aspects of the Arrangements have been clarified.

The Chairman remarked that the issues raised by Ms. Srejber, namely on an international debt-adjustment mechanism and quota increase, were all on the table and would be considered by the Board, as well as in other fora. It was important to bear in mind that consideration of those issues was time consuming and would necessarily proceed at a slower pace.

Ms. Lissakers commented that she agreed with Ms. Srejber that it was important not to lose sight of the positive contagion effects of the Mexican crisis. The debate on policy adjustment and financing had often been presented as an either/or proposition; however, in her view, the events in Mexico had demonstrated clearly that, in certain circumstances, policy adjustment and financing went hand in hand. Argentina was another case where both adjustment and financing were necessary. However, there were other countries that had suffered from the contagion effects of the Mexican crisis and where adjustment had been more appropriate than financing. Furthermore, whether or not adjustment was more important than financing was not an argument against an enlargement of the Arrangements, particularly as a country that requested extraordinary financing would also be firmly committed to the strict policy adjustment that accompanied the financing. With regard to activating the General Arrangements to Borrow, contributors would emphasize the importance of conditionality and of the necessary policy adjustments to accompany any borrowing from the Arrangements.

Ms. Srejber said that her remarks had not pertained to Mexico in particular. She had emphasized that, rather than focusing on the financing role of the Fund, attention should also be given to surveillance and policy adjustment.

The Chairman pointed out that more progress had been made on strengthening Fund surveillance than on strengthening the financial resources of the Fund.

Mr. Wijnholds said that Directors had not advocated reliance on either financing or adjustment, but had stressed the importance of both. He recalled that at the discussion on the short-term financing facility in 1994, some Directors had expressed reservations about the staff's proposal to introduce such a facility because they felt that it placed far too much emphasis on financing and not enough on adjustment. In cases such as Mexico, it would be inappropriate to focus only on financing without stressing the importance of policy adjustments; indeed, financing all of Mexico's outstanding maturing debt had created problems. However, the Fund had started taking a balanced approach and was focusing on the issues of financing and adjustment equally; in that context, he looked forward to the forthcoming discussion on the role of the Fund.

The Chairman noted that there was a consensus in the Board that there should be an appropriate balance between financing and adjustment.

Mr. Schoenberg remarked that he agreed with Ms. Lissakers that financing and adjustment should go hand in hand and that the availability of financing enhanced the willingness of members to adjust. However, the question was whether it was necessary to provide a member with access to resources in the amount of about 800 percent of its quota in order to induce it to adopt the necessary adjustment measures. If that were the case, it would be necessary either to question the willingness of members to adjust or to reconsider the access limits.

Mr. Shields made the following statement:

As will be discussed at the meetings over the coming month, these issues depend on the whole question of the role of the Fund. I look forward to our discussing in greater depth these issues next week and specifically the General Arrangements to Borrow in the context of the whole question of what the Fund should be doing about its finances, the Fund's liquidity, the need for a quota increase, as well as issues relating to the Fund's response to crises which develop--seemingly much faster than they used to--and the relevance of the proposed emergency financing mechanism.

I respect your wish to concentrate on borrowing and particularly not to go into the emergency financing mechanism details today, but clearly we will need to talk of that soon. I would hope that the discussions would then proceed in parallel--in fact, not just in parallel but also quite closely tied together. Obviously, among the subsidiary issues associated with General Arrangements to Borrow, I note the comments of Mr. Tulin and Ms. Lissakers on the currency stabilization fund and also what Mr. Waterman had to say earlier.

If we concentrate on the Fund's borrowing arrangements, it seems to me that this is a good opportunity not only to look only at the size of those, but also in particular to try to enlarge the group of countries that participate in the General Arrangements to Borrow. Obviously we have moved a long way in 10 years--more than 10 years. During that period there is a whole group of countries which now play a much greater role on the world stage and which clearly have the capacity to enter into borrowing arrangements with the Fund. When we do--if we do--expand such arrangements, clearly these need to give an enhanced stake to these countries as a Fund creditor. It also seems to me they should gain from a share in the decisions which are made to activate borrowing arrangements. This means that, essentially, they will take on a responsibility in the world economy that their current importance and economic strength fully justifies.

In the context of how the discussions proceed over the next few months, I think this discussion and future discussions in the Board are crucial parts of the process. I agree very much with what Ms. Lissakers said just now about the need for transparency in all these discussions, whether they be within the G-10 or outside it.

On the specific points raised in the paper and the discussion this morning, first on the question of the potential size of an increase in General Arrangements to Borrow, I am happy to side with those who wish to double the resources available under the General Arrangements to Borrow and to find the increase in resources both from existing participants and from new ones. Second, obviously, more consideration will need to be given under the terms under which new financing arrangements are agreed and made available. And they will need to be attractive both to the existing G-10 and new participants, so that both sets of countries feel that their stake in decisions and their protection makes the enlargement worthwhile.

Third, if we are looking at which countries might be included in the enlarged borrowing process, it seems to me the numbers cannot be excessively large. There is a lot of discussion in the staff paper about the consultation process in order to keep that manageable. Probably it means a reasonably tight number of countries altogether. I think the Fund paper is very useful in that it looks at possible criteria that might be used and at the potential groups of new participants. I also note the analysis of possible keys for determining shares for credit arrangements. But when we are looking at which countries, then, should hopefully be brought in, I think we need a fairly eclectic process. I certainly would not rule out a priori any member that was currently making use of Fund credit, because I would hope that ultimately they would be in a much stronger external position and, therefore, a very useful contributor.

There are suggestions in the paper about the possibility of separate credit arrangements based on the operational budget. One of the key aspects of the General Arrangements to Borrow at the moment is that there really is a collective relationship among the participants, which I think needs to be maintained. As Mr. Shaalan pointed out in his statement, and others have commented upon, it is not really clear what difference there is between this more broad-based proposal and just an increase in quotas for those in the operational budget, except, I think--an important distinction--that it would provide less rights than a quota increase would. And it could be even more cumbersome to operate.

On the question of operational modalities for the General Arrangements to Borrow, I think this is something that we will probably have to discuss in the future. At the moment, I think we should just leave things as open as possible, but clearly, nevertheless, with the timetable that would move us a long way and would actually allow positive proposals for the Annual Meetings this autumn.

The Chairman said that he agreed that the "collective relationship" among the G-10 that Mr. Shields had referred to had been useful, particularly in providing financing for G-10 members prior to 1982, and because the G-10 had served as a "think tank" for the Fund. However, in terms of providing financing for non-G-10 members, he considered that it would be preferable to have the issue discussed in a wider forum than the G-10, so that all countries that participated in the financing would have the opportunity to express their views and would share the same status with G-10 members.

Mr. Shields noted that the staff's proposal for a supplementary borrowing facility based on the quarterly operational budget meant that the members contributing to the facility would change quarterly; such a flexible instrument would lack the cohesiveness of the current General Arrangements to Borrow, which had a fixed and permanent set of participants and clear agreement among participants about their contributions.

The Chairman noted that the problem lay in the financing of non-G-10 members: one could imagine situations in which G-10 members would not be contributing resources because of their weak external positions, but would participate in the decision making, and situations in which non-G-10 members would be providing financing, but would not enjoy the same status as G-10 members in the decision-making process.

Mr. Shields remarked that he had drawn a distinction between the General Arrangements to Borrow and the supplementary facility proposed by the staff. He considered that the rules relating to activation procedures of the General Arrangements to Borrow would need to be assessed thoroughly.

Mrs. Cheong made the following statement:

> At the discussions on adequacy of the Fund's resources, this Chair agreed with views of many Directors that the Fund quotas should be raised to meet greater financing needs arising from the increased volatility of capital flows in an environment of globalized capital markets. At the same time, we were not adverse to proposals to expand the General Arrangements to Borrow. Now, after evaluating the staff paper, my authorities have stressed that quota increases should be the priority means to raise Fund resources, and they can only assess their participation in the expanded General Arrangements to Borrow after some progress is made in discussions on the amounts of quota increases.
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> With this understanding, countries in our constituency have indicated agreement in principle to an expanded General Arrangements to Borrow, provided the terms and conditions are applied to all participants equally, that they share in the decision making on use of its resources, and that the General Arrangements to Borrow is not used to assist countries facing currency crisis when there is little or no threat to the international monetary system. Their actual participation will, however, be decided later when all features of the scheme have been agreed to. On the number of new participants, my authorities share Mr. Zhang's views that as many countries as possible should join the enlarged General Arrangements to Borrow.
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> In this regard, they have found the preliminary calculations by the staff to illustrate the share of participants in the new General Arrangements to Borrow to be useful. However, given the current state of discussions, as pointed by Mr. Shaalan, the amount for the new General Arrangements to Borrow is dependent on the volume of quota increases, and both these amounts in turn are dependent on estimates of total resources required by the Fund to meet the new challenges. My authorities have, therefore, noted the calculations by the staff. One member was of the view that a participants' share based on calculated quotas would be preferred over reserves, as the latter may fluctuate sharply. It is

appropriate that their views on the other features of the General Arrangements to Borrow, such as activation procedures, be conveyed later, when a clearer picture emerges after we make some progress on the quota issue.

On the alternative proposal by the staff, we agree with points raised by Mr. Mesaki and Mr. Shaalan, but would, nevertheless, keep an open mind. If I understand correctly, Mr. Kaeser proposed that the staff develop this alternative proposal further. I would support this move and urge that in further work, the staff should take account of the advantages and disadvantages of this proposal that have been raised at this meeting. Further development of this alternative proposal could provide us with more options when we next discuss the General Arrangements to Borrow issue at a later date.

Mr. Lanciotti made the following statement:

The latest reform of the General Arrangements to Borrow was a direct response by the major industrial countries to the serious strains that emerged in the international financial system in mid-1982, partly associated with the debt crisis, as a way of reinforcing the line of defense against international monetary instability. The reform's effectiveness is difficult to assess, as the Arrangements have never been used since their reform, but it certainly constituted a reassuring response by the international community to the potential troubles affecting the world economy.

In today's world, the challenges have increased, enhanced by the increasing interdependence among countries, and involve a larger volatility of capital flows, with potentially destabilizing effects. Allowing the Fund to be in a position to continue to assist its members with adequate resources is crucial in such circumstances, and I welcome this preliminary occasion to fulfill the mandate of the Interim Committee to "examine the issues related to borrowing by the Fund from members and, in particular, the role of the General Arrangements to Borrow".

While addressing the points listed at the end of the paper, I would like to share some more general considerations.

I am convinced that as a general principle, the use of the Arrangements might be greatly facilitated should the procedures for their activation be simplified. This notwithstanding, the questions of how and to what extent this principle should be interpreted remain. It can be argued that the Arrangements' current mechanisms, designed with the 1983 reform, have not been subject to the test of actual implementation, and that, therefore, it is hard to predict whether or not the Arrangements can be efficiently utilized for present purposes. From this point of view, I would be inclined to avoid radical modifications or changes, and am in favor of a possible streamlining of the present procedures. Further discussion and analysis might aid in understanding the limits and the possibilities of this option.

