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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/86

10:00 a.m., September 13, 1995

Contents

## Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman

| Executive Directors | Alternate Executive Directors |
|---|---|
| | A. A. Al-Tuwaijri |
| M.-A. Autheman | A. Fayolle |
| J. Bergo | E. Srejber |
| | V. J. Fernández |
| I. Clark | |
| | J. A. K. Munthali, Temporary |
| H. Evans | J. Shields |
| K. P. Geethakrishnan | W. Hettiarachchi |
| | R. Kannan, Temporary |
| J. E. Ismael | L. M. Cheong |
| D. Kaeser | |
| A. Kafka | A. Calderón |
| W. Kiekens | J. Prader |
| Y.-M. T. Koissy | A. Barro Chambrier |
| G. Lanciotti | N. Coumbis |
| K. Lissakers | B. S. Newman |
| H. Mesaki | T. Fukuyama |
| | S. Rouai, Temporary |
| C. Saito | A. G. Zoccali |
| | J. A. Costa |
| S. Schoenberg | B. Esdar |
| | Y. Y. Mohammed |
| D. V. Tulin | |
| E. L. Waterman | J.-H. Kang |
| | O. Havrylyshyn |
| Zhang M. | Wei B. |

A. Mountford, Acting Secretary
W. S. Tseng, Acting Secretary
D. M. Rajnes, Assistant
S. W. Tenney, Assistant

Also Present

African Department: R. C. Williams. Central Asia Department: M. S. Lutz. European I Department: M. Russo, Director; J. Artus, Deputy Director. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; J. C. Dunn, I. Kapur, A. Knöbl, A. K. Lahiri. External Relations Department: S. J. Anjaria, Director; G. Hacche, M. E. Hansen, D. R. Hawley, J. C. Roushdy. Fiscal Affairs Department: P. S. Heller, D. C. L. Nellor, B. S. Weder. IMF Institute: A. Ouanes. Legal Department: W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; J. L. Hagan, H. V. Morais. Policy Development and Review Department: J. T. Boorman, Director; D. N. Lachman, Deputy Director; T. Leddy, Deputy Director; M. G. Gilman, N. L. Happe, K. J. Langdon, A. K. McGuirk, S. K. Wajid. Research Department: M. Mussa, Economic Counsellor and Director; F. Caramazza, D. T. Coe, P. R. de Masi, R. A. Feldman, M. S. Kumar, F. Larsen, M. A. Pradhan, R. F. Wescott. Southeast Asia and Pacific Department: M. R. Kelly, R. P. Kronenberg. Statistics Department: J. B. McLenaghan, Director. Treasurer's Department: G. Wittich, Deputy Treasurer, E. Decarli, M. Papaioannou, M. A. Wattleworth. Western Hemisphere Department: E. Hernández-Catá, Deputy Director; J. R. Márquez-Ruarte, F. Van Beek. Office of the Managing Director: S. Sugisaki, Special Advisor; G. R. Saunders, Personal Assistant, J. Quick, Personal Assistant, Designate. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, P. A. Akatu, B. Andersen, P. Cailleteau, R. F. Cippa, S. K. Fayyad, J. Guzmán-Calafell, A. R. Ismael, J. Jonáš, M. F. Melhem, H. Mori, S. O'Connor, T. Oya, M. Petrie, A. Vernikov. Assistants to Executive Directors: P. I. Botoucharov, D. Daco, D. Desruelle, C. Duenwald, A. Galicia, R. Glennerster, C. M. Gonzalez, A. Guennewich, O. A. Himani, P. Jilek, H. Kaufmann, W. C. Keller, K. Kpetigo, T.-M. Kudiwu, J. Pesola, Song J., V. Trivedi, V. Verjbitski, R. von Kleist, Zubir bin Abdullah.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from Executive Board Meeting 95/84 (9/11/95) their consideration of a staff paper on prospects and policy issues related to the world economic outlook (EBS/95/136, 8/14/95), together with a statistical appendix (EBS/95/137, 8/15/95), boxes and an annex providing supplementary material (EBS/95/138, 8/16/95). They also had before them a background paper on world economic and market developments (EBD/95/121, 9/6/95; and Cor. 1, 9/8/95) and a report on foreign exchange and financial markets in July 1995 (EBD/95/114, 8/14/95).

Mr. Lanciotti said that his remarks for the previous discussion (EBM/95/84) on the correlation between the deutsche mark/U.S. dollar exchange rate and the nominal exchange rate of the lira had been made with reference to the volatility of exchange rates, not to their levels. Approximately 25 percent of the volatility in the lira exchange rate had been induced by the volatility of the dollar.

The staff representative from the Research Department stated, with respect to financial market turbulence, that there was no evidence of increased short-term--weekly or monthly--volatility in financial markets. Short-term fluctuations could be quite large, but that was nothing new and not a cause for concern. In the context of the world economic outlook exercise, the staff had focused on sustained swings in exchange rates and in real interest rates. Although the exchange rate movements that had taken place over the past 18 months were large, they were not unprecedented. Moreover, it was not just the size of the movements that mattered, but also the sensitivity of economic actors to those movements. From that perspective, there were a number of reasons to pay increased attention to financial market behavior in Fund surveillance generally and, therefore, also in the staff papers on the world economic outlook and the capital markets report.

Financial markets were clearly becoming more powerful, the staff representative noted. That fact was reflected in the rising stocks of financial assets, the rapid growth in the volume of transactions, and the development of new, highly leveraged financial instruments. Problems of financial fragility, therefore, could play a role in reinforcing the effects of financial shocks. The integration of financial markets implied that the repercussions of changes in market sentiment could increasingly affect countries around the world through both financial linkages and contagion effects.

There were a number of cases where the markets had become extremely sensitive to concerns about emerging or accumulating imbalances or about perceived failures to address long-standing policy weaknesses, the staff representative noted. It was hard to determine whether such sensitivity was on the rise, but the staff considered that it probably was. Nevertheless, the potentially disciplining effects of shifts in market sentiment could not become a substitute for Fund surveillance. After all, the whole point of

Fund surveillance was to help countries address their economic problems before the markets forced necessary policy changes.

The comments put forward by Mr. Kaeser at EBM/95/84 on the plague of the fourteenth century and his remark that the Fund seemed to be using the threat of unfavorable market reactions as a new way of trying to convince countries to pursue sound macroeconomic policies was an interesting hypothesis to examine, the staff representative commented. However, there was a need for caution. Although it was frequently possible, ex post, to identify a relationship between a particular shift in market sentiment and specific economic problems, there had been many cases in which the markets had been overly complacent about accumulating imbalances, or in which they had overreacted to imbalances and then failed to acknowledge progress as policies were changed. In such situations, market signals might not be helpful as a guide for policymakers.

That underscored the need to integrate financial market analyses into the traditional policy and business cycle analyses in the World Economic Outlook, the staff representative considered. Such an approach would help lead to a better understanding of financial market developments. It would also allow the Fund to focus on what appeared to be some increasingly important forces in the world economy that had potentially significant implications for economic performance and for economic policies.

At EBM/95/84, several Directors, including Ms. Lissakers, Mr. Evans, Mr. Clark, Mr. Mesaki, and others, had urged the staff to be cautious about making overly precise statements about the appropriate level of exchange rates, in particular given the difficulties involved in assessing the underlying fundamentals and their relationship with exchange rates, the staff representative recalled. Ms. Lissakers had also noted the need to look at those issues in a global context--and not only in terms of bilateral exchange rates--and to take into account the rapid changes in the structure of the world economy. Taking into account those caveats, Directors had expressed broad agreement with the conclusions contained in the staff's analysis and with its assessment that the present configuration of exchange rates generally seemed to be much more in line with economic fundamentals than had those prevailing in June 1995.

The staff would clearly agree with Directors on the need to avoid making overly precise statements about the appropriate level of exchange rates, as could be seen from the World Economic Outlook, the staff representative continued. At the same time, there was a need to think systematically about the fundamentals that appeared to influence the foreign exchange value of a currency in order to form judgments about exchange rates. Although the macroeconomic balance approach should not be the sole basis for such judgments, the staff had found that that approach provided a useful framework for analysis.

In coming to the conclusion that intervention should be backed up by policy changes to convince markets that exchange rates needed to be brought

back into line with fundamentals, the staff had considered a situation in which exchange rates were misaligned from a longer-term perspective and where there was scope for adjusting the short-term stance of monetary policy in a direction that would be consistent with both the desired correction of exchange rates and broader policy objectives, the staff representative went on. The intervention episode in August 1995 was a case in point.

As to whether the overall budget deficit of 1.9 percent of GDP in the United States could be seen as a key factor behind the low saving rate, Mr. Kaeser had been correct to point out that the low level of private saving was also an important part of the story, the staff representative said. In terms of policy, however, the weakness of national savings had provided an added incentive to speed up the pace of fiscal consolidation. The low level of private saving pointed to a need to go somewhat further than simply balancing the budget. Similar considerations could, of course, be made with respect to the medium-term budget objectives of other industrial countries, especially those with rapidly aging populations, where it might also be appropriate to bring budget positions into moderate surpluses. The staff had made similar recommendations in previous papers on the world economic outlook.

The staff paper for the current discussion suggested that exchange rate considerations seemed to be complicating the process of fiscal consolidation, at least in some countries in the European Union (EU), the staff representative noted. That observation had been put forward in the context of a general discussion on the desirability of fiscal consolidation in the industrial countries and the associated scope for easing monetary conditions at the same time that world long-term interest rates would likely fall. The staff would agree with Mr. Waterman's caveat about the need for vigilance in monetary policy also for countries with strong budget positions, such as New Zealand and Australia.

However, the scope for changing the policy mix was not clear-cut for the members of the EU, where monetary policy was assigned to the objective of exchange rate stability, the staff representative said. Those countries might have greater concerns than other countries about the short-run effects of fiscal consolidation on unemployment. At least that concern seemed to be an important reason for the slow pace of fiscal consolidation in many EU countries. The existence of large risk premia in interest rates should permit significant reductions in real interest rates as fiscal consolidation proceeded, but there might still be a fear that markets would fail to acknowledge such progress sufficiently quickly and, therefore, that fiscal consolidation might be associated with a rise in unemployment over the short run. In that context, it might be worth pointing out that the present very low interest rates in Germany, and perhaps the possibility that they might decline a bit further, would seem to provide a particularly good opportunity for other EU countries to step up their fiscal consolidation efforts over the period ahead.

The decoupling of business cycles between the developing countries and the industrial countries, in itself, was not necessarily good, the staff representative considered. For example, if that would mean that the developing countries could experience a recession when the industrial countries were growing briskly--as in the cases of Mexico and Argentina in 1995--it would not be a good thing. However, it was fortunate that developments in industrial countries and developing countries had not been synchronized in 1991-93, when the developing countries had experienced a period of strong expansion during the industrial countries' recession. Otherwise, the relatively mild slowdown in world activity could have been much more serious.

As Mr. Evans had emphasized, the decoupling of business cycles was quite recent; the world economy could still experience types of shocks that would adversely affect both developing and industrial countries at the same time, the staff representative said. As Mr. Waterman had pointed out, as financial markets became more integrated, a greater number of financial shocks would have the potential to be felt throughout the world.

Box 3 on financial liberalization in Africa and Asia was intended to draw some lessons for the African countries from the successful financial liberalization experiences of many Asian countries, the staff representative from the Research Department noted. It was for that reason that the Box had focused on the contrasts between the experiences of Asia and Africa that were particularly striking. The staff would attempt to include some references to the Western Hemisphere countries in Box 3 without losing sight of that basic objective.

Another staff representative from the Research Department recalled that, at EBM/95/84, a number of Directors had commented on growth and inflation performance in the developing countries. In particular, Mr. Autheman and Mr. Havrylyshyn had noted that, if the fast-growing countries of Asia were excluded, the performance of the developing countries as a group would not have been as impressive. Although the strong performance of the developing countries as a group masked considerable variation among the developing country regions, the discussion of policy issues for the developing countries and the projections for regional groups were always presented in aggregate terms in the World Economic Outlook. While none of the other developing country regions had performed as strongly as Asia over the past two decades, growth had recently strengthened somewhat in Africa. Growth in Latin America had been considerably stronger in the 1990s than in the 1980s, although the improved performance had been interrupted by the Mexican crisis.

The strong performance of Asia did not reflect only developments in "soon-to-be-industrial countries," the staff representative said. If the level of per capita GDP on a purchasing power parity basis were used as a criterion for classification, only the four newly industrializing economies of Asia--Hong Kong, Korea, Singapore, and Taiwan Province of China--would qualify as "soon-to-be industrial" economies. Although those four economies

had grown rapidly, their combined GDP weight was not large. Therefore, excluding them from the projections would make virtually no difference in the average growth rate for Asia as a whole, or for the developing countries in aggregate. It was primarily China, but also Indonesia, Malaysia, and Thailand, that accounted for the strong growth in Asia, and the level of per capita GDP in those countries remained well below the range of per capita incomes in industrial countries.

As to the overheating in some Asian markets and its policy implications, it was important to note that overheating could be manifested in a number of ways: through a deterioration in the external accounts, with possible adverse effects on investor confidence; through a rise in standard measures of inflation; and through a run-up in prices in asset markets, the staff representative stated. Experience in a number of industrial countries, most notably Japan, provided examples of the dangers of not taking asset price developments into account in formulating monetary policy, and of not adjusting the stance of monetary policy at an early stage. Experience also showed that the adjustment of balance sheets following large swings in asset prices could be a protracted process, with profound implications for the stability of the financial sector and for the real economy. Thus far, the phenomena of asset price inflation and deflation had been examined mainly from the perspective of the industrial countries, but the staff would agree with Mr. Ismael that it would be useful to examine that issue in the context of developing countries in Asia and other developing country regions.

At EBM/95/84, Mr. Kannan had raised questions about the sharp reduction in the average rate of inflation in the developing countries from 48 percent in 1994 to 19 percent in 1995, the staff representative recalled. The hero in that story was Brazil, where inflation rates had plummeted since the introduction of the real in July 1994. Consumer prices in Brazil had risen almost 800 percent during the first half of 1994, but they had increased only about 10 percent during the first six months of 1995. On an average annual basis, the increase in the consumer price index was projected to fall from more than 2300 percent in 1994 to about 74 percent in 1995. That was the main factor behind the sharp reduction in inflation projected for 1995 in the Western Hemisphere and in the developing countries as a group. It should be noted that the rate of inflation was projected to decline by about 10 percentage points in Africa and in the developing countries of the Middle East and Europe.

Average nonfuel primary commodity prices were projected to decline in 1996 by about 1 percent, the staff representative noted. That decline was attributable to expected increases in supply following the unusually high commodity price rise, of more than 13 percent, in 1994 and an expected further increase of 8 percent in 1995, with particularly sharp increases in prices for cereals, coffee, cotton, rubber, and many metals. Some of the factors that had boosted commodity prices in 1994 and 1995, such as the frost in Brazil, were transitory. More important, the supplies of most commodities had already increased sharply, putting downward pressure on

prices. In recent months, there had been widespread declines in the prices of food and agricultural raw materials. Cotton prices, for example, had declined by 30 percent over the past three months.

Oil prices were also expected to decline in the short run, as indicated by the futures market as of late August, the staff representative continued. That decline reflected market expectations of increased supplies from higher non-OPEC production, especially from the North Sea, as well as, perhaps, expectations of the possible re-entry of Iraq into the oil market.

The staff considered that the downside risk and upside potential in the projections for Canada were about evenly balanced, the staff representative commented. Projected GDP growth in 1996 was somewhat above the consensus forecast, but the output gap was expected to close only gradually, with GDP growing somewhat above potential for a number of years. Growth should also be supported by the favorable outlook for inflation and the expected narrowing of the long-term interest differential vis-à-vis the United States. The staff estimate for potential growth was essentially the same as that of the Bank of Canada. As Mr. Clark had noted at EBM/95/84, the staff estimates for the equilibrium rate of unemployment were also similar to those of the Bank of Canada.

The significant downward revision of 1.8 percentage point in the growth forecast for Canada since the May 1995 World Economic Outlook mainly reflected weaker than expected growth in the first half of 1995, the staff representative noted. That weakness partly reflected the slower growth of exports related to soft demand from the United States and a railroad strike in Canada, as well as the rise in interest rates in the spring. In addition, the interest-sensitive components of demand had weakened with the run-up in interest rates in the last part of 1994. Real GDP growth in Canada was currently projected to be somewhat stronger in 1996 but, over the medium term, it was projected to be about the same as in the May World Economic Outlook.

Although the rate of growth in Canada was expected to pick up in 1995 and 1996, weak confidence and high real interest rates continued to restrain the Canadian economy, the staff representative continued. The staff considered that both of those factors could be addressed by a more ambitious fiscal consolidation program.

The estimates for the medium-term structural budget deficits of the seven major industrial countries as a group (G-7) had been revised downward since the May World Economic Outlook, the staff representative noted. The current projections suggested a structural deficit of about 2 percent of aggregate potential GDP, compared with 2.4 percent in May 1995.

The most significant revisions had been made for the United States and Italy, the staff representative continued. The U.S. structural budget deficit was currently estimated to be about 1.4 percent of GDP by 2000,

compared with an estimated 2.5 percent in May 1995. The new U.S. Administration budget proposal, which included policies to reduce the deficit over the next 10 years, and the changed political situation in Congress warranted lowering the assumption for the structural deficit in the medium term. In Italy, the Government's medium-term plan, announced in July, was expected to put government finances on a more sustainable path, and pension reforms and sharply lower interest rate projections also contributed to the downward revision of the estimated structural deficit from 4.4 percent of GDP projected in May 1995 to 2.7 percent of GDP.

It should be emphasized, however, that those assumed improvements would need to be matched by the enactment of concrete measures, the precise nature and timing of which were still somewhat uncertain, the staff representative from the Research Department commented.

Mr. Kafka stated that the Brazilian authorities expected the annual increase in the cost of living index to be less than 20 percent for 1995. Indeed, the most recent estimates suggested that the cost of living index had increased by only 0.93 percent in the four weeks ending in the first week of September 1995.