A smooth and rapid activation of the Arrangements is crucial in the event of abrupt financial emergencies. It is a source of concern that the activation procedures can be potentially time consuming, particularly when considering the possible use of the General Arrangements to Borrow by nonparticipants. I am therefore open to the discussion of possible solutions, provided they are consistent with the general principle that I stated before.

I greatly appreciated the calculations provided by the staff. I find the staff's approach to be correct in trying to detect the appropriate methodology to meet the principle that the credit commitments of the participants should reflect their size and role in the international economy and their ability to provide financing to the Fund.

I also find interesting the suggestion to include "other countries with the capacity to support the system to develop financing arrangements." I fully realize that the exercise is purely illustrative, but I think that it may indeed constitute a useful basis for discussion. At a first glance, the criteria used to select the list of countries reported in the tables seem suitable, and the groups that emerge from the application of the criteria appear to be well selected. It is also interesting to learn that the list could be extended, and I expect that future work might present a larger set of options, subject to different criteria.

Concerning the simulation of illustrative credit lines under an enlarged General Arrangements to Borrow presented in Table 8, I note that the contributions of single countries, including the current participants, strongly depend on the choice between alternative hypotheses of basing the contributions on quotas or on reserves. This is fully consistent with the results presented in the previous tables, which report the shares of selected countries or groups of countries using various indicators. I wonder, nonetheless, whether other possible distributions might emerge from different criteria, and how sensitive the results are to alternative assumption.

Finally, I agree with the staff document that, while an increase in the resources of the General Arrangements to Borrow might usefully supplement the Fund's own resources, it is not a substitute for an increase in quotas under the Eleventh General Review. In this context, I think that the distinction between ordinary resources--quotas--and extraordinary resources--the General Arrangements to Borrow--is useful.

Mr. Al-Tuwaijri made the following statement:

At the outset, I would like to thank the staff for producing this interesting and useful review of the General Arrangements to Borrow, which highlights a number of important issues that need to be addressed in our discussions of borrowing by the Fund. However, the background paper, which provides a chronological review of borrowing by the Fund, was issued only two days ago. This has not provided sufficient time to solicit my authorities' comments on the sections relating to the Fund's borrowing from Saudi Arabia.

In discussing a possible enlargement or modification of the General Arrangements to Borrow, or other borrowing arrangements by the Fund, we need to consider a number of related issues: first, as the Managing Director has pointed out in his statement, there could be a link between our discussion today and our forthcoming discussion of an emergency financing mechanism; second, there could be a possible link between our need to borrow and the possible establishment of currency stabilization funds, as Mr. Tulin's statement suggests; and third, a discussion on borrowing by the Fund is intertwined with our forthcoming discussion on the role of the Fund.

Against this background, I find it difficult at this point to express concrete opinions on the issues raised in the staff paper. The paper raises the possibility of various options that could be pursued. However, to reach a judgment on the size of borrowing arrangements available to the Fund, as well as the modalities of such borrowing, we first need to come to an assessment on the borrowing needs of the Fund and the purposes for which such borrowing will be undertaken. In the circumstances, we would need to revisit this issue following the discussions we have planned on the aforementioned subjects.

Finally, I will make three additional observations. First, it would be helpful if the forthcoming paper on the emergency financing mechanism attempted to give some indication of the Fund's possible borrowing needs, in the event that such a mechanism was established. This would help us reach a better assessment on the adequacy of the size of the General Arrangements to Borrow. Second, discussions on increasing borrowing arrangements by the Fund have implications for our forthcoming discussion on the possible sale of gold. Indeed, one cannot expect the Fund to be in a position to mobilize borrowed resources on a large scale without the continued assurance of a sufficiently sound reserve position. Third, it would be helpful if the staff would prepare a flow of funds matrix tabulating the various facilities with their possible sources of funds--such as the General Arrangements to Borrow, a new General Arrangements to Borrow, or a similar facility--and the possible uses of funds, including the emergency financing mechanism and the currency stabilization fund. This should prove to be a useful tool in helping us evaluate the proposals before us.

The Chairman remarked that gold constituted the wealth of the institution and should be used with great care. It was important to distinguish between the sale of a portion of the Fund's gold and borrowing by the Fund; indeed, sale of a portion of the Fund's gold should not in any way undermine the Fund's ability to borrow.

Mr. Al-Tuwaijri noted that he was not suggesting that there be any link between the two issues. He thought it would be helpful to assess borrowing by the Fund in the context of the overall financial resources and facilities of the Fund.

Mr. Cailleteau made the following statement:

Like many other speakers, I found it difficult, even at this very preliminary stage, to disconnect the question of enlargement of the General Arrangements to Borrow from the question of their allotment. In this regard, I see a natural but not an equivocal link with an emergency financing mechanism; the G-7 stated in the Halifax communiqué that the enlargement of the General Arrangements to Borrow is intended to support this procedure. I would be reluctant, however, to dwell too much on the use of the enlarged General Arrangements to Borrow to finance the currency stabilization fund, as that rests on a categorical--and to my knowledge rather different--interpretation of the intentions of the potential contributors.

In order to limit this intervention according to the guidelines of the Chairman, I will stress the following principles to which my authorities are attached. An increase of borrowing resources is an exceptional source of financing. That means first that we fully endorse the view that the consideration of the enlargement of the General Arrangements to Borrow should not retard or impair the quota exercise, which is the primary and natural means of strengthening the Fund's resources. That also means that this character of exceptionality must be reflected in the conditions for activating this instrument. We consider there is a trade-off between flexibility and solemnity in the use of the General Arrangements to Borrow. We remain of the view that the cooperative approach in the activation of the General Arrangements to Borrow is a guarantee--that can appear complex and cumbersome--for the credibility of the Fund and the sovereignty of the contributors. Indeed, the activation of this kind of line of credit by the Fund is associated, in the eyes of the market, with dramatic situations--such as the need to cope with an impairment of the international monetary system--thus this is a kind of last resort credit line; therefore, its access must be reserved for exceptional circumstances and governed by exceptional conditions. Naturally, if an organic link is established with an emergency financing mechanism--which we would be inclined to advocate--the conditions of activation could be tailored to the specific features of this new mechanism.

As regards the practical modalities, I will stress the following points: we have to be efficient and equitable. To be efficient means that we have to maintain the integrity of the G-10, as a renegotiation of the present agreements would be, in the best case, lengthy, and, in the worst, inconclusive. A renegotiation of the present arrangements would therefore be a recipe for failure. The requirement of efficiency also means that we might duplicate, as much as possible, the modalities of the present arrangement to save some precious time. This requirement means lastly that the enlargement should be limited to about 10 countries, a reasonable number of countries, to ensure that the procedures for activation will remain manageable. Concerning the choice of new members, we are rather open: I believe we could find a satisfactory balance between any rule-based approach and the eclectic approach alluded to by Mr. Shields. A solution could be to know whether there are candidates, and what would be their preferences. To be equitable, means that we must offer a comparable treatment to all members in order to have a helpful collective relationship.

In the spirit of those two principles, we would see the enlargement of the General Arrangements to Borrow taking the form of a new, separate, broad arrangement of 20 members or so, inspired by the technical modalities of the present one, clearly related to the creation of a new emergency mechanism, that is, with specific conditions for activation tailored to the exigencies of this new mechanism.

Mr. Kafka remarked that, based on past experience, it was somewhat doubtful whether the General Arrangements to Borrow would be drawn upon in the future. It was important that discussions for an increase in quota under the Eleventh General Review proceed quickly. Apart from quotas, the emergency financing mechanism--both as a lending and borrowing mechanism--was also an option for increasing the resources of the Fund. The Arrangements should be a one-tier system, with all members enjoying equal status, and the activation procedures should be simplified. He agreed with Ms. Lissakers that the first step in designing the new Arrangements would be to elicit the views of member countries on an informal basis. He also agreed with the suggestions of Mr. Kaeser, which should be further examined. He considered that members should enter into lending and borrowing arrangements with the Fund, perhaps in two tiers, to address individual and systemic crises. That might be the most effective way of ensuring evenhandedness in the Fund's surveillance.

Mr. Geethakrishnan made the following statement:

The discussions on augmenting the resource base of the Fund commenced some time last year. We have explored several avenues. The Mexican crisis not only lent added urgency but also clearly established that the amount of Fund support required in times of such crisis would be of a much higher order than was our expectation and understanding earlier.

It is therefore quite heartening to find one group of members--the G-7--coming out clearly with a definite solution in one of the areas that we have beer discussing, that is, the General Arrangements to Borrow. The Halifax communiqué categorically states that the General Arrangements to Borrow are to be doubled, and for this very clear unequivocal commitment the G-7 needs to be congratulated. Pending continued exploration of other avenues, we have something definite at least on one area.

The staff paper, which goes into the nitty-gritty, does a good job of explaining the details. However, and perhaps in accordance with an old adage that the longer the snake the more the number of places where it can be hit, the exhaustive analysis in the staff paper gives rise to some questions, some issues on which further clarification would be necessary.

The first query arises from the fact that the General Arrangements to Borrow have been used only by the members, as a facility, since inception, I hope I am not wrong in assuming that we are now visualizing an enlarged General Arrangements to Borrow which would be available to support any and all members of the Fund who need access to this facility. If I am wrong and the facility is to be available only for its members, then it would be largely for that membership to decide on the rules of the game. Nonmembers would have little say in the matter and can fruitfully devote their time and efforts to exploring other measures of durably augmenting the Fund's resource positions, a matter in which they have a clear role.

If the Mexican crisis has established one thing beyond doubt, it is that while the Fund could process a proposal expeditiously--there were many who thought that even the Fund was not quick enough--accessing other sources of funds could be problematic. The support from the United States was quite generous, but the controversy that it generated in domestic politics clearly highlights the likely difficulties in extending such support rapidly. As far as the Bank for International Settlements is concerned, there was clearly a gap between the initial expectation and the final outcome.

I therefore think that it would be best if a member, in crisis, had to approach only the Fund, leaving it to the Fund to process the request, access the General Arrangements to Borrow, and draw and disburse the resources to the needy member. This would require that the members contributing to the General Arrangements to Borrow should be willing to authorize the Fund to draw the funds as and when required and also delegate to the Fund all responsibility for processing a request for funds. I readily see that it is easy for a non-General Arrangements to Borrow member to give such generous gratuitous advice, but whether the General Arrangements to Borrow members would also see the issue in this light is a different matter. If we are to have a dual processing of a request, by the Fund and the administrators of the General Arrangements to Borrow, then even if the processing is to be done simultaneously, it would lead to all kinds of problems and delays. We will then be faced with what Mr. Kaeser referred to the other day as the "upper house" or "upper chamber" syndrome.

If my first set of worries related to the relationship between the General Arrangements to Borrow and the Fund, the second set relates to an inter-relationship among the members of the General Arrangements to Borrow. To start, is the doubling of the General Arrangements to Borrow to be achieved though its existing members, that is, the G-10 only, or is it definite that the present set of members is looking forward to additional members joining its group? If the answer is in the affirmative, then is the list of possible additional members already predetermined by a set of prescribed criteria as detailed in the staff paper, or is any member who is willing and able to participate with a generous commitment of funds acceptable and welcome to the present group of members? Assuming that there is an interest in increasing the membership, the third question that arises is the relationship between the existing members--who may be called the primary members--and the new members--who may become secondary members. Will they all have an equal standing, with each having a voice proportional to the funds committed?

This issue becomes important because the General Arrangements to Borrow today is a largely close-knit group, the G-10, which meets often for other purposes also. At the same time, if the membership is extended on the basis of willingness and ability to contribute, then this cohesiveness will be lost. And perhaps one answer would be, as I mentioned earlier, for the enlarged group to act as a forum only for getting commitments of resources and thereafter delegate everything to the Fund. More easily said than done! If the membership is to be increased, and if, in the interest of securing speed and efficiency in decision-making, all powers are to be delegated to the Fund, then the question of a quid pro quo becomes relevant and important. Mr. Ismael drew attention to the quod pro quo idea the other day during the preliminary discussions on the Halifax communiqué. Are there any thoughts on this aspect?

These are some of the basic doubts that come to my mind when I go through the staff paper. I may be wrong in seeking these clarifications from the staff. Perhaps--at least at this stage--clarifications could be given only by the G-7 or the G-10 chairs. Whoever gives these clarifications, it would help in having a better understanding of what is visualized when we talk of the doubling of the General Arrangements to Borrow in the context of augmenting the Fund's resource base to tackle Mexican-type crises. In deference to the Chairman's wishes, in this intervention I have not attempted to link the General Arrangements to Borrow with any other matters such as the other channels for augmenting Fund resources, the role of the Fund, the emergency financing mechanism, the order in which various proposals should be discussed, which items should have higher priority, and so on.

If I have not tried to counteract the issue raised in the staff paper, it is because I feel that we should first know what shape the G-10 wishes to give this proposal. For instance, if the further elaboration by the G-10 of their thinking on this issue reveals that the General Arrangements to Borrow are likely to remain largely a members-only club type of arrangement, then it will be in the interest of the vast majority of our members to proceed with the consideration of the various other proposals that we have been discussing for some time. I am therefore looking forward to an early elaboration of this thinking by the G-10.

Mr. Schoenberg remarked that it was premature to discuss the nature of the operations that the General Arrangements to Borrow would support. The Arrangements had been designed to provide a pool of resources that the Fund could borrow from when its own resources were insufficient to meet an extraordinary large demand for Fund financing from members.

Mr. Geethakrishnan said that for non-G-10 countries it was important to hear the views of the G-10 regarding access to resources of the General Arrangements to Borrow by non-G-10 countries. For a country such as India that could potentially face a Mexican-style crisis, it was important to know whether it would be able to borrow from the G-10 in the event of a crisis. To increase the resources of the General Arrangements to Borrow in the order of doubling would entail a large increase in the Fund's resources; if developing countries such as India would not have access to those resources, they would, instead, focus their efforts on a quota increase, which would be beneficial to them. It was in that context that he had asked for further elaboration from G-10 members.

Mr. Schoenberg replied that the G-10 had begun discussing those issues, but members had not reached a decision as yet. In his view, in addressing the question of activating the General Arrangements to Borrow for use by non-G-10 members, it would be necessary to reassess the rules for activating the Arrangements, because thus far they had been activated to support requests by G-10 members only, as those countries alone fulfilled the criteria for activating the Arrangements, namely, the risk of a systemic crisis and the need for large amounts of financing that could not be provided from the Fund's ordinary resources.

Ms. Lissakers pointed out that consideration had been given to activating the General Arrangements to Borrow to support a currency stabilization fund for Russia.

The Chairman recalled that, at the time when the Fund was considering activating the General Arrangements to Borrow to support a currency stabilization fund for Russia, the G-10 Directors had noted clearly that, in keeping with the rules governing the activation of the General Arrangements to Borrow, the Managing Director would have to demonstrate that a systemic crisis was impending and that the Fund's liquidity was not sufficient to support a currency stabilization fund for Russia.

Ms. Lissakers noted that the issue of activating the General Arrangements to Borrow for non-G-10 members was indeed complicated. In response to Mr. Geethakrishnan, she remarked that the G-7 in its communiqué had established a link between an emergency financing mechanism and enlargement of the General Arrangements to Borrow. Thus, the intention was to broaden the scope of the current Arrangements.

Mr. Geethakrishnan said that although the G-7 had indicated that there was a link between an emergency financing mechanism and the General Arrangements to Borrow, leading to a conclusion that the Arrangements could be activated for use by non-G-10 members, thus far, the G-10 members themselves did not appear to have reached an agreement on the issue. Fund support for Mexico's program would have been of a different nature had such Arrangements been available for being activated. For developing countries, it was important to know whether resources of the General Arrangements to Borrow would be accessible to them.

Ms. Lissakers remarked that the G-7 had established some link between an emergency financing mechanism and the General Arrangements to Borrow.

Mr. Geethakrishnan noted that, if that was indeed the case, then he welcomed the fact that the enlarged General Arrangements to borrow would be available to support non-G-10 members in times of crisis.

Mr. Tulin remarked that it was standard banking procedure to keep a bank's liabilities and assets distinct. Thus, strictly speaking, there was no need to draw a link between the General Arrangements to Borrow as a possible source of additional liquidity and the allocation of Fund resources. However, even if it were inappropriate to draw a link between the General Arrangements to Borrow and an emergency financing mechanism or a currency stabilization fund, it was important to address the issue of simplifying the activation procedures to make the resources of the General Arrangements to Borrow more easily accessible to non-G-10 members.

The Chairman stressed that it was important to maintain the original mandate of the General Arrangements to Borrow, namely, that it continue to remain essentially a source of borrowing of the last resort that the Fund could draw upon to finance primarily the large balance of payments needs of the G-10 countries. Although the General Arrangements to Borrow had not been activated for the past 17 years, it was nevertheless important to maintain the Arrangements. He welcomed the fact that G-10 members were ready to increase the size of the Arrangements, because the potential problems of both the G-10 and non-G-10 countries had increased. In responding to the Mexican crisis, the Fund had been fortunate, because its liquidity had been sufficient to allow it to support Mexico's program with its own resources. The issue facing the Fund was how to ensure that it would have the necessary resources to respond to other members that could be faced with similar crises in the future. One possibility would be to enlarge the General Arrangements to Borrow or have similar parallel arrangements and alter the activation procedures to make the resources available to the membership at large; an alternative would be to have supplementary borrowing arrangements--as proposed by the staff--that would coexist with the current General Arrangements to Borrow. Such a supplementary borrowing arrangement would also have firm rules regarding activation and would be monitored closely by the Executive Board and would enable the Fund to respond to crises that were perhaps not systemic and were not a threat to the smooth functioning of the international monetary system, but were nevertheless serious enough to warrant Fund support. He was pleased that Directors had been willing to consider such an arrangement where all participating members would have equal status.

Ms. Patel made the following statement:

> The establishment of the General Arrangements to Borrow has provided the Fund with an important means with which to strengthen its ability to more effectively manage the international monetary system by supplementing its resources. The role of the General Arrangements to Borrow has become even more relevant in the current economic environment, where capital mobility has increased significantly and the volatility of capital movements can give rise to financial emergencies. Doubling the size of the current General Arrangements to Borrow will not only strengthen the Fund's liquidity position, but also enable it to respond in a timely and adequately manner to such eventualities to ensure financial market's stability.
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> However, notwithstanding its importance in dealing with the very specific cases of emerging strains in the international

monetary system, the General Arrangements to Borrow is not likely to be available to a large number of developing countries, despite the seriousness of their balance of payments problems, as they do not pose any threat to the system. It is therefore important that while an attempt is being made to reinforce the mechanisms for safeguarding the stability of the financial markets, this should not overshadow the need for an increase in quotas under the Eleventh General Review. This exercise is critical to ensure, on a more permanent basis, the availability of Fund resources to deal with the financial requirements of its members.

In view of the new realities in the international economy, a question arises as to whether the present structure of General Arrangements to Borrow is consistent with the potential problems that are likely to emerge and could affect the international monetary system. It would seem that the Fund would need to support its resources in order to be able to respond quickly to these emerging problems. Perhaps, it might be useful to consider ways in which General Arrangements to Borrow might be adapted to cope more effectively with these problems. In the same vein, it would also be useful to consider ways that could facilitate the ability of the potential contributors of General Arrangements to Borrow to do so easily, although some criteria might be useful.

On the specific issues raised in the paper, it is indicated that there have been no activations of the revised General Arrangements to Borrow since its enlargement in 1983. This appears to be attributable to the complex and restrictive conditions required for its activation. It seems to be reasonable, therefore, that the current cumbersome procedures should be simplified, particularly if it has to respond rapidly to emerging financial crisis. As a first step in this direction, we can agree with the suggestion advanced by the staff to streamline these procedures for activating the General Arrangements to Borrow by focusing them more directly on the Executive Board. We do not see any convincing argument why different criteria have to be applied for activating the General Arrangements to Borrow for participants and nonparticipants. Furthermore, as the staff has indicated, in the present system of globalized markets, it is difficult to give operational significance to weather a transaction meets the criterion of forestalling or coping with an impairment of the system. Deletion of these criteria appears therefore, to be reasonable.

The Treasurer noted that the Toronto meeting of the working group of the G-10 Deputies had raised many of the same points that Directors had made that day. A number of members of the working group had considered that an increase in the size of the General Arrangements to Borrow to about SDR 32-37 billion would be appropriate; they had discussed the nature of the enlarged Arrangements, that is, whether there would be parallel arrangements or associated arrangements with new participants or new structures that would incorporate the General Arrangements to Borrow as a unit or with the present participants as individual contributors. They also discussed the link between the General Arrangements to Borrow and new parallel or associated arrangements in the form of new arrangements outside the General Arrangement to Borrow, and discussed two options in particular, both of which were quite similar. The working group had commented only briefly on the proposal in the staff paper of supplementary lines of credit, as they had not had enough time to reflect on the staff paper.

As regards activation procedures, a number of members of the working group considered that the different procedures for participants and nonparticipants should be maintained, while others felt that the procedures in practice were not that different. For instance, in activating the General Arrangements to Borrow for use by a participant, the Managing Director was required to consider whether the transaction was necessary to cope with a possible impairment of the system; for nonparticipants, he was required to ascertain whether the transaction was also necessary to cope with a possible impending systemic crisis and that the Fund's liquidity was low. In an environment of globalized markets, the distinction between a systemic crisis and impairment of the system was one of nuance rather than substance. In addition, in order to activate the Arrangements for a nonparticipant, the Managing Director was required to ascertain that the arrangements were necessary because the Fund's resources were inadequate to meet actual and potential requests for financing, while for participants, the Managing Director had to ascertain only that borrowing was necessary to supplement the Fund's existing resources. The increasing integration of the world economy raised questions about whether the different conditions for activating the General Arrangements to Borrow for participants and nonparticipants should be maintained.