The staff representative from the Research Department said that the most recent staff estimates projected an annual increase of about 30 percent in the cost of living index for Brazil. Although that estimate was a little higher than the authorities' estimates, it represented a substantial improvement over previous years.

Mr. Schoenberg commented that the revisions to the staff projections for Canada were welcome. However, they reinforced the concern expressed by his chair at the time of the previous world economic outlook exercise that the staff's medium-term growth projections for Canada, which then showed growth of about 4 percent, were overly optimistic.

The Economic Counsellor and Director of the Research Department recalled that, in view of the substantial output gap that had existed at the end of the recession in 1991, the staff had based its estimates on the assumption that that gap would be closed over time. Indeed, in 1994, the Canadian economy had realized fairly strong growth of about 4 percent. However, the output gap was currently much smaller than it had been in the early 1990s; hence, the staff had scaled back its growth projections for the period ahead.

Ms. Lissakers noted that there had been a significant improvement in the structural deficits of the major industrial countries, in particular the United States, since the previous world economic outlook exercise. That improvement showed that the G-7 countries had used the recovery well in terms of addressing their deficit problems. That progress should be reflected in the Board's Report to the Interim Committee on the Madrid Declaration.

The Chairman stated that the progress made in reducing the structural deficit of the G-7 countries would be taken into account in reporting to the Interim Committee on progress made under the Madrid Declaration.

The Economic Counsellor recalled that, at the press conference following the release of the World Economic Outlook in April 1995, he had described the exchange markets as "going a little bit nuts," because the value of the yen had risen to ¥ 80 per $1. The direction of exchange rate movements over the past six weeks was more closely in line with the direction implied by economic fundamentals. As Directors had noted, it was the policy of the Fund to avoid making precise statements about the nominal value of exchange rates, or about the precise level of exchange rates that would be consistent with economic fundamentals. The reasons for that policy were related to the sensitivity of exchange rate issues and the fact that there was a fairly broad range within which exchange rate movements could be maintained consistent with fundamentals. The current exchange rate of the yen was clearly within that broad range. Although the yen was not in imminent danger of moving beyond the floor of that range, some further depreciation of the yen against the dollar would not be inconsistent with economic fundamentals. The staff would prefer to refrain from taking any strong position on what the exchange rate of the yen "ought" to be.

The very large risk premia in Italian long-term interest rates compared with German interest rates suggested that the lira's foreign exchange value was still being depressed by concerns about fiscal policy, the Economic Counsellor noted.

It should be noted, however, that when a particular currency appeared to be misaligned, there was not necessarily another identifiable currency on the other side of the misalignment, the Economic Counsellor commented. For example, during the summer of 1995, the value of the U.S. dollar, in real effective terms, had been at the bottom end of the trading range maintained since the mid-1980s. Although the staff would not have characterized the dollar as significantly misaligned at that point, it was clearly weak within the range of reasonable fluctuation.

As the staff paper showed, the yen had appreciated very strongly since the early 1990s, not only against the U.S. dollar, but also against the broad array of currencies of Japan's trade partners, the Economic Counsellor said. Although the U.S. dollar had appreciated against some currencies, it had depreciated against the yen and the deutsche mark, and closely related European currencies.

The problem described by Ms. Lissakers as "the excessive intermediation tax associated with the continued workout of Japanese financial institutions' substantial bad loan problem" would likely affect the pace of the Japanese recovery over the next three years or so, the Economic Counsellor considered. The Japanese financial institutions could be expected to maintain reasonably wide spreads between their lending rates and their cost of funds, thereby contributing to a slowdown in the pace of the recovery.

Although there were some things the Government could do to ameliorate that situation, much of the losses from the nonperforming loans would have to be made up by increasing profits in that manner. For example, in the early 1990s, when the banks in the United States had suffered substantial losses on real estate and other loans, they had maintained wide spreads between lending and deposit rates for some time. The relatively low level of the federal funds rate, and accordingly the cost of funds to banks, had helped with the resolution of that problem. A similar situation could be expected to arise in Japan. The low level of both the official discount rate and money market rates engineered by the Bank of Japan would allow the financial institutions that were solvent to work their way out of the loan problem while creating less of a drag on the pace of recovery than might otherwise be the case.

Ms. Lissakers noted that the summary on Japan in the world economic outlook paper focused on only the yen exchange rate as an impediment to growth. It should also take into account the high cost of credit in assessing the prospects for economic recovery in Japan.

The Economic Counsellor considered that the high cost of credit in Japan would be a significant factor in determining the pace of economic recovery. Indeed, the staff's current forecasts for Japan did not expect buoyant growth in 1996. However, it should be noted that there was a very large output gap in Japan. The staff was not projecting annual growth rates of 5 or 6 percent in the first couple of years of the recovery--as might normally be expected for an economy snapping back from that magnitude of output gap--in recognition of the fact that several factors were likely to continue to place a drag on the recovery, even once it became firmly established.

His comments for the discussion on world economic and market developments at EBM/95/84 were not intended to suggest that the banking crisis in Japan had had only limited effects on confidence, the Economic Counsellor said. Indeed, the substantial negative effect of that crisis on confidence was one of the key reasons the recovery in Japan had not gotten under way in 1995. His comments for EBM/95/84 had been made with reference to the actions taken during the summer of 1995 to address the problems of the two failed credit unions, which had failed quite publicly with runs on deposits, and the closure of a medium-sized bank. The markets had taken it as a good sign that the authorities were taking explicit actions to deal with the problems of bad loans and of insolvent institutions, because those problems had been apparent for a long time. Moreover, because there had not been a public failure of a financial institution in Japan since the 1920s, there had been serious concerns that such an occurrence might produce extremely adverse public reactions. However, that had not been the case. In the event, the authorities had effectively dealt with the situation in a manner that had avoided further negative shocks to confidence. In that respect, perhaps, the market's reaction to the problems of the financial sector, which had been weighing heavily on confidence and the public mood for some time, should be examined from a historical perspective.

Ms. Lissakers commented that the lingering banking problem in Japan had kept the cost of credit high and it had distorted, or frozen, the markets for certain assets, in particular real estate. Therefore, it was important to note that the way that problem was addressed would affect the growth rate in Japan and the pace of its economic recovery. If the large banks were expected to make up the losses associated with bad loans, that would raise the cost of credit to the economy as a whole. In the circumstances, the general reference to the need for structural reform contained in the world economic outlook paper was too vague; the section on Japan should be expanded to cover the banking problem in more detail. That problem and how it would be handled went way beyond questions of confidence or "public mood."

The Economic Counsellor said that perhaps there was a need to differentiate between the financial sector problem and the confidence problem. Both problems were clearly present in Japan. Ms. Lissakers was correct to note that, if the larger financial institutions were forced to take on the losses associated with bad loans, that would likely place a drag on the work-out process and impede the recovery. Therefore, it would be advisable to use public sector funds to absorb some of the losses. That had happened in the case of the credit unions that had failed. But, for the financial institutions that were solvent, which would include all of the large banks and much of the banking system as a whole, it would be unrealistic and undesirable to expect large injections of public funds to help cover the losses. In that context, a work-out process, accompanied by somewhat wider spreads between lending and deposit rates, was to be expected. In addition, the effects of that work-out process, in terms of slowing the pace of recovery should be recognized.

Mr. Mesaki commented that it was important to stress that most Japanese financial institutions, especially the larger banks, were solvent and fairly secure. At the same time, however, most of those institutions faced significant bad loan problems. In an effort to address those problems in an effective manner, the authorities had appointed a special committee to examine the situation of the financial sector in detail and to report to the Ministry of Finance by the end of September. The authorities clearly recognized that the financial sector problems would have some impact on the economy as a whole but, thus far, there was no evidence of a direct link between the bad loan problem and economic growth.

The Economic Counsellor said that he agreed with the observation put forward by Mr. Autheman at EBM/95/84 that part of the problem for Japan might be that its underlying growth rate was no longer substantially stronger than those of other industrial countries. The staff projections showed that Japan's potential GDP growth rate was about the same as that of the United States and Western Europe. Although the number of hours in the average work week in Japan had traditionally been much larger than in most other industrial countries, that number was declining. How much it would come down remained to be seen. Similarly, although the underlying potential growth rate for Japan had fallen to below 3 percent, the precise level of

underlying potential growth was not yet clear. The magnitude of the output gap was based on a substantial reduction in the assumed growth of potential in the economy. Although reasonable people could differ with respect to the precise size of the output gap, the fact that it was quite large was not in dispute.

Mr. Schoenberg stated that he shared the concerns expressed by Ms. Lissakers. The unsolved problems in the Japanese financial system worked like an anchor on the Japanese economy, not so much because of the prospect of immediate bank failures, but because of the impact on confidence and the reduced room for maneuver of the commercial banks to satisfy costumers' needs. The fact that the Japanese economy was in its fourth year of nearly stagnant growth could not be explained by the exchange rate problem alone.