The supplementary lines of credit proposed in the staff paper were no more a substitute for a quota increase than any other borrowing, the Treasurer considered. As with any other borrowing, such lines of credit would only supplement the Fund's resources and would be drawn upon in circumstances similar to those that required activating the General Arrangements to Borrow. They could not, if only by their size, substitute for a quota increase. In the past, borrowing had been activated when the Fund's liquidity had been low, when there had been a large increase in requests for financing, and in the interim period prior to a quota increase. The supplementary lines of credit would be activated only as needed or would be designed to serve as a form of insurance and in that respect would be no different from any other form of borrowing by the Fund. However, the system of supplementary credit lines had advantages that other borrowing arrangements had lacked: first, they would enable the Fund to tap the surplus resources of a large number of countries, and, as the list of such countries would change quarterly, such an arrangement would allow the Fund to have access to the resources of those countries with the strongest balance of payments and reserves position in any quarter; second, the procedures for activating the supplementary lines of credit would be more democratic as decision making would rest with the Executive Board, and not, as with the current Arrangements, the G-10 and the Executive Board. The Board would review on a quarterly basis those countries that would be eligible for inclusion in the operational budget, and hence, those countries that would contribute their surplus resources to the supplementary lines of credit. The supplementary lines of credit could be permanent, but would be reviewed periodically, and would exist in parallel with the General Arrangements to Borrow, and it was intended to be more flexible than the current Arrangements.

As regards the legislative procedures for countries contributing to the supplementary lines of credit, the staff envisaged that the borrowing arrangement would be agreed with all Fund members at the outset, and, at that time, legislative approval from all member countries would be sought, the Treasurer observed. However, it was not envisioned that further legislative approval would be required whenever the lines of credit were activated.

Mr. Shaalan said that he was grateful for the clarification of the difference between a quota increase and the supplementary lines of credit. He wished to emphasize that the proposed lines of credit should not become a substitute for a quota increase.

The Chairman remarked that there was unanimous agreement among Directors that enlarging the General Arrangements to Borrow or introducing new borrowing arrangements would not substitute for a quota increase.

The Treasurer noted that the General Arrangements to Borrow had not been designed to finance a particular facility. The Arrangements had been designed to replenish the Fund's ordinary resources in exceptional circumstances and therefore the resources of the General Arrangements to Borrow were as fungible as other Fund resources. The Chairman in his statement had cautioned against drawing a link between an emergency financing mechanism and the General Arrangements to Borrow. Indeed, one could imagine a situation in which the Fund's ordinary resources might be used to finance emergency lending and other cases in which the Fund would need to activate the General Arrangements to Borrow to respond to a request for large-scale but not necessarily emergency financing.

Mr. Shields observed that, under the proposed procedures for activating the supplementary lines of credit, members whose currencies were included in the operational budget could be asked to participate in the supplementary facility. He asked whether the decision that a member provide financing would rest with the Executive Board or with the member.

The Treasurer replied that once a country's currency had been included in the operational budget and initial legislative approval to participate in the supplementary lines of credit had been granted, the decision to call upon members to provide emergency financing would rest with the Executive Board.

Mr. Shields observed that he had reservations about whether such a procedure was democratic.

The Treasurer observed that under the General Arrangements to Borrow, a member's voting power was commensurate with the size of its contribution, that is, it was a weighted voting system. Such a system was different from the normal voting procedures used in the Board, under which a member's vote was determined by its quota contribution. Directors might prefer a voting system that reflected their contributions to the borrowing arrangement rather than one that reflected their quota contributions; however, such a system would not necessarily be democratic if it could block the activation altogether.

Ms. Lissakers remarked that one of the drawbacks of a borrowing arrangement with universal membership was that it would be very similar to a quota increase. Under the proposed borrowing arrangement, the decision to activate the lines of credit would be no different from that relating to a stand-by arrangement or other Fund-supported programs, that is, the decision would rest with the general membership. The problem was that certain members would be asked to provide exceptional financing without a commensurate increase in voting power. Such a system, in her view, was not particularly appealing.

The Chairman remarked that, although certain countries provided the resources for the enhanced structural adjustment facility (ESAF) account, the decisions relating to the use of ESAF resources were based on the normal voting procedure in the Board, that is, the contributing members' votes were not a reflection of their contributions to the ESAF, but of their quota contributions. In activating the supplementary lines of credit, the voting system could be designed in one of two ways: either the Board could adopt the same voting system that was used for other Fund facilities, including the ESAF, or members could be given voting powers commensurate with their contributions, as with the current Arrangements. In his view, the staff's proposal of supplementary lines of credit provided for appropriate safeguards; in particular, as financing would be of an exceptional nature, it would be monitored closely by the Executive Board. He was confident that the Executive Board would exercise firm vigilance over the need for such exceptional financing in individual cases and would ensure that borrowing from the supplementary arrangement was accompanied with tough conditions. Establishing the supplementary lines of credit would require legislative approval in some countries where the central banks were not allowed to enter into agreements with the Fund without prior approval from the legislature, but he considered that obtaining legislative approval would not be an insurmountable problem. Moreover, any enlargement of the General Arrangements to Borrow would also require legislative approval in some countries.

Ms. Lissakers remarked that the decision to activate the borrowing arrangements entailed two decisions: one, the decision by the Fund whether or not to lend to a member facing a crisis; second, a decision by those members providing resources whether or not they should go ahead and lend to the Fund. The second decision was not related to the provision of Fund resources, but was about whether those individual members should lend to the Fund, and, thus, that decision should rest with those members providing the financing.

The Chairman said that he agreed that two separate decisions were involved in activating the borrowing arrangements. The sequence in which the two decisions were made in the context of the current Arrangements were not wholly satisfactory, and, depending on Directors' views could be either continued or reconsidered. He could envisage a decision-making procedure under which the decision to lend would rest with the Executive Board, but the decision to provide financing would be made by the contributing members alone, and their voting power would reflect the size of their contributions. He considered that such an approach would be inappropriate, but he would leave that matter for Directors to reflect on further.

The Treasurer remarked that the General Arrangements to Borrow were unique in that they were the only facility in the Fund where the decision to lend rested solely with the contributing members; with all other facilities--for example, borrowing for the ESAF, or the arrangement with the Saudi Arabian Monetary Agency--the decision relating to the borrowing of resources by the Fund and made available by certain members rested with the membership at large.

The Chairman remarked that the issues discussed were indeed important, from both a financial and institutional perspective. He would ask Directors to reflect on those matters in a spirit of open mindedness and with a view to reaching a consensus.

The Chairman made the following concluding remarks:

> Today's discussion on the General Arrangements to Borrow, although preliminary, has been very useful. It was important to hear the differing views of members of the Board, and I am particularly grateful for those who have contributed with candor to this meeting.
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> First, while welcoming a discussion on the General Arrangements to Borrow and its possible enlargement, all Executive Directors expressed the view that any enlargement of the General Arrangements to Borrow was not to be regarded as a substitute for an increase in quotas under the Eleventh General Review. Indeed, several Directors considered it should not impinge on the timing and size of the quota increase. This was another way of stressing the essentially supplementary nature of the Fund's borrowing arrangements.
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> Second, there was very broad agreement that there was a strong case for an increase in the size of the credit lines under

the General Arrangements to Borrow; the order of a doubling of the size was mentioned by many, with precautions; and even those who said that the case for doubling was not made accepted that consideration of that amount would be reasonable. Most Directors were of the view that a relatively large supplementary borrowing arrangement was an important form of insurance for the Fund in the event that it was called upon to finance drawings by a few relatively large members either simultaneously or in rapid succession and, perhaps, in emergency situations.

Third, a number of Directors stressed that the Fund should have a comprehensive strategy to deal with emergency situations in the new international environment of globalized markets. In that context, I heard a number of calls for early Board consideration of an emergency financing mechanism. Directors will receive the paper shortly. The Halifax summit established the three basic principles of an emergency financing mechanism, which, were: strong conditionality, quickness in decision making, and front-loaded financing, if needed. The paper would elaborate on those three principles, and would also define how an early warning system--a pre-emergency regime--might work; in particular, in the event that the staff perceived a risk emerging, there would be effective channels of communication between the staff and the Executive Board. Such a system would avoid a repeat of the situation with respect to Mexico that occurred in late January, when the Fund was confronted with a crisis and the Board had to act rapidly.

Fourth, many Directors emphasized that, if the number of possible lenders to the Fund were increased in the context of a large increase of the General Arrangements to Borrow credit lines, consideration should be given to increasing the number of participants that adhere to the General Arrangements to Borrow itself so that all potential lenders were given equal status in the arrangements. However, other Directors considered that it was desirable to hold open the possibility of parallel borrowing arrangements with respect to new potential lenders that would be the same as, or similar to, the General Arrangements to Borrow itself. It is clear that, in the course of our further discussions, the relationship between the General Arrangements to Borrow and possible new parallel arrangements will need to be clarified and that any final structure will establish the right balance between contributions and responsibilities.

Fifth, Directors noted the usefulness of the illustrative calculations made by the staff regarding the composition of a list of possible members that would seem, on a medium- to long-term basis, to be sufficiently strong to lend to the Fund, and the distribution of credit lines in the context of doubling the size of the General Arrangements to Borrow credit lines. Those illustrative calculations showed that, with the increasing integration and globalization of the world economy and financial system, new groups of creditors or potential creditors were emerging, which were outside the main industrial economies. Many Directors noted that it was essential that the Fund should be in a position to tap those new surpluses in order to strengthen the Fund's liquidity position over the long run. The possibility of borrowing from private capital markets was also mentioned as an avenue we should never rule out.

Sixth, a number of speakers believed that--with reference to General Arrangements to Borrow decision making and consultation--the group of additional members in an expanded General Arrangements to Borrow should not be large. Some other Directors believed that it would be worthwhile to explore the possibility of developing supplementary borrowing arrangements with a relatively large number of members, with the provision that supplementary lines of credit could be drawn upon in accordance with the Fund procedures regarding the selection of currencies for inclusion in the Fund's operational budget and, indeed, with all appropriate safeguards. Those Directors requested some elaboration of the modalities of such borrowing arrangements beyond that provided in the staff paper in order to indicate how such a system could work. The staff will issue a short note on the operational modalities of such a scheme for the consideration of the Executive Board.

Seventh, many Directors welcomed this opportunity to review the procedures relating to the activation of the General Arrangements to Borrow. The General Arrangements to Borrow has not been activated since its modification and enlargement in 1983, and the speed at which the arrangements could be activated was uncertain. Many Directors were of the view that the activation procedures were somewhat cumbersome and possibly time consuming, given the nature of both the informal and formal consultations required in connection with the Managing Director making a proposal to activate the arrangements. Many Directors were of the view that reconsideration of the current activation procedures was warranted. In that context, a number of Directors supported the suggestion that consideration of the Managing Director's proposal to activate the arrangements could be centered on the Executive Board, should be made more open, more transparent, and democratic, and that the activation procedures might be simplified. A number of other Directors noted that the General Arrangements to Borrow activation procedures would need to be considered by the G-10 itself.

Eighth, a number of Directors felt that the different criteria for activating the arrangements with respect to participants and to nonparticipants were not warranted. Those

Directors were of the view that the use of the General Arrangements to Borrow should be to supplement the Fund's resources in general and to finance the use of the Fund's resources by any member rather than a particular member or group of members. Those Directors were of the view that the special criteria on which the Managing Director was required to be satisfied before he could propose an activation of the General Arrangements to Borrow for a nonparticipant might not be fully in accord with developments in the world economy. Again, a number of other Directors noted the need to judge the efficiency of the activation procedures in the event that the General Arrangements to Borrow needed to be activated at short notice to finance an emergency situation. Those Directors felt that the activation procedures had worked relatively well in the past, and noted that the consultations called for in the General Arrangements to Borrow Decision could be carried out expeditiously both by the G-10 Deputies and the Executive Board. This is certainly an area where further reflections would help, and I believe that we can find an appropriate solution.

As regards our next steps, I must say that I am a little bit concerned. We are, for obvious reasons, at a very early stage in our work, and, owing to the nature of things, our discussions will have to proceed in parallel with the G-10's deliberation on the subject. At the same time, there is some urgency because of our mandate from the Interim Committee. When I see the G-10's working calendar--to which the technical working group of the Deputies will propose a set of options sometime in the middle of September for discussion by the Deputies later that month--I see a certain difficulty in reconciling the calendars of the G-10 and the Executive Board, as we will have to be ready in time for the Interim Committee's meeting in October. I will also need to be ready to conduct some consultations with potential participants. There is therefore a problem of the timetable and I would urge members of the Executive Board to help their capitals take a pragmatic view on this and to try to expedite this process so that we can complete our work rapidly. We will need to have a strong General Arrangements to Borrow or another borrowing facility in place before, and not after, the quota increase.

In addition, we will, as requested, circulate as soon as possible a brief paper on the modalities of supplementary lines of credit. I hope that the Executive Board can consider this and other possible forms of enlargement and strengthening of the General Arrangements to Borrow in September, bearing in mind that I will have to report on this matter to the Interim Committee.

I would like to add three further personal points of emphasis. The first is on the relationship between an emergency financing mechanism or procedure and the General Arrangements to

Borrow. It was for the sake of maintaining clarity in the discussion that I suggested that we have two separate discussions, although I know that there is a connection or link between the two. Even if the link between the General Arrangements to Borrow and an emergency financing mechanism is not absolute, they need to be considered together. It is not an absolute link, because one can imagine that the General Arrangements to Borrow could be activated in the absence of a situation justifying the use of an emergency financing mechanism, and we can envisage situations where an emergency financing mechanism could be activated without having to call on the General Arrangements to Borrow. Mexico was a case in point. The staff will prepare a paper on an emergency financing mechanism for consideration by the Executive Board in early September.

The second problem is the need to reconcile two important things: the ability of this institution to react promptly and firmly to situations of emergency, and, in such circumstances, to have available in the Executive Board enhanced, intensified, effective instruments for consultation and control. If I felt frustration in this Executive Board at the time of the Mexican crisis, it was not because we had to act expeditiously and firmly or because our financing was front loaded, but mainly because we were not able to put in place and to activate with sufficient speed such an intensified consultation mechanism. We must reconcile that, but we must do the reconciliation by utilizing to the fullest the unique capabilities of this Executive Board. We are talking about strengthening the Fund's surveillance procedures, about strengthening programs, and about quickness in analysis and diagnosis. I do not know any body in the world better suited to meeting these kinds of challenges than this Executive Board, which is used to taking the lead each time tough work has to be done. It should not be difficult to establish the procedures for activating an emergency financing mechanism to allow for both expeditiousness in decision making and the involvement of capitals.

But there is an extra dimension that nobody has mentioned this morning--that is, the political dimension. In situations that require activating large amounts of financing in exceptional circumstances, the political dimension becomes an important element. For that, I would remind you that we have an Interim Committee, which is the most legitimate structure to represent the world's financial policymakers. Of course, normally it is a body that can meet only with advance notice, but it is also possible to elicit from the members of the Interim Committee a quick response when needed, either by inviting them or their Deputies to meet on short notice here or to take a decision by mail or by phone.

So, I would urge you to consider that, if it becomes necessary to introduce a consultative process to take account of the political dimension in cases that involve activating strong emergency financing, the Interim Committee should be the suitable body to this end. I say that with particular emphasis because the Halifax communiqué mentions the need for "revision of the Ministerial committees of the Fund and World Bank to promote more effective decision making." Bearing in mind also the efforts of Chairman Maystadt, and the letter he sent to his colleagues last year on reinvigorating the Interim Committee, I would suggest that giving a particular role to the Interim Committee in the activation of emergency financing would simultaneously meet two important objectives--political consultation and effective, speedy, advice.

Third, there is the question of the relationship between the actual ability to contribute and the need to maintain a certain cohesiveness in the group that provides financing. Of course, the cohesiveness of the G-10 has been established by 34 years of history and it is well established. However, I think the cohesiveness among the contributors could also be ensured in the framework of the scheme for establishing credit lines suggested by the staff, particularly if the Executive Board would be the central place for implementing it. Although the list of potential contributors--those included in the operational budget--will vary, it will be reasonably homogenous over time. In my view, the problem of cohesiveness should not be intractable.

All these issues deserve further consideration and reflection. They are important questions, central to the mandate we have received to adapt the Fund to the challenges of the future.

2. DEVELOPMENT COMMITTEE - REVIEW OF FUTURE OF COMMITTEE

The Managing Director reported on the recommendation of the Troika to strengthen the Development Committee.

The Managing Director made the following remarks:

As you know, Mr. Wolfensohn has made proposals to the members of the Development Committee to change the Committee's procedures. These proposals, which I fully support, are intended to revitalize the Committee and have received broad support from members. As a result, the Chairman of the Committee, Mr. Wolfensohn, and I were able to agree at our recent meeting on a proposed general approach, which we hope will find support in the respective Executive Boards and lead to a successful conclusion by the Committee on October 9 of the review on the future of the

Committee. The main elements of the suggested approach are set out in a note circulated to Directors yesterday by Mr. Shakow, the Acting Executive Secretary of the Committee.

I will highlight the main points of this approach that are of particular relevance for the Fund. The Committee's basic mandate and structure would remain the same. The Fund would continue to be a partner in the Committee, but the focus would shift significantly toward Bank issues of policy importance and other matters of broad significance for development. The current practice of meeting twice a year would continue for the time being. The format for future meetings could be refined, based on the experience with the Committee's meeting on October 9. Increased flexibility would be introduced into the Committee's work. In particular, plenary discussions would be more focused on a few specific propositions whenever possible, restricted sessions would become the predominant format to increase candor and active participation, and the communiqué would be kept brief. Major changes in format are proposed for the October 9 meeting.

The agenda item agreed at the Committee's meeting this spring--implications of the Social Summit--would remain one of the elements of the agenda. An outline of the key issues on this subject, prepared jointly by the Bank and Fund staff, will be circulated for information soon, and the full paper has been scheduled for discussion by the Fund's Committee of the Whole on September 6.

There would be a short plenary session, limited to brief introductory statements focusing on the Social Summit by the Chairman, the President of the World Bank, the United Nations Secretary-General, and myself. Following that, a restricted session would consider a number of critical Bank-related policy issues, and this discussion would be continued during a luncheon for Ministers. As an initial suggestion, Mr. Wolfensohn has put forward for the restricted session the topics of IDA, debt to multilateral development banks, and the future of the Committee. Further thought is being given to the topics, and we will come back to you so that Ministers are prepared.

I understand that Mr. Wolfensohn has briefed the Bank's Board informally this morning and that the Bank Board is agreeable to this general approach.

Mr. Schoenberg asked whether the Development Committee would continue to be a joint committee of the Bank and the Fund.

The Managing Director replied that the Committee would continue to be a joint committee, which was appropriate, as the Committee's purpose was the transfer of resources to developing countries--an issue that was relevant to the work of both the Bank and the Fund. However, the Committee would shift its focus to development-related issues; the papers would continue to be prepared by the staff of both institutions, and Executive Directors of the Fund would comment on those papers as before.

Mr. Schoenberg wondered whether it was appropriate that the Fund continue to be partner in the Development Committee, as the Committee would be focusing on development issues.

The Managing Director remarked that the Troika--the Chairman of the Committee, the President of the World Bank, and he--had agreed that it was not necessary to change the constitution of the Committee, but a shift in the focus of its work would be beneficial for the Committee. Executive Directors at the Fund would continue reviewing the papers as they had in the past, paying special attention to Fund-related matters.

Mr. Al-Tuwaijri asked whether the review on the future of the Committee was continuing.

The Managing Director observed that a working group of senior officials from member countries had been deliberating on the future of the Committee. The group had concluded that there was no need to change the constitution of the Committee; however, they had recommended that it was necessary to enhance the policy dialogue between the Bank's management and the ministers of the member countries.

The changes that he had outlined would be discussed further at the October 9 meeting of the Development Committee, the Managing Director continued. The changes that had been proposed were not permanent, but would give the new management of the Bank an opportunity to reflect further on the role of the Development Committee.

Mr. Geethakrishnan observed that many of the issues that the Committee addressed were global issues in which the Fund had an equal interest. Thus, in his view, it was important that the Executive Directors of the Fund continue to be involved in the work of the Committee.

Mr. Schoenberg stressed that, although he agreed that some of the issues that the Development Committee addressed were relevant to the work of the Fund; however, as the Committee would be dealing mostly with Bank-related issues, he wondered whether it was appropriate that the Fund continue to be involved in the work of the Committee.

The Managing Director remarked that that issue had been discussed by high-ranking government officials of major countries for the past 18 months, and they had decided that the Committee should continue to be a joint committee.

3. MARSHALL ISLANDS - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with the Marshall Islands (SM/95/121, 5/24/95). They also had before them a statistical appendix (SM/95/122, 5/26/95).

The staff representative from the Southeast Asia and Pacific Department made the following statement:

> Discussions on the Article IV consultations with the Marshall Islands and the Federated States of Micronesia have been scheduled on the same date in view of the similar economic issues that they face, especially the need to adjust to lower prospective U.S. financial assistance. The required degree of adjustment is greater in the case of the Marshall Islands because of its existing severe budget and external debt problems. Comparative data are shown in the table in the Annex.
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> Under the 1986 Compact of Free Association, the United States agreed to provide substantial financial support to the Marshall Islands and the Federated States of Micronesia through annual budgetary grants, which have been gradually reduced and are to be entirely phased out after the year 2001. Although it is possible that the Compact could be extended beyond this date, the authorities have no information on either the likelihood of that happening or the extent of financing that can be expected. In response, the governments in both countries have begun to curb spending, but their fiscal positions remain in deficit and their balance of payments positions continue to be structurally weak. The key policy issue is addressing these imbalances and establishing paths toward external viability by the end of the Compact period.
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> The two economies have a narrow productive base, consisting primarily of subsistence farming and fishing; physical and financial infrastructure is inadequate; and restrictions on land use limit the extent of production expansion. Both countries use the U.S. dollar as domestic currency, which circumscribes the role of monetary and exchange rate policies. The public sector is the main source for formal employment, and its high wages deter private sector development. External grants fund a high proportion of government expenditure, and the bulk of foreign aid finances imports, which are equivalent to about two thirds of GDP.
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> Fiscal reform is the cornerstone of the adjustment strategy. Emphasis has to be placed on cutting the wage and salary bill, eliminating subsidies to public enterprises, and implementing revenue proposals of past Fund technical assistance missions. Fiscal consolidation needs to be supported by measures to strengthen infrastructure and institutions so that private sector

activities can expand. This process will likely result in a decline in output and income in the short run, as nominal wages are cut and the required rationalization of the civil service results in temporary rising unemployment. The early pursuit of adjustment will, nonetheless, help smooth the inevitable transition.