Mr. Kiekens noted that the differences in the evolution of short-term and long-term interest rates in Japan warranted further consideration. When the short-term interest rate had declined in the summer, the long-term interest rate had risen. Similarly, the recent cut in the discount rate had been followed by an immediate increase in the long-term interest rate. He wondered whether a general perception of high risk was at play. Perhaps, the medium-term outlook for the Japanese fiscal position was worsening, leading to higher interest rates. There was a need to examine whether the short-term interest rate or the long-term interest rate was most important for economic activity.

Mr. Mesaki commented that the long-term interest rate in Japan was less than 2.96 percent. By Japanese standards, that was very low.

The Economic Counsellor said that it was important to be careful about the distinction between real and nominal interest rates. As confidence that policies would provide sufficient impetus to the recovery had strengthened, long-term interest rates had risen. There was also a reduced expectation of persistent disinflation than there had been in the past.

Another important factor was the widespread concern among Japanese investors about the losses they had suffered on foreign-currency-denominated instruments and foreign investments generally, the Economic Counsellor commented. Over recent months, investors had become more convinced that the yen was not going to continue to appreciate unabated, and they were beginning to realize that long-term yields in Japan were low compared with those in the United States and Europe. The move back to yen-denominated assets would be justified only if the yen continued to appreciate. If not, foreign-currency-denominated assets would be relatively more attractive. There was a lot of anecdotal evidence on outflows of investment funds from Japan, showing that longer-term interest rates in Japan needed to be more competitive with those prevailing in the rest of the world, especially if the exchange rate of the yen was to remain stable.

Ms. Lissakers noted that Japan, which had a savings rate of 30 percent of GDP, was expected to generate growth of 2.5 percent. At the same time, the United States, which had a substantially lower savings rate, was expected to achieve a similar rate of growth. Perhaps the staff could comment on the relationship between savings behavior and rates of growth.

The Economic Counsellor said that labor force input measured in terms of the growth of hours worked, was going to rise very sluggishly in Japan. In the United States, it was estimated that labor input would continue to rise more quickly. Therefore, the staff projections indicated that, although potential GDP growth was similar for Japan and the United States, the growth in output per hour worked would remain 1 percentage point or so higher for Japan than for the United States. That projection was consistent with the higher rate of savings and investment in Japan than in the United States.

It was important to bear in mind that investment was usually measured in terms of physical capital; thus, the single most important form of investment in all economies and certainly in the industrial economies, namely, investment in human capital, was not included, the Economic Counsellor considered. If investment in human capital--and the savings that necessarily went along with it--was taken into account, the rate of savings and investment in the United States compared with that in Japan would not look quite as disparate as it did based solely on physical capital.

Mr. Autheman stated that he agreed with the staff on the need to revise the estimates for the underlying growth trend in Japan. However, he wondered whether the assessments of underlying growth trends in the past had been correct. In making such assessments, there seemed to be a tendency to focus on a variety of short-term factors, such as the exchange rate over-valuation or the financial crisis. That approach tended to imply that those phenomena were not related to the excessive rate of growth in the late 1980s. Indeed, if the output gap in Japan in 1988-92 was not seen as excessive compared with other countries, the financial crisis could be seen as a mysterious external shock. If the underlying growth trend had been overestimated in the late 1980s, that would mean that Japan was currently going through a process of real adjustment. Although that adjustment might be painful in terms of its implications for the financial sector, it would not be seen as exceptional, especially compared with the painful adjustments that had taken place in other counties, such as in the United States following its banking crisis.

The Economic Counsellor commented that there was no convincing answer to the question raised by Mr. Autheman at the present stage. It was plausible that--rather than peaking with a positive output gap of about 3 percent in 1990--the output gap in Japan had really been 4-4.5 percent and, correspondingly, that the current projection for an output gap of 6.5 percent in 1996 should be more like 4-5.5 percent. In estimating output gaps, the staff followed certain procedures in a manner that was consistent across different industrial countries, the Economic Counsellor said.

Although it was clear that Japan currently had a very large output gap for 1995 and 1996, it was not possible to prove the exact size of that gap. Nevertheless, size was not the vital question, as it did not substantially affect the overall policy requirements for the period ahead. In that respect, it was clear that Japan would need to ensure that its monetary, fiscal, and structural policies supported the recovery as well as the longer-term transformation of the Japanese economy that appeared to be essential.

With respect to another country in which the output gap had grown to sizable proportions, namely Mexico, there had been differences between Ms. Lissakers, on the one hand, and Mr. Evans and Mr. Schoenberg, on the other hand, about both the actual contagion effects experienced in the early part of 1995 and the potential contagion effects that had been avoided as a consequence of Mexico's policy adjustments and the international support package, the Economic Counsellor recalled. The contagion effects actually experienced were described in both in the May World Economic Outlook and, to a more limited extent, the world economic outlook paper currently under consideration. They had also been given considerable attention in the staff paper on international capital market developments.

The contagion effects that had been prevented by timely and vigorous intervention were a matter for speculation, since they represented the road not traveled, the Economic Counsellor commented. As the staff had indicated on previous occasions, had there not been a substantial international support package for Mexico, the threat of actual default on the tesobonos would have been very substantial. In that event, Mexico would have faced an even deeper and more prolonged recession that would have had more pronounced adverse spillover effects on key trading partners, especially the United States, and would have had substantially greater contagion effects for other countries, as investors began even more vigorously to reassess their investments. The precise magnitude of those losses was, of course, also a matter for speculation, but the recession in Mexico, which clearly would have been quite steep and quite sharp, probably would have been prolonged well into 1995. The additional depth and duration of the recession in Mexico could easily have cost another 5 percentage points or more of Mexican GDP. The growth forecast for 1995 had been revised downward to minus 5 percent compared with the potential growth rate of Mexico of about 4 percent. Taking into account the likely adverse spillover effects on trading partners and others, it would be reasonable to suggest that additional losses to the world economy could have amounted to $25-30 billion. If the political support for reform efforts had been seriously undermined in Mexico and elsewhere, even larger losses might have accrued.

In assessing the events in Mexico, it would be useful to compare plausible estimates of the loss that was forestalled with the cost of the actions that had been taken by the international community, the Economic Counsellor continued. The costs to the international community were not zero by any means. When substantial interventions of the kind that had taken place in Mexico occurred, it was always possible to make mistakes. It

was possible to provide support when it was not warranted, and it was possible to create the wrong expectations on the part of investors that they would always be bailed out regardless of the circumstances. Such mistakes could encourage inappropriate behavior, not only because governments might not be willing to undertake the type of adjustment that Mexico embarked on, owing to expectations of support, but also because they could undermine market discipline. For example, in the case of the debt crisis, it was not the expectation that international support would bail out debtors, but the expectation that no sovereign country would ever default, that had spurred excessive bank lending.

In trying to assess the costs and benefits of the assistance provided to Mexico, it would be reasonable to attach a risk premium to the external financial assistance that had been provided, the Economic Counsellor went on. In the case of Mexico a risk premium of 10-20 percent of the face value of the assistance provided would come to a cost of about $5-8 billion. A comparison of that cost with the losses that were forestalled showed a very high benefit-cost ratio, particularly in light of the Government's program. Moreover, in the case of Mexico, there had been significant spillover effects. Therefore, the staff was convinced that the situation would have been significantly worse--albeit not catastrophic--in the absence of the international support package.

As the staff paper on international capital markets noted, the Mexican crisis did not appear to pose any serious systemic threat to the payments system, the Economic Counsellor added. In the case of the debt crisis of the early 1980s, when there had been large-scale involvement by major international commercial banks, there had been significant risks to the banks and, consequently, to the payments system.

In line with the desire to avoid making overly precise statements about the appropriate level of exchange rates, the degree of ambiguity in the World Economic Outlook on the possible effects of fiscal consolidation in the United States on the foreign exchange value of the dollar was intentional and appropriate, the Economic Counsellor commented. Nevertheless, given the present level of the dollar exchange rate, any failure to fulfil the markets' current expectations for further strong fiscal consolidation could have a negative impact on the U.S. exchange rate. It would also have negative implications for bond prices.

It would be difficult to argue that the fiscal problems in the United States were a key reason for the dollar's weakness, because long-term interest rates in the United States had remained low compared with German interest rates, the Economic Counsellor continued. In that respect, there did not appear to be a general confidence problem with respect to U.S. fiscal policy. However, the same could not be said for the cases of Italy, Sweden, and other countries that had large premiums on their interest rates.

There was nothing in either the world economic outlook paper or the staff paper on international capital markets to suggest that capital controls or, more broadly speaking, measures to influence the level and characteristics of capital inflows were a good thing, the Economic Counsellor stated.

There was a general agreement that it would be desirable for governments to be careful about the size, maturity structure, and currency denomination of public debt, the Economic Counsellor said. Indeed, it should be noted that the issues related to the tesobono problem were not unique to Mexico. For example, if the United States had held $900 billion in yen-denominated, short-term debt at the end of 1994--which was approximately the size of the tesobono issues in relative terms--the depreciation of the dollar would have driven the size of that debt up to $1.2 trillion. In that light, the financial markets' reaction to exchange rate developments over the past year might not have been merely salutary. It would be important for the larger industrial countries, which enjoyed the privilege of being able to borrow in their own currencies, to recognize that exchange rate issues were very important for a number of countries that did not have that privilege.