With regard to the adjustment strategy, the process of fiscal reform has not yet commenced in the Marshall Islands, although it is already under way in the Federated States of Micronesia.

Government expenditure in the Marshall Islands has continued to expand rapidly in recent years, with the fiscal deficit averaging 15 percent of GDP. Extensive commercial borrowing has been undertaken against future Compact funds to finance current expenditure as well as capital development, outstanding debt has reached 165 percent of GDP, the debt-service ratio is equivalent to 43 percent of exports of goods and services, and government financial holdings are virtually exhausted. Information recently received indicates that across-the-board reductions in current spending will be incorporated in the 1996 budget, but details will not be announced prior to the November 1995 general election.

The Micronesian authorities have begun fiscal adjustment, with government expenditure falling by 30 percentage points of GDP since 1991; as a result, the fiscal deficit has averaged only 3 percent of GDP. However, commercial borrowing has been undertaken against Compact funds, outstanding debt is 55 percent of GDP, future debt service is equivalent to 25 percent of exports of goods and services, and financial holdings of the Central Government have declined. The federated government structure has complicated efforts to build a consensus for the coordination of policy implementation, and the autonomy of state governments has permitted some of them to continue pursuing unduly expansionary policies. Information recently received suggests that the national government budget for 1995/96 envisages lower expenditure, to be achieved largely through subsidy cuts. In addition, the State of Chuuk has engaged the national Government in an effort to resolve its financial difficulties.

As regards external support, while the bulk of the financial assistance to the two countries during the next few years will continue to be provided by the United States, the authorities of both countries are seeking technical and financial assistance from other multilateral and bilateral donors. The Asian Development Bank (AsDB) has placed development advisory teams in each country to help with the preparation of an adjustment strategy that could mobilize donor support and is convening initial Consultative Group meetings in December 1995. The Fund staff is collaborating closely with the AsDB in this process as well as offering continued technical assistance in the fiscal, monetary, and statistical areas.

Mr. Petrie made the following statement:

The staff report has highlighted the constraints facing the Marshall Islands economy of a relatively narrow resource base together with limited financial resources and administrative capacity. This will make the adjustment to the projected large decline in external assistance all the more difficult. Nevertheless, my authorities appreciate the staff's frank assessment of the current situation and medium-term prospects for the Marshall Islands economy.

My authorities accept that the burden of macroeconomic adjustment will have to be borne mainly by the fiscal sector. Preparation of the 1995/96 budget--for the fiscal year (FY) starting October 1, 1995--is under way, with the draft budget expected to be presented to Congress in August. My authorities have indicated that they are aiming at a combination of significant expenditure cuts and some new revenue measures. No further commercial borrowing is intended. All ministries and agencies have been asked to apply a 10 percent across-the-board reduction in expenditures to their 1994/95 budget. In addition, a thorough line-by-line scrutiny of all budget submissions is being undertaken at the moment to identify additional expenditure cuts. Recommendations by a Fund technical assistance mission are also being considered. However it is too early to say what will be adopted, until the budget proposals have been considered by Cabinet and approved by Parliament in September.

At the same time, my authorities recognize that stimulating growth in those areas where the Marshall Islands has a comparative advantage--fishing, tourism, and agriculture--is necessary. To that end, construction of a 150-room hotel in Majuro has commenced and is expected to be completed by June next year. Its cost of $10 million is being financed from the Government's financial holdings. The Government has also financed the purchase of a SAAB aircraft for Air Marshall Islands. They will be seeking to recover part of the costs of the aircraft from the Governments of Kiribati and Tuvalu under a proposed arrangement to establish a subregional airline holding company.

My authorities realize the magnitude of the adjustment task they face, and have advised us that Asian Development Bank staff and consultants who will constitute a Policy Advisory Team over the next three years have recently arrived in Majuro. They will be working with the Government in formulating a comprehensive package of reforms for presentation to an Asian Development Bank-organized Consultative Group meeting in December. These reforms will also integrate the World Bank study on reforming the public sector. A task force has now been established for this purpose.

My authorities also realize that much needs to be done to strengthen the technical capability and administrative capacity of the revenue collecting departments. In this regard, the early recruitment of a tax advisor under technical assistance from the Fund would be appreciated, so that outstanding tax reforms can be considered simultaneously with the structural reforms proposed under the auspices of the Asian Development Bank assistance.

Finally, on behalf of my Marshall Islands authorities, I wish to thank the staff for its continuing assistance. We appreciate the frankness of their advice in guiding us on the very difficult path of adjustment in the coming years.

Mr. Wang made the following statement:

We note that the authorities have made certain progress in the management of the economy since the last Article IV consultation. However, as recognized in Mr. Petrie's helpful statement, the economy of the Marshall Islands is still far from reaching a sustained path toward greater self-sufficiency. A narrow production base, diminishing Compact funds, and likely exhaustion of government holdings of financial assets present an extremely daunting challenge for the authorities. Like the staff, we also think there is no alternative but to implement fundamental structural changes to diversify the ownership structure of the economy to promote growth. Diversification of ownership will help not only to boost the production base and increase competition but also reduce the excessive size of public employment.

In the fishing, food production, and tourist sectors, which have been identified as having medium-term growth potential, market incentives such as price liberalization and reformed land use policy should be allowed to play a greater role in stimulating private participation. It is good to know that the Asian Development Bank is actively supporting the authorities' efforts to expand the production base. We encourage the authorities to strengthen their cooperation--including technical assistance--with regional and global financial institutions.

The fiscal situation in the Marshall Islands remains a source of concern. Failure to achieve the deficit target and the likely exhaustion of government financial holdings have led the budget to the verge of being out of control. We join the staff in stressing the need for urgent fiscal action to curb current expenditure in order to hold the overall budget deficit within an acceptable level. We fully support the suggestions by the staff relating to the reduction of various outlays.

In concluding, we share the staff's assessment and policy advice, and we believe that the expansion and the diversification of production, together with immediate fiscal adjustment, are the most daunting tasks confronting the authorities.

Mr. Botoucharov made the following statement:

The staff should be commended for producing a candid and straightforward report on the present status of the Marshall Islands' economy. Since the previous Board discussion (EBM/94/44, 5/20/94), the macroeconomic situation has clearly deteriorated and, as the staff notes, the required adjustment efforts are much greater than previously envisaged. Therefore, I fully endorse the staff's position that, although the renewal of the Compact agreement after its formal conclusion in the year 2001 is not out of the question--and the authorities hope for that--a far-reaching adjustment to eliminate the pronounced basic macroeconomic imbalances and to overcome structural problems remains a necessity.

The main policy issues confronting the Marshall Islands are very similar to those facing the Federated States of Micronesia and are clearly set out in the staff report and statement. They refer to the need for decisive fiscal consolidation, owing to the limited role of the monetary and exchange rate policies, and for broad-based structural adjustment measures. As I am in broad agreement with the staff's appraisal and recommendations, I will cover only a few points.

Fiscal adjustment undoubtedly remains the most important challenge facing the authorities of the Marshall Islands. Mr. Petrie and the staff indicate the authorities' commitment to substantially cut government expenditures, and to introduce new revenue measures, and I certainly welcome these intentions. In particular, with regard to expenditures, I agree that the maintenance of high-level capital expenditures is warranted during the period in which the infrastructure needs to be built up, but it should be offset by cutting public sector wages, eliminating unnecessary subsidies to the public enterprises, and accelerating policies of commercialization and privatization. The required overall adjustment for fiscal year 1995/96, however, amounts to a massive 26 percent of GDP. The question therefore is not whether this adjustment is necessary, but whether it is achievable. I would appreciate the staff's comments on this.

As regards the need for structural reforms and the expansion and diversification of the productive base, I welcome the authorities' recognition of the importance of well-focused infrastructure programs to encourage private sector development. It is essential that the Marshall Islands establish the preconditions for diversification of the narrow productive base and for enhancing the role of the private sector. This, ultimately, will foster rapid growth and ensure economic viability. In this light, I would be interested in some further details about the prospect of direct foreign investment, especially in the fields of tourism and air transportation.

Finally, although this chair welcomes the practice of discussing both the Marshall Islands and the Federated States of Micronesia on the same day, we would appreciate it if in the future we were given the chance to discuss more than two island countries in one day. For instance, some Caribbean countries could be included as well. This would present the Board with a good opportunity to compare these countries' policies and development--and I believe that it would also save some time.

The Acting Chairman said that the staff would give thought to what could be done to organize the agenda along the lines suggested by Mr. Botoucharov.

Ms. Brettschneider made the following statement:

The staff report provides a very frank assessment of the economic situation in the Marshall Islands, and of prospects for the future if current trends continue. I have little to add to the staff's analysis--particularly in view of the comments of previous speakers--which is completely in line with our own.

The picture has been troubling for a number of years now, as concrete action to prepare for the cut-off of Compact funds from the United States has continued to be weak in the Marshall Islands, if not altogether absent in some critical areas. Developments since the previous Article IV consultation have only intensified our concerns about the deterioration of the fiscal situation, the continued borrowing against Compact funds, and the delays in structural reforms and diversification that will be critical to attaining economic self-sufficiency led by the private sector.

In examining the bigger picture, I found striking the apparent lack of urgency on the part of the authorities, even when faced with the very real prospect that government finances would run dry by the end of this fiscal year in the absence of additional measures. Although we may have a tendency to look at the year 2001 as the so-called cut-off point of U.S. assistance under the Compact, the Marshall Islands is set to run out of time much earlier, unless bold steps are taken immediately to reduce the budget deficit, which is projected to reach a staggering 20 percent of GDP in 1994/95 under the current policies.

Underlying this lack of urgency is, perhaps, the expectation or hope that more funds will be forthcoming, either from the United States or from nontraditional sources. It is no secret that the future of U.S. foreign assistance across the board is uncertain in the current political environment. Potential recipients are therefore under closer scrutiny than ever as to how deserving they are of a piece of the rapidly shrinking pie of resources. This assessment is, of course, based on the strength of the reform effort of the country in question.

The same is true throughout the donor community, as was made clear in the Board discussion of foreign assistance trends earlier this year. The Marshall Islands should take this message to heart and be prepared for tough questions at the Consultative Group meeting that is being organized by the AsDB for later this year.

Although we recognize the sensitivities involved in an election year, the macroeconomic situation in the Marshall Islands has reached crisis proportions that cannot be ignored. Waiting until after the elections to act will put the task at hand even farther out of reach.

On specific policy issues, we fully endorse the staff's recommendations with respect to potential areas for fiscal tightening. With current expenditure absorbing 62 percent of GDP, it is clear that efforts will need to be focused in this area. It is hard to see how this effort can be successful without further reductions in subsidies and meaningful consolidation of the government wage bill, both through wage restraint and a significant streamlining of personnel.

Contrasting current expenditure figures to expenditure on human resource development, we find that the latter has fallen by an alarming rate over the past five years, which has led to declining education and health standards. These trends are further complicated by the Marshall Islands' high rate of population growth. Ensuring a productive work force will require a renewed focus on social sector priorities.

We share the staff's questions about the appropriateness of the Government's hotel construction project and the purchase of a second aircraft for Air Marshall Islands, and view their recommendations to curtail these projects as part of the adjustment process as prudent. Instead, the authorities' efforts should be focused on creating the necessary conditions for private sector development to expand the productive base.

Achieving economic self-sufficiency by the time of the Compact phase-out will hinge on the success of these efforts.

The Acting Chairman, responding to a request by Mr. Oya to make a combined statement on Marshall Islands and the Federated States of Micronesia, assured him that his comments on Micronesia would be taken into account in concluding the Article IV consultation with Micronesia.

Mr. Oya made the following statement:

First of all, I would like to commend the staff for preparing well-organized and informative Board papers after working very hard on a difficult mission that kept the staff team away from Washington for almost one month.

Although I highly commend the quality of the staff papers, I believe that there seems to be more room for reducing the staff's workload relating to small island countries, mainly by streamlining paperwork. I would say that staff reports should be about ten pages. In this connection, I welcome the staff's initiative in combining its statements on Marshall Islands and the Federated States of Micronesia by identifying common features of both countries. I would urge the staff to go further in this direction.

On substance, as I said earlier, I agree with most of the staff's analysis and advice, and I have very little to add. As regards Marshall Islands, it is alarming that outstanding debt has reached 165 percent of GDP and the debt-service ratio is equivalent to 43 percent of exports of goods and services. I have to say that there are very few countries in the world that are in a worse situation. I urge the authorities to begin drastic fiscal consolidation immediately, in cooperation with the Fund.

Regarding the Federated States of Micronesia, it is crucial for the national and state governments to give priority to formulating a coordinated strategy to foster the development of the private sector, especially in the area of fisheries and tourism.

Although the large-scale restructuring of the economy, which is necessary for both of the countries, may be painful, I would urge the authorities of both countries to press ahead with their adjustment efforts, bearing in mind the staff's view that the cost of postponing the efforts is likely to be much higher.

The Acting Chairman said that he agreed that every effort should be made to be as efficient as possible in dealing with all countries. With particular reference to the length of staff papers, the emphasis recently had been on their brevity. In the case of Marshall Islands, it should be noted that the staff report was 12 pages in length, if account was taken of the fact that the text began on page 3. Moreover, as Mr. Oya and Ms. Brettschneider had mentioned, the situation of the Marshall Islands was verging on crisis, and full consideration and exposition of the issues involved should surely have helped Executive Directors in formulating their comments.

The staff representative from the Southeast Asia and Pacific Department said that it had been useful to learn from Mr. Petrie's statement that the Government was proposing a 10 percent across-the-board cut in expenditure for 1995/96 and that it was committed not to undertake any further external borrowing. However, those steps fell far short of the immediate measures that the staff had hoped the authorities would take. It was not a question of whether the proposed measures were achievable, but that there seemed to be no other choice in the current difficult situation.

Because the authorities had no funds and could no longer borrow, the staff representative noted, drastic action was required, with respect both to current expenditure and to a very ambitious investment program. The staff would certainly encourage the authorities to curtail the investment program by abandoning the hotel project and the second aircraft purchase; as a second best solution, if they were determined to move ahead, and assuming the money could be found, the staff would encourage foreign participation in both projects. A greater effort could have been made to attract foreign direct investment for the hotel project. The Government should also press ahead with the efforts it had begun to make to encourage the Governments of Kiribati, Tuvalu, and Nauru to participate in a subregional airline.

The staff would also advise the authorities to move ahead with the implementation of a number of proposals for revenue measures that had resulted from a Fiscal Affairs Department technical assistance mission in 1992, the staff representative added. He understood that the authorities had shown some further interest in taking the measures if additional technical assistance could be provided. The Fiscal Affairs Department had made provision in the 1995 regional allocation plan for that purpose.

Much more needed to be done to develop the private sector over the medium term, the staff representative from the Southeast Asia and Pacific Department stated. Unfortunately, there was not much to report in the way of changes with respect to two key elements of such development: wage flexibility and land tenure reform. The staff had endorsed the position taken by the U.S. chair that the amount of assistance that could be expected both from the United States and from other donors over the longer term would depend crucially on the success of the Marshall Islands' own efforts to strengthen its adjustment program. The staff would continue to stress that position, both during discussions at the 1995 Annual Meetings and at the first consultative group meeting that the Asian Development Bank was organizing later in the year.

Mr. Petrie thanked Executive Directors for their comments, which he would relay to his authorities. It was clear that the Marshall Islands authorities had undertaken only limited adjustment to date and were therefore facing the need for abrupt action. They had indicated that they would not undertake any further commercial borrowing. The preparations for the 1995/96 budget suggested that they realized the limited options available to them. However, the issue would be complicated, because the budget would be finalized in the run-up to presidential elections in November.

With respect to the issue of data provision to the Fund, Mr. Petrie said that his authorities had indicated that they would endeavor to improve the flow of information they provided to the Fund between Article IV consultations, within the constraints of their limited statistical capacity.

Finally, Mr. Petrie observed the authorities would welcome the indication by the staff representative that the Fiscal Affairs Department had made provision for technical assistance to assist them in strengthening their revenue capacity.

The Acting Chairman made the following summing up:

The Executive Directors broadly agreed with the staff appraisal. Directors expressed disappointment at economic developments in recent years, including the very low growth in output, the widening fiscal deficits, the heavy external commercial borrowing, and the running down of financial holdings of the Government. In view of the scheduled elimination of U.S. financial assistance by the year 2001, Directors urged the authorities to develop promptly a comprehensive strategy to eliminate the pronounced macroeconomic imbalances, overcome deep-rooted structural problems, and establish a path toward external viability. While recognizing the magnitude of this task, they underscored the importance of urgent action to help smooth the inevitable transition. The situation was seen as having reached crisis proportions.

Directors considered that fiscal policy should be the cornerstone of the adjustment strategy and that drastic steps needed to be taken urgently. Large cuts in current expenditures were imperative, especially through lower civil service employment, public sector wage restraint, and the elimination of subsidies for public enterprises. Directors encouraged the authorities to abandon plans to operate a hotel and urged a full analysis prior to undertaking further aircraft purchases. They endorsed the desirability of implementing revenue measures proposed by earlier Fund technical assistance missions. Outstanding external debt and debt-service obligations had reached unsustainable levels, and there was a crucial need to avoid further commercial borrowing and rebuild the financial holdings of the Government.

Directors stated that the creation of a more dynamic private sector is vital to absorb redundant labor from the public sector and ameliorate the economic impact of declining external support. Fishing, small-scale agriculture, and tourism were seen as promising sectors. However, wage flexibility will be needed if the private sector is to absorb the resources released from the public sector. The public investment program should concentrate on providing the necessary infrastructure to support private sector activities. Enhanced efforts should be made to promote foreign direct investment, facilitate the use of land for commercial purposes, and encourage longer-term development lending with the banking system.

Directors welcomed the proposal for the AsDB to convene an initial Consultative Group meeting for the Marshall Islands in late 1995. The establishment of a good track record by the Marshall Island authorities would be essential for mobilizing greater financial support.

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

4. FEDERATED STATES OF MICRONESIA - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with the Federated States of Micronesia (SM/95/119, 5/24/95). They also had before them a statistical appendix (SM/95/120, 5/26/95).

The staff representative from the Southeast Asia and Pacific Department made the following statement:

Discussions on the Article IV consultations with the Marshall Islands and the Federated States of Micronesia have been scheduled on the same date in view of the similar economic issues that they face, especially the need to adjust to lower prospective U.S. financial assistance. The required degree of adjustment is greater in the case of the Marshall Islands because of its existing severe budget and external debt problems. Comparative data are shown in the table in the Annex.

Under the 1986 Compact of Free Association, the United States agreed to provide substantial financial support to the Marshall Islands and the Federated States of Micronesia through annual budgetary grants, which have been gradually reduced and are to be entirely phased out after the year 2001. Although it is possible that the Compact could be extended beyond this date, the authorities have no information on either the likelihood of that happening or the extent of financing that can be expected. In response, the governments in both countries have begun to curb spending, but their fiscal positions remain in deficit and their balance of payments positions continue to be structurally weak. The key policy issue is addressing these imbalances and establishing paths toward external viability by the end of the Compact period.

The two economies have a narrow productive base, consisting primarily of subsistence farming and fishing; physical and financial infrastructure is inadequate; and restrictions on land use limit the extent of production expansion. Both countries use the U.S. dollar as domestic currency, which circumscribes the role of monetary and exchange rate policies. The public sector is the main source for formal employment, and its high wages deter private sector development. External grants fund a high proportion of government expenditure, and the bulk of foreign aid finances imports, which are equivalent to about two thirds of GDP.

Fiscal reform is the cornerstone of the adjustment strategy. Emphasis has to be placed on cutting the wage and salary bill, eliminating subsidies to public enterprises, and implementing revenue proposals of past Fund technical assistance missions. Fiscal consolidation needs to be supported by measures to strengthen infrastructure and institutions so that private sector activities can expand. This process will likely result in a decline in output and income in the short run, as nominal wages are cut and the required rationalization of the civil service results in temporary rising unemployment. The early pursuit of adjustment will, nonetheless, help smooth the inevitable transition.

With regard to the adjustment strategy, the process of fiscal reform has not yet commenced in the Marshall Islands, although it is already under way in the Federated States of Micronesia.

Government expenditure in the Marshall Islands has continued to expand rapidly in recent years, with the fiscal deficit averaging 15 percent of GDP. Extensive commercial borrowing has been undertaken against future Compact funds to finance current expenditure as well as capital development, outstanding debt has reached 165 percent of GDP, the debt-service ratio is equivalent to 43 percent of exports of goods and services, and government financial holdings are virtually exhausted. Information recently received indicates that across-the-board reductions in current spending will be incorporated in the 1996 budget, but details will not be announced prior to the November 1995 general election.

The Micronesian authorities have begun fiscal adjustment, with government expenditure falling by 30 percentage points of GDP since 1991; as a result, the fiscal deficit has averaged only 3 percent of GDP. However, commercial borrowing has been undertaken against Compact funds, outstanding debt is 55 percent of GDP, future debt service is equivalent to 25 percent of exports of goods and services, and financial holdings of the Central Government have declined. The federated government structure has complicated efforts to build a consensus for the coordination of policy implementation, and the autonomy of state governments has permitted some of them to continue pursuing unduly expansionary policies. Information recently received suggests that the national government budget for 1995/96 envisages lower expenditure, to be achieved largely through subsidy cuts. In addition, the State of Chuuk has engaged the national Government in an effort to resolve its financial difficulties.