It was also vital for countries to be sensitive to developments in the financial sector, the Economic Counsellor continued. If the banking system was borrowing large amounts of money denominated in foreign currency--even if it was onlending that foreign currency--serious problems could arise if the debtors went into default. The experience of Mexico, where many debtors had defaulted on foreign-currency-denominated instruments, showed that prudential regulation needed to be concerned with foreign currency debt, in particular short-term foreign-currency-denominated debt.

There might be selected instances in which efforts to influence the nature and characteristics of capital inflows could be beneficial--particularly for countries experiencing very large inflows that were forcing their exchange rates up to uncompetitive levels, the Economic Counsellor went on. However, the delicate questions related to capital controls should be taken up separately, and no blanket endorsement of such measures was intended by the staff.

As to the relationship between capital account liberalization and appropriate liberalization of the domestic financial system, it was critical to ensure that the banking system was adequately capitalized and that appropriate prudential supervision was in place before moving to full liberalization, the Economic Counsellor said. Experience in a number of countries, both industrial and developing, clearly showed that, if the banks were not solvent at the time of the liberalization, very serious problems could easily emerge.

Ms. Lissakers considered that the Article IV consultation process should include a review of the foreign currency structure of bank

liabilities and assets, especially for countries actively involved in the international capital markets.

The Economic Counsellor said that, although the current world economic outlook paper covered fiscal policy issues, the staff had considered that, at the present juncture, it would be appropriate to focus more narrowly on exchange rate issues. In that respect, the staff considered that it would be important to avoid following a standard, predetermined format for world economic outlook exercises, so that each exercise could focus on the most prominent issues affecting the world economy at the time the World Economic Outlook was issued.

He agreed with the comment put forward by Mr. Waterman at EBM/95/84 that it might not be advisable to conclude that monetary policy should be eased simply because fiscal consolidation was being undertaken, the Economic Counsellor stated. For example, in 1994, the U.S. economy had experienced some of the negative impact, in terms of aggregate demand, from the fiscal consolidation measures that had been enacted in 1993. At that same time, however, the economy had experienced very strong rates of growth, and monetary policy had been significantly tightened. That experience highlighted the fact that there was no automatic relationship between the appropriate stance of monetary policy--which should be geared to the pace of growth in the economy and the development of inflationary pressures--and fiscal policy. If the budget discussions currently under way in the United States resulted in further fiscal consolidation--which was to be hoped--that would likely have a mildly negative impact on real GDP growth over the short term. Therefore, monetary policy could be expected to tighten less, or even to ease a bit more, than might otherwise be the case. However, it was doubtful that developments with respect to fiscal policy would take a prominent position in setting monetary policy.

With respect to whether monetary policy could be characterized as an instrument to spur economic growth, it was important to distinguish between the objectives that governed the conduct of monetary policy and the effects of monetary policy, the Economic Counsellor considered. It was important to bear in mind that monetary policy clearly had certain implications for the likely course of economic activity, even through that was not its objective. It was also important to bear in mind that the effects of monetary policy on growth were relatively complex. For example, although the tightening of monetary policy in the United States in 1994 had slowed the pace of economic activity, it had also helped to contain what would otherwise have been a significant rise in inflationary pressures. In the particular circumstances of the United States, the short-term effect of the monetary policy tightening in 1994 had been to reduce the rate of growth. However, by preventing the economy from overheating in 1995 and 1996, the monetary policies pursued in 1994 had also helped to allow the level of output to rise closer to potential over the medium term.

Against that background, the analysis contained in the world economic outlook paper was not intended to imply that monetary conditions had been

eased in Germany with the objective of spurring economic growth, the Economic Counsellor stated. However, the easing of interest rates in Germany, which had permitted a more general easing of monetary conditions within Europe, was a positive factor that would likely contribute to a renewal of more rapid growth later in 1995 and in 1996.

There was a need to look at the role growth objectives played in the formulation of monetary policy, and how growth and monetary objectives might be interrelated, the Economic Counsellor commented. There were clear differences among central banks with respect to both their stated objectives and how they adjusted policies in light of those objectives. Moreover, there were sometimes differences in the statements made by central banks and their actions. Nevertheless, even if the objective of monetary policy was to keep output as close to potential as possible over the medium-term, it would likely be formulated in much the same way as it would if the primary objective was to keep the rate of inflation low and relatively stable. Low and stable rates of inflation were a precondition for maintaining output growth at high and stable levels.

The Chairman made the following summing up:

> Directors shared the view that the world economic situation remains broadly positive, with much of the membership enjoying continued economic growth and relatively low inflation. They observed that the world economy has shown resilience to the episodes of financial market turmoil in the recent past. Directors welcomed the recent realignment of the world's major currencies, noting that it seemed to have corrected much of the overshooting that had occurred earlier in the year and that it had reduced the downside risks to prospects for noninflationary growth in some major countries. Reaping the full benefits of this favorable outlook required continued vigilance, and Directors considered that the Madrid Declaration continued to provide a broadly relevant framework for the orientation of policies.
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> Directors saw the modest downward revisions in growth projections in most industrial countries, with the exception of Japan, as reflecting a temporary midcycle pause in the expansion, with underlying growth fundamentals remaining generally positive. In the United States, the United Kingdom, Australia, and New Zealand, the moderation in growth should help to alleviate inflationary pressures, although there was a need for continued prudence in the conduct of monetary policy. Among the continental European countries, where output gaps were larger, the expansion was likely to continue at a pace somewhat above potential growth, but progress in reducing unemployment was likely to be slow. In this context, the recent easing of official interest rates in Germany, France, and several other countries was welcomed as appropriate in light of these countries' low inflation rates.

In Japan, given the desired orderly reversal of the yen appreciation and the stock market's advance, there was now greater likelihood of a pickup in growth in 1996, but the timing and strength of that pickup remained somewhat uncertain. Directors welcomed the further cut in official interest rates in early September, and stressed the need to ensure that the supplementary fall 1995 budget would avoid a withdrawal of fiscal stimulus until the recovery was well under way. While some Directors called for additional fiscal stimulus, some others pointed to the longer-term costs of a further deterioration in the fiscal position--they considered that, after the recent easing, monetary and fiscal policies were not likely to provide much more help in stimulating growth. All speakers agreed that major structural reforms--further deregulation and market opening--were needed to revitalize the Japanese economy. The recent successfully managed closure of some insolvent financial institutions was an important step toward the resolution of the bad loan problem, but Directors cautioned that other financial institutions might need restructuring, that the restructuring process would be protracted, and that financial sector problems might continue to slow the pace of recovery.

Directors noted the continuing strong growth prospects in much of the developing world, and welcomed the extent to which the contagion effects of the financial crisis in Mexico appeared to have been successfully contained. Directors observed that financial markets had become more discerning as to the economic fundamentals among developing countries, and capital inflows had remained high or had resumed in many cases, including in several countries in the Western Hemisphere. In Asia, while the prospect of a fourth consecutive year of very high growth was welcomed, Directors cautioned about the risks of overheating in some countries in that region. In Africa, growth prospects had improved with more favorable external conditions and as a result of the adoption of market-oriented policies by a growing number of countries; but many deep-seated structural weaknesses remained to be tackled and potential policy slippages constituted a risk to the forecast. In the Middle East, growth prospects had generally improved, but the recent weakening of oil prices was likely to have adverse effects on the oil exporting countries in the region.

Directors also welcomed the improved outlook in some of the economies in transition, noting the extent to which economic performance had varied across countries depending on their progress in macroeconomic stabilization and structural reform. Output was expanding vigorously in a number of countries that were more advanced in the transition process. Economic activity was expected to continue to decline in countries where progress with stabilization and reform remained inadequate or fragile.

Price performance had improved in many countries, and inflation was expected to remain low in most of the world economy, even though there was no room for complacency with respect to the need to safeguard and continue progress toward reasonable price stability. Directors observed that a series of pre-emptive monetary tightening moves in some industrial countries where slack had been rapidly absorbed during 1994 had demonstrated the commitment by central banks to resist inflationary pressures, and this had served to reduce inflation expectations. Although there had been a pickup in producer prices in some areas, wage increases remained moderate in most countries and earlier pressures in commodity markets had abated somewhat. Directors stressed that the inflation outlook depended on the continued pursuit of prudent macroeconomic policies.

Regarding the main risks facing the world economy, several Directors expressed concern that some of the possible underlying causes behind the financial market turbulence seen earlier in the year might again lead to shifts in market sentiment. They pointed to the risks associated with the volatility in globalized financial markets and the growing concerns about the stability of the banking system in several countries. Several Directors cautioned that it would be important not to overreact to what was likely to be a temporary slowdown in the economic expansion in some of the large industrial countries by delaying plans for fiscal consolidation or pursuing excessively stimulating monetary policies. Directors stressed that countries needed to address forcefully the problems of high structural unemployment and excessive budget deficits. Larger than expected budget deficits could easily cause risk premiums to increase, interest rates to rise, and economic growth to be weaker.