As regards external support, while the bulk of the financial assistance to the two countries during the next few years will continue to be provided by the United States, the authorities of both countries are seeking technical and financial assistance from other multilateral and bilateral donors. The Asian Development Bank (AsDB) has placed development advisory teams in each country to help with the preparation of an adjustment strategy that could mobilize donor support and is convening initial Consultative Group meetings in December 1995. The Fund staff is collaborating closely with the AsDB in this process as well as offering continued technical assistance in the fiscal, monetary, and statistical areas.

Mr. Petrie made the following statement:

As the staff report clearly sets out, the Federated States of Micronesia faces a major challenge in adjusting its economy to the phasing-down of external assistance over the next six years, given the size of current U.S. Compact assistance in relation to the Micronesian economy. This adjustment is made more difficult by the particular problems of a small and geographically dispersed population, remoteness from international markets, a lack of natural resources, and the limited technical and administrative capacity in the public sector.

My authorities agree with the staff's analysis that the strategy required is to reduce the size and role of the public sector, and to create the conditions needed for sustained private sector growth. This is the basis of the strategy set out by the President in his 1994/95 budget speech, in which he called for a halving of the ratio of current government expenditure to GDP by the end of the Compact period. However, the necessary changes have to be managed carefully, and implemented only after public discussion and understanding of the need for them.

My authorities agree with the general thrust of the many detailed recommendations in the staff report. I will therefore comment briefly on developments since the staff mission.

The 1995/96 National Government Budget submitted recently to Congress (for the fiscal year starting October 1, 1995) contains: a 16 percent cut in subsidies that includes the elimination of subsidies for the National Fisheries Corporation and the Development Bank as well as a 50 percent reduction in the subsidy for copra production; and a cut in total spending of 2.3 percent compared with the 1994/95 budget.

In addition, the Customs Act, (which will improve revenue collection by closing loopholes) has been resubmitted to Congress.

At the state government level, the authorities are moving forcefully to address the financial problems in the State of Chuuk. In accordance with a memorandum of understanding with the National Government, the Chuuk State Government is to cut total spending on wages and salaries in FY 1996 by 20 percent, increase sales tax rates, and end the subsidy to the Utilities Corporation. The reform package is to be considered by the Chuuk State legislature in the near future.

As the staff report indicates, my authorities will be preparing proposals for consideration by the AsDB-coordinated Consultative Group meeting to be held in December. The Economic Management and Policy Advisory Team financed by the Asian Development Bank and the United States, which started work in May, will be assisting the Government in preparing a comprehensive macroeconomic and microeconomic development strategy, together with project proposals, for the consideration of the international community. The team is also involved in ongoing reform efforts at both the state and the national levels. These efforts, together with the measures included in the 1995/96 budget submitted to Congress, represent a strengthening of the adjustment effort in the Federated States of Micronesia.

Finally, I would like to thank the staff mission for its efforts and cooperation in conducting the Article IV mission. I would also like to formally record my authorities' appreciation of the technical assistance they have received from the Fund, and from the Fund/UNDP Pacific Financial Technical Assistance Center in Fiji, and to indicate the importance they attach to the recent extension of the Fiji Center's operations.

Mr. Wang observed that the policy advice provided in the staff paper was precise, realistic, and commensurate with the basic situation in Micronesia. Many of the points he had made on the Marshall Islands were relevant to Micronesia, given the similarities of their economies.

He wished to emphasize two additional points, Mr. Wang said. First, his chair welcomed the authorities' decision to cut subsidies and spending but regretted the lack of significant efforts to reduce the wage bill and the absence of a net reduction in the overall government work force. As a result, the work of devoting limited public resources to infrastructure development had been made more difficult.

Second, the staff had correctly emphasized the importance of enhancing the role of banks in economic development, Mr. Wang said. The authorities had taken steps to amend regulations to remove the ceilings on commercial bank loan rates and strengthen supervision, but his chair believed that there remained room for the removal of administrative directives regarding banking activities, an approach that could further promote domestic lending activities.

Ms. Brettschneider made the following statement:

> As was the case with the staff's work on the Marshall Islands, the staff report on the Federated States of Micronesia provides a clear picture of the challenges and prospects faced by the Federated States of Micronesia as the end of the Compact period approaches. My authorities are in close agreement with the staff analysis of the Micronesian case and support the recommendations outlined in the staff report.
>
> The staff supplement details the many similarities between the issues facing the Marshall Islands and those facing the Federated States of Micronesia, and much of what I said in the preceding discussion applies to the Federated States of Micronesia as well.
>
> While the Federated States of Micronesia has made somewhat further progress in beginning the adjustment process, for which the authorities deserve to be commended, there is still a long way to go before financial viability and self-sufficiency can be realized.
>
> Rather than repeat my earlier statement, I would only emphasize the key message, namely, the need to pursue fiscal adjustment and structural reform efforts rigorously and expeditiously to prepare the ground for the phasing-out of Compact funding. Concrete action in these areas will be essential to send a strong signal to potential donors that the Federated States of Micronesia is serious about economic reform and is deserving of further financial and technical support from the international

community. The authorities' efforts to formulate a medium-term structural adjustment strategy with the help of the AsDB is most welcome in this regard.

I noted that the staff's consultations in the Federated States of Micronesia included both national and state officials. In view of the considerable autonomy that the state governments exercise in the Federated States of Micronesia, we were encouraged by the opportunity provided by the consultations to increase understanding at all levels of government of the need for policy adjustment in the immediate term. Improving coordination of budget and investment decisions between the two levels will be a critical element of a successful adjustment effort.

As in the Marshall Islands, spurring private sector activity will be critical to expanding the productive base. The Government's job is to make resources available for private sector use through its own fiscal discipline, and by providing the regulatory framework, a sound financial system, and other infrastructure necessary to support private investment. This is true at both the federal and state levels. A key challenge for the authorities, therefore, will be to scale back government involvement in economic activity and make room for the private sector to take the lead.

Although somewhat more limited in scope than in the case of the Marshall Islands, the Government's borrowing against future Compact receipts has aggravated the external debt situation. The burden of higher interest payments on public sector debt ties up resources that could be put to more productive use if made available to the private sector. This situation would only be exacerbated in the event of additional borrowing, and we join the staff in cautioning against further external commercial borrowing.

As a final point, and again one that applies to the Marshall Islands, we hope the Micronesian authorities will design their fishing industry development strategy to ensure the sustainability of this very rich natural resource. Although we recognize that development in both the Federated States of Micronesia and the Marshall Islands will depend to a large degree on the exploitation of this resource, we hope the authorities will adopt sound practices that will allow the fishing industry to flourish over the long term, particularly in light of the disturbing trends of overfishing globally.

The staff representative from the Southeast Asia and Pacific Department said that, after about three months of work by the policy advisory team sponsored by the Asian Development Bank, encouraging progress had been made in helping the authorities to formulate policies with a view toward presenting a comprehensive medium-term adjustment program at the consultative group meeting to be held later in the year.

On more specific policy measures, as mentioned by both the staff and Mr. Petrie in their statements, the National Government had presented a budget to Congress that appeared to be aimed at further improving fiscal policy, the staff representative noted. The state of Chuuk had approached the National Government to help it solve its financial crisis. Therefore, even though the budget process was in its late stages, the staff hoped that the Executive Board's discussion would make an impression upon the authorities of the state governments, which were still formulating their individual budgets, to follow the example of the National Government and do more to improve their fiscal position.

As for the fishing industry, the staff representative concluded, the World Bank was studying the issue and had a project under way to help the authorities come up with a coordinated policy, both in terms of coordination among the five governments as well as in respect of environmental or ecological implications.

Mr. Petrie thanked Executive Directors for their comments. The Federated States of Micronesia had clearly started the adjustment process, albeit in a cautious and measured way. The authorities saw a need to create a general awareness of the size of the further adjustments facing the country.

One of their problems was the inherent difficulty of governing a population of only 100,000 under a federal system. The National Government would continue to face problems of coordination in carrying out the development effort and, in particular, in ensuring the necessary adjustment in the consolidated public finances. However, as mentioned by the staff representative, the agreement reached recently with Chuuk--which was not only the largest of the state governments, but also larger than the National Government, and which had been the source of financial problems--was an encouraging sign, although as he had noted in his opening statement, it still had to be ratified by the Chuuk Congress.

With respect to data provision, Mr. Petrie noted that the Micronesian authorities had also indicated that they would endeavor to improve the flow of information they provided to the Fund between Article IV consultations, subject, again, to the constraints of their limited capacity.

Finally, like other Directors, Mr. Petrie said that he welcomed the initiative taken by management in 1994 and again in 1995 in planning the Board's discussion of Micronesia and the Marshall Islands on the same day. The scheduling facilitated useful cross-country analysis by the staff and made for a more productive Board discussion. He would support the same approach in 1996, perhaps with one or two other small island countries being lined up for discussion on the same day.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. Directors supported the authorities' intention to formulate a comprehensive adjustment program in light of the generally disappointing economic growth in recent years and the scheduled phase-out of U.S. grant assistance by the year 2001. They underscored the need for greater coordination among the national and state governments in this undertaking. Directors encouraged the authorities to finalize their adjustment strategy in time for the Consultative Group meeting that is being organized by the AsDB for later this year.

Directors commended efforts to contain government expenditures in recent years, but noted that these efforts had not addressed sufficiently the underlying impediments to private sector development, namely, very high civil servants' salaries and an inadequate physical infrastructure. They welcomed measures to address the financial problems of the State of Chuuk and efforts contained in the National Government's 1995/96 budget recently submitted to Congress to improve its fiscal position. They recommended that similar efforts be made in the 1995/96 state budgets, with emphasis on restructuring the civil service, containing the government wage bill, phasing out subsidies to public corporations, and improving revenue performance.

In view of the country's increasing debt burden, Directors cautioned against further external commercial borrowing.

Directors considered that the development of the private sector would require a more efficient financial system and a consistent regulatory framework. They therefore encouraged the removal of restrictions on interest rates and bank lending, a reform of the land tenure system, harmonized policy and procedures on foreign investment, and coordinated sectoral strategies on fisheries as well as in tourism.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/95/71 (7/26/95) and EBM/95/72 (7/27/95).

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/95/124 (7/25/95) is approved.

APPROVAL: March 12, 1997

REINHARD H. MUNZBERG
Secretary

Federated States of Micronesia and Marshall Islands:
Economic Indicators for 1994/95

(In percent of GDP, except where stated)

	Federated States of Micronesia	Marshall Islands
Population (number)	105,000	50,000
Nominal GDP (in millions of U.S. dollars)	216	94
GDP per capita (in U.S. dollars)	2,057	1,875
External grants	47.7	44.9
Government expenditure	74.5	94.1
Overall budget deficit	-1.7	-20.3
Outstanding external debt (end of period)	54.7	164.8
External debt service (in percent of exports of goods and services)	25.1	43.1
Financial holdings of Government (end of period) 1/	53.8	4.5

1/ An approximate measure of gross international reserves.