As to the policy challenges, Directors discussed developments in the exchange markets over the course of 1995. Several speakers pointed to the difficulty of identifying equilibrium exchange rates, noting the complexity involved in assessing the consistency of exchange rates with economic fundamentals. Nevertheless, Directors agreed that movements in key currency values and interest rates in the first half of the year did not fully reflect economic fundamentals.

They welcomed the recent coordinated intervention by central banks, which had contributed to correcting the misalignments. This had demonstrated the benefits of cooperative action among the major industrial countries to address common concerns. At the same time, Directors cautioned against drawing too broad conclusions that exchange market intervention was a generally powerful and reliable tool that could be used to influence exchange rates in all circumstances. They stressed that, if the recent successes in correcting exchange rate misalignments were to

endure, they needed to be solidly supported by adequate macroeconomic and structural policies.

While observing that progress has been made on the fiscal front in some industrial countries, Directors stressed that much more remained to be done to restore an adequate degree of fiscal balance and to put public debt-to-GDP ratios on a clearly declining trend. They warned against fiscal adjustment fatigue and urged countries to continue to use the expansion wisely by putting their fiscal houses in order. Fiscal consolidation remained essential to alleviate pressures on global real interest rates and to offset growing invisible liabilities of most public pension and health care programs. Directors generally agreed with the staff's conclusions that, in countries with large risk premiums in bond yields and highly depreciated currencies, fiscal consolidation might have substantial beneficial effects on confidence and risk premiums, and help to strengthen exchange rates even in the relatively short run. In other cases, the short-run effects of fiscal consolidation on the exchange rate was a complex issue, since the immediate interest rate effect would tend to weaken the exchange rate while confidence effects might well pull in the opposite direction. In the longer run, however, an improved budget position and the resulting rise in national saving would tend to strengthen the equilibrium net foreign investment position which, in turn, should imply a stronger currency.

Directors noted that monetary policy had been quite successful in maintaining inflation levels closer to price stability than had been seen in nearly 30 years in many countries. With inflation remaining low, many countries, particularly in continental Europe, had taken the opportunity to reduce policy interest rates. A number of Directors considered that, when accompanied by fiscal consolidation, such a rebalancing of the policy mix improved the prospects for sustainable growth. At the same time, in view of the high level of capacity utilization in most industrial countries, Directors emphasized the need for monetary policy to remain focused on preserving medium-term price stability.

There was continued concern about the economic and social costs of the high level of structural unemployment, particularly in Europe. Governments were urged to reduce labor market distortions that contributed to high unemployment, which would include taking steps to reduce employers' social insurance contributions for the young and low-skilled; to lessen the impact of minimum wages for young workers; to increase wage flexibility by reducing or eliminating indexation provisions; and to improve education and training.

Directors noted that robust growth in many developing countries--especially those in Asia and Latin America, but also in other regions--had been associated with increased openness and greater integration into the global economy, both through traditional trade linkages and through new financial linkages. Strong and consistent reform and stabilization efforts had promoted increased openness, contributed to the impressive growth performance of many developing countries, and made them more resilient. Industrial countries had benefitted from this process, especially during the recent slowdown when rapid growth in developing countries had helped to sustain the growth of world trade and output. Directors acknowledged, however, that despite widespread consensus on the benefits of open trade regimes, significant barriers to trade were still prevalent in a number of developing countries. In this connection, appropriate policies were needed to make these economies more responsive to the new trading opportunities arising from increased global integration and the conclusion of the Uruguay Round.

Directors recognized that closer integration also posed new risks for many developing countries. The Mexican financial crisis highlighted the risk of economic disruptions from sudden reversals of capital flows, especially in countries where macroeconomic fundamentals were not sufficiently strong. Directors emphasized that it would be essential to strengthen domestic financial markets and address macroeconomic policy imbalances in some countries for them to fully benefit from the opportunities of a closely integrated world economy.

For countries experiencing large capital inflows, Directors urged policymakers to ensure that fiscal policy remained prudent and did not put pressure on monetary policy to restrain domestic demand. In some countries, greater flexibility of exchange rates might be warranted on the basis of improvements in economic fundamentals and would also help to contain inflation. Directors underscored the need to strengthen prudential regulations, to address weaknesses in financial systems, and to guard against excessive increases in domestic credit, especially where foreign capital inflows were intermediated largely through the domestic banking system.

Directors agreed that freedom of capital movement would promote growth and improve the allocation of resources over the longer run. Some Directors considered that liberalization of the capital account should be undertaken gradually in economies where financial markets were not well developed, banking sectors were fragile, or where macroeconomic imbalances had not been corrected. Directors stressed, however, that a phased approach should not lead to undue delays in capital account liberalization, especially as the latter could serve as an impetus for financial reforms and

strengthen the domestic financial system. Some Directors observed that measures to limit short-term foreign currency-denominated borrowing by banks might be justified on prudential grounds, and that broader measures to discourage excessive short-term debt creating or portfolio inflows might prove useful in some circumstances. Directors stressed, however, that restrictions on capital flows should be viewed as temporary measures, and not as a substitute for stronger adjustment efforts.

Directors agreed that policies in the more advanced economies in transition should aim at sustaining growth and disinflation, continuing structural reforms and, in particular, deepening the role of market-oriented principles. For countries less advanced in the transition process, Directors welcomed recent signs of progress toward macroeconomic stability and structural reform. These countries should continue to concentrate their efforts on achieving or consolidating macroeconomic stabilization and on establishing market-oriented institutions.

Directors expressed concern about the fragility of the banking system in almost all of the economies in transition, including in some of those most advanced in the transition process. But speakers noted that concerns in this area extended to other countries as well. In the transition countries, Directors agreed that a comprehensive banking and enterprise reform strategy was necessary to resolve problem loans early on. Weaknesses in the banking system should be addressed through strengthened banking supervision, improved assessment of credit risk, more stringent capital requirements, and greater participation by foreign banks to spur the modernization of domestic banking practices. Banking sector reform would improve corporate efficiency in the enterprise sector which, in turn, would further strengthen banks by increasing the number of economically viable borrowers. In the meantime, where banking crises emerge, they must be dealt with promptly and in a manner that discourages their recurrence.

## 2. CURRENCY STABILIZATION FUNDS - FUND POLICIES - FURTHER CONSIDERATION

The Executive Directors continued from Executive Board Meeting 95/68 (7/19/95) their consideration of Fund policies with regard to currency stabilization funds.

The staff representative from the Policy Development and Review Department made the following statement:

In concluding the Executive Board discussion of currency stabilization funds (CSFs) on July 19, the Managing Director indicated that the staff would prepare a short note recapitulating

the general conditions and specific modalities that could apply to a CSF, bearing in mind Executive Directors' views expressed in the two meetings held on this subject. On that basis, the Executive Board would seek to come to an early decision on the conditions under which the Fund could support such mechanisms and, if so, how.

This note sets out in summary form general conditions and main operational characteristics for CSFs that would appear, on the basis of the Board's discussions to date, to have general support among Executive Directors. The staff would envisage that, if the Board concludes that the Fund should be prepared to support CSFs for members in certain circumstances, the points listed below would constitute the substance of a summing-up by the Managing Director, which would guide the staff in discussions with members and the Board in its consideration of individual CSFs. Any such operations would be approached in an experimental way and would be kept under close review.

Experience has shown that under certain circumstances a nominal exchange rate anchor can be a powerful instrument, when employed in the context of strong macroeconomic stabilization policies, in bringing about a rapid decline in inflation. In the framework of a Fund upper credit tranche stand-by or extended arrangement, Fund financial support for the specific purpose of providing a precautionary pool of resources to supplement reserves for a transitional period--that is, a currency stabilization fund (CSF)--could provide an important element of additional confidence in support of an exchange-rate-based stabilization strategy and, under appropriate conditions, would be consistent with the purposes of the Fund.

In particular, for CSFs to play their intended role, economic policies would need to be sufficiently tight to deliver an inflation path compatible with the targeted exchange rate anchor--that is, the anchor would need to be realistic and sustainable on the basis of the member's policies, so that little, if any, use of the CSF for exchange market intervention would be expected; it would need to be understood with the authorities that economic policies would be adapted promptly as necessary in response to changing conditions, so as to ensure the maintenance of the nominal exchange rate objective; and the underlying program would need to be fully financed (i.e., without taking account of the resources of the CSF).

Fund support for CSFs would be considered in cases of high inflation where a nominal exchange rate anchor is adopted as part of a credible, comprehensive adjustment strategy to achieve a rapid and substantial decline in inflation and where close monitoring is possible to ensure that the exchange rate anchor and

supporting policies continue to be appropriate. It would be expected that a CSF would be activated at a relatively early stage in the process of reducing inflation, but only when the Fund can be confident that the member's policies are sufficiently strong and will be implemented and adapted as necessary; activation could take place at the outset of an arrangement or during the course of a review.

The most appropriate exchange rate arrangement to be supported by a CSF would be an exchange rate peg with relatively narrow margins, or a preannounced crawl, that would limit the discretionary use of the exchange rate. Careful consideration would need to be given to establishing the appropriate level at which to establish the exchange rate peg (or crawl), avoiding a real exchange rate that is excessively low or high relative to historical levels or other relevant indicators. It would not be the purpose to maintain the anchor indefinitely, and the appropriateness of the exchange rate and the exchange arrangement would be kept under continuous review by the authorities and the Fund, both during and subsequent to the disinflation effort.

The policy conditions necessary to ensure the success of an exchange-rate-based stabilization, and thus essential to Fund support for a CSF, include: (1) fiscal adjustment and credit creation consistent with targeted inflation; (2) appropriate measures to deal with backward-looking automatic wage and other indexation schemes; (3) establishment of a high degree of current account convertibility and an open trade regime, and other measures to encourage a return of flight capital; (4) contingency plans for dealing with large capital outflows or inflows, which would depend on full interest rate flexibility and should also involve contingency fiscal measures; (5) establishment of integrated operational management of foreign exchange reserves and intervention policy; and (6) other structural and institutional elements supportive of the effort to reduce inflation sharply. More specific conditions would depend on the particular circumstances of each country.

It would be possible to consider cofinancing of CSF's; however, certain basic principles would need to govern Fund policies with regard to cofinancing for Fund-supported CSFs. First, the Executive Board would retain control over all use of Fund resources in support of CSFs. Second, cofinancing should not unduly complicate the operations of CSFs. Third, terms associated with resources provided through cofinancing should be at least as favorable to the borrower as those associated with Fund financing. Fourth, resources made available through cofinancing procedures should not in any way affect the safeguards of Fund resources and the Fund's preferred creditor status. If cofinancing were judged

to be feasible and beneficial in a particular case, specific features would need to be determined at that stage.

A CSF would be established as an element (or "window") within a Fund upper credit tranche stand-by or extended arrangement and would have revolving features permitting repeated use under specified conditions. ESAF-eligible member countries would be able to use CSFs through arrangements in the General Resources Account that would operate in parallel to an ESAF arrangement.

Access under arrangements including a CSF element would be subject to the limits (annual and cumulative) applicable to stand-by and extended arrangements. Maximum access under the CSF element would be 100 percent of quota. Access under the CSF element would be determined on a "net" basis--that is, outstanding use of CSF resources could not exceed a specified percentage of a member's quota (not exceeding 100 percent in any case), taking account of the repurchase and reconstitution procedures set out below. The determination of access levels for individual cases would be guided by the usual criteria of need, strength of policies, and capacity to repay the Fund, taking into account the adequacy of precautionary reserves to instill confidence in the member's exchange rate regime. In practice, access under CSFs would be expected to vary considerably on a case-by-case basis, depending on the degree to which the assessed need for reserves was already met from other sources. Appeal could be made to the exceptional circumstances clause, if necessary, but in no case would access under the CSF element of an arrangement exceed 100 percent of quota.

Normally, a CSF would have four equal tranches, with flexibility to raise access under the first tranche to a maximum of 35 percent of the size of the CSF with offsetting reductions in the third and fourth tranches (i.e., 25/25/25/25 percent or 35/25/20/20 percent of the size of the CSF or other variations in between) depending on the particular circumstances of each case. There would also be flexibility, where warranted by the circumstances, to vary the number (and consequently the size) of tranches within a range of three to five tranches.

The documentation establishing a CSF would specify the precise details of the reporting requirements. These would need to be sufficient to enable the Board to assess the appropriateness of requests for activation, availability of resources and extensions of repurchase expectations under a CSF. Daily reporting of key financial variables (such as exchange rates, interest rates, exchange market turnover, intervention, and reserves) would be expected. Reporting requirements could be modified or supplemented by the Executive Board during the operation of the CSF as a condition for approving the availability

of CSF resources or completing reviews under the arrangement. It would normally be expected that a Resident Representative would be in place to facilitate close monitoring and compliance with the reporting requirements.

Activation of the CSF element of an arrangement would be based on a determination by the Executive Board that the conditions are appropriate. In assessing whether to activate the CSF element, the Executive Board would consider whether the exchange rate policy was realistic and sustainable; whether the exchange rate policy would be firmly supported by fiscal and monetary policies, including rapid policy adjustments, as necessary; whether the program is fully financed; and, whether adequate monitoring and reporting procedures are in place and functioning properly.

Upon activation, access to the first tranche would become available. The first tranche would represent a form of working balance, which could be purchased and held for the duration of the CSF or drawn, repaid, and redrawn again without the need for further review by the Executive Board so long as the member remained in compliance with the arrangement, including supplementary measures (objectively defined) as might be required by the Board in connection with the CSF element, such as reporting requirements. Decisions to make available CSF resources beyond the first tranche would also be made by the Executive Board and would take into account, inter alia, assessments of monetary, fiscal, and exchange market developments and the sources of exchange market pressure; evaluation of past intervention operations and use of CSF resources; evaluation of the stance of monetary and fiscal policies, including adherence to performance criteria under the arrangement; continued compliance with the conditions of integrated foreign exchange management; continuous adherence to reporting and monitoring requirements; and any other conditions set out at the establishment of the CSF. Policy adaptations could be required. Upon approval, resources in the upper tranches would remain available for purchase for a period of two weeks. At any given point in time, if the member's outstanding credit under the CSF fell into a particular tranche, the maximum size of a request for availability of resources would be equal to any amount remaining unused in that tranche or the size of the subsequent tranche, which ever is larger. Drawings beyond the first tranche would normally be for the purpose of replenishing some pre-established proportion of the member's own reserves used in intervention.

CSF purchases would be subject to a one-year repurchase obligation in those cases where Article V, Section 4 is applicable. A one-year repurchase expectation would apply to those

first CSF tranche purchases that are not subject to Article V, Section 4. In addition, CSF purchases beyond the first tranche would be subject to a repurchase expectation that would provide for repurchase within three months; requests for extension of such three-month repurchase expectations would be permitted, with approval of the Board, up to three extensions, so long as the CSF remained in operation. Consideration of requests for extension of repurchase expectations would take into account the same factors relevant to requests for availability of CSF resources. Failure to comply with a repurchase expectation would preclude further use of the Fund's general resources until the repurchase expectation had been satisfied. Failure to comply with a repurchase obligation would result in an overdue obligation to the Fund with all the usual consequences.

Repurchase of a purchase under the CSF element of the arrangement would reconstitute the member's right to request the availability of resources under that element, subject to the conditions for such requests noted above.

Charges associated with CSFs would be the same as those that pertain to stand-by and extended arrangements.

Procedures for handling Fund operations under CSFs would include:

On establishment of a CSF element within a Fund arrangement, a monthly report would be circulated to the Board providing a one page summary of recent developments and prospects, a table of selected CSF-related economic indicators, and a brief assessment of whether the member remains in compliance with all terms and conditions of the CSF and the related arrangement. If called for, these reports would be supplemented on occasion by somewhat longer reports for discussion. All data and information circulated in these reports would be treated with the utmost confidentiality. CSF-related material would also be covered in the staff reports for reviews under the arrangement.

The Board would be notified immediately of a member's intention to request availability of CSF resources. The minimum circulation period for the Board to act on a member's formal request for the availability of CSF resources would normally be five working days. Under emergency circumstances this could be compressed to 48 hours or, possibly, in informal consultation with the Board, a shorter period.

After a request for the availability of CSF resources is received, the staff would circulate as soon as possible an updated summary of the economic situation and a staff assessment of compliance, to be supplemented as necessary by a briefing at a

Board meeting. Under normal circumstances, the period between circulation of the updated summary and the Board discussion of the request would be at least 48 hours. However, under exceptional circumstances, the circulation period could be abbreviated. Disbursement procedures would be in keeping with the Fund's Rules and Regulations, i.e., normally requiring three business days from initiation of a purchase.

Mr. Clark made the following statement:

In his concluding remarks following the previous Board meeting on Fund policies with regard to currency stabilization funds (CSFs), the Chairman asked Executive Directors to reflect on the question of whether there is a role for Fund-supported CSFs, where the authorities wish to adopt an exchange rate anchor and where there is a firm commitment to the policies needed to sustain the anchor. Based on the general conditions and main operational characteristics of such CSFs outlined by the staff in their August 3, 1995 statement, I can answer this question in the affirmative. Having said that, I would like to make a few remarks on the role of CSFs and on some of the modalities involved.

The key role of a CSF is to support a nominal exchange rate anchor, where the latter forms the basis of a macroeconomic stabilization strategy. The main contribution that a CSF can make under those circumstances is to add credibility to an ambitious adjustment program, thus helping to reduce both inflationary expectations and the impact of disinflation on the real economy. While the credibility of the exchange rate peg, and the reform effort more generally, can be enhanced by a CSF, the adoption of a fixed exchange rate cannot be a substitute for appropriate macroeconomic stabilization. Indeed, the success of an exchange-rate based disinflation program, and hence the applicability of a CSF, depends crucially on the implementation of monetary and fiscal policies that are sufficiently tight to deliver an inflation path that is consistent with the exchange rate peg. Moreover, the initial parity chosen must be credible and, thereby, sustainable in the sense that private agents have confidence in the authorities' ability to support the parity. The signaling function of an externally-financed stabilization fund can play a key role in enhancing private agents' confidence in the parity. Finally, I would stress that the use of a CSF should be limited to very short-term foreign exchange intervention against a temporary, speculative attack on the exchange rate peg. Sustained exchange market pressure, however, would need to be addressed through a realignment of the peg and/or an adjustment of financial policies. In this context, as part of the design and presentation of a stabilization strategy based on a nominal exchange rate anchor, it would be important in my view to examine closely the issues and

highlight the risks relating to the choice of exchange rate arrangement. Combined with a continuous review of the appropriateness of the exchange rate and the exchange rate arrangement, this would facilitate any transition from one exchange rate regime to another.

With respect to the modalities of a CSF, I generally agree with the guidelines set forth by the staff, and the comments I made in my statement of July 18, 1995 in this area continue to reflect this chair's views. I believe that the particular operational features of a CSF should be designed to reflect the trade-off between minimizing risk to Fund assets and allowing the facility to be flexible enough to fulfill its objectives. I would argue that the safeguarding of Fund assets is best accomplished via the conditionality attached to the CSF, and not through building excessive restrictions into its modus operandi.

With respect to the specific operational characteristics of a CSF, I agree with both the proposed structure and access outlined in the staff statement. Regarding tranching, I continue to believe that the number of tranches should be limited to three--as was the case with the Polish zloty stabilization fund. In any event, four tranches should be considered an absolute maximum. With respect to reporting requirements, the staff's recommendations appear reasonable. However, I suggest that it would be useful for the Executive Board to know well in advance which countries might be potential candidates for a CSF request. This "advance warning" could be sounded, for example, during the country matters sessions. Finally, I broadly concur with the staff on the activation and use of CSF, on repurchase/reconstitution, and on charges for the use of CSF.

In conclusion, I reiterate my support for currency stabilization funds as a way of enhancing the credibility, and thus the chance of success of an exchange-rate based economic stabilization program. The strict conditionality that attaches to the CSF as it is currently envisaged should ensure that the Fund's resources are not unduly compromised.

Mr. Bergo made the following statement:

A CSF arrangement entails considerable potential risks that need to be balanced against the effectiveness of such an instrument in providing confidence to an appropriate exchange rate anchor. If CSFs are constructed appropriately, the risks would presumably be limited, but so would the potential benefits. There are also resource costs to the Fund, and this chair has been inclined to down-prioritize further CSF consideration at this stage. However, I realize that the Fund needs to be in a position to provide a firm answer when approached regarding the attitude of

the Fund on this issue, and that there appears to be fairly broad support for Fund supported CSFs provided the conditions and modalities are appropriate. Against this background, I can go along with a conclusion that the Fund should be prepared to support CSFs for members in certain circumstances.

In doing this I attach great importance to in practice closely adhering to the general conditions and main operational characteristics for Fund supported CSFs contained in the staff statement, which I find to be broadly acceptable.

Consequently, I can be rather brief and would only like to make three short remarks.

First, while I can agree that the points listed in the statement could constitute the substance of a summing-up by the Managing Director that should guide the staff and the Board in individual cases, and that any CSF operations should be approached in an experimental way and be kept under close review, I would be somewhat concerned if this experimentation includes too much flexibility with respect to the modalities and, in particular, the policy conditions. Moreover, I would find it useful if the staff includes considerations of the comparative benefits of CSFs compared to other possibilities of Fund support for using the exchange rate as a nominal anchor in the stabilization process, when holding discussions with individual members showing interest in Fund supported CSFs.

Second, I agree that the appropriateness of the exchange rate and the exchange arrangement should be kept under continuous review by the authorities and the Fund. I would, however, like to add that such deliberations preferably should include some forward-looking considerations, including on appropriate "exit" strategies and on the necessary supportive policies. It would also be appropriate to emphasize that CSFs at best can provide additional confidence in support of an exchange-rate-based stabilization strategy, but that a comprehensive strategy to achieve and safeguard macroeconomic stabilization is the foundation and, in fact, the only effective route for building the confidence needed to limit exchange rate pressures. Accordingly, I think we should be very careful not to recommend use of CSFs too early in countries' stabilization efforts and for too loose exchange rate pegs.

Finally, I find the suggested operational modalities to be broadly appropriate. I appreciate the intention to brief the Board on a regular basis, and I presume that the suggested procedures will include prompt briefing at any time the circumstances so warrant. I am also satisfied to note that a Resident Representative is no longer considered a precondition for

effective monitoring, even if I have taken note of the word "normally". On tranching, I still believe that three tranches with some front-loading would be appropriate to ensure the intended signaling effect, and I have a feeling that four or five tranches would be excessive.

Ms. Lissakers made the following statement:

I believe the staff statement does a good job of recapitulating the sense of the Board on the general conditions and modalities of a possible The Fund-supported currency stabilization funds. Therefore, I will be brief.

We support the proposed policy regarding currency stabilization funds.

The primary purpose of such CSFs would be to support credible, comprehensive exchange rate-anchored stabilization programs aimed at bringing about and securing a rapid decline in inflation.

Upper credit tranche conditionality would be required, including the monetary and fiscal policies needed to secure the objective of low inflation.

The CSF would provide transitional support during the stabilization period and would not be expected to support the indefinite maintenance of the exchange rate anchor.

I agree the CSF should operate as a window within a stand-by or extended arrangement and should have the revolving features described in the staff statement.

Access should be determined within established Fund policies of a maximum of 100 percent of quota annually and cumulative access of 300 percent of quota. The staff proposes that outstanding use of CSF resources should not exceed 100 percent of quota in any case. Given the revolving characteristics of the CSF component, this limit on outstanding CSF resources is acceptable.

The staff statement recognizes that, in practice, access under CSFs would be expected to vary considerably on a case-by-case basis. Any drawings to meet the separable program requirements for reserve accumulation or balance of payments financing would have to be met within the same annual access limits. Where necessary, therefore, we would be prepared to consider use of the exceptional circumstances clause to allow annual drawings to exceed established limits, provided the CSF element does not

exceed 100 percent of quota and that the supporting policies are sufficiently strong.

I agree with the proposals concerning reporting requirements, the guidelines for activation and use of the CSF, the repurchase and reconstitution provisions, and the operating procedures.

I continue to believe the structure of charges on CSFs drawings should attempt to do two things. It should provide incentives that reinforce the reconstitution and repurchase of the CSF element and it should better reflect risk factors.

As I suggested at our discussion yesterday on the emergency financing procedures, I think any drawings beyond ordinary access levels should carry a risk premium over and above ordinary charges. Equally, this should be applicable to any CSF drawings that cause ordinary access limits to be exceeded.

Since the CSF element is meant to have a revolving feature, we should not levy a service charge on each purchase and repurchase. This would only encourage the borrower to postpone reconstitution. Instead, I think the service charge should be based on the maximum outstanding balance on the CSF element.

As I have stated in our earlier discussions, my authorities are convinced that nominal exchange rate anchors, when accompanied by rigorous macroeconomic policies, can be powerful instruments to bring about rapid disinflation. Currency stabilization funds lend credibility to the exchange rate anchor. Where countries are willing to make the necessary policy commitments, the Fund should be willing to use its resources to support such CSFs.

Mr. Mesaki made the following statement:

My authorities' position on currency stabilization funds has not changed since the previous Board meeting on this issue. They are still doubtful about the early introduction of currency stabilization funds.

I will concede that a nominal exchange rate anchor can be a useful instrument, as pointed out by the staff, for countries with strong Fund-supported programs. However, we remain skeptical about the establishment of CSFs for the following reasons.

First, it is extremely difficult to determine the most appropriate level of the fixed exchange rate, in light of the highly uncertain economic prospects of countries that are in the process of drastic economic transformation. Experience shows that the wrong choice of fixed exchange rate leads to catastrophic results.

Second, the utmost attention should be paid to the degree of confidence in the authorities' commitment to economic reform. I am not convinced by the argument that the introduction of a fixed exchange rate system itself would strengthen confidence in the authorities in this regard. Strong commitment by the authorities might not in itself be enough. I believe that confidence can be enhanced only after the successful implementation of sound economic policies. If confidence in the authorities is enhanced, exchange rates would stabilize even without a fixed exchange rate system.

Third, in the event individual members request the establishment of a CSF, I believe the Fund can meet the member's demand appropriately enough by using existing Fund instruments. Consideration should be given to equal treatment of members, which is a basic principle of this institution. If the Fund approves a CSF invoking the exceptional circumstances clause for a member, it virtually means providing more Fund resources with the same conditionality to the member, and this could undermine the principle of equity vis-à-vis other members with floating exchange rate systems. It could be argued that CSFs will be established only for programs with stronger conditionality. However, it is difficult to define the strength of a program, and establishing a CSF with additional access would inevitably give the impression that the Fund favors a fixed exchange rate system. Although I do not have particular difficulties with the proposed modalities, I have doubts about the more fundamental aspects and do not support an early conclusion of this issue. Further careful discussion by the Board is needed before the conclusion of the general issue of the effectiveness of CSFs for the containment of inflation and the factors that should be taken into account when determining appropriate exchange rates. In addition, I would emphasize that I still believe that the necessary preconditions for introducing fixed exchange rate systems have not been satisfied in most of the economies in transition, and there does not seem to be any justification for rushing into a decision.

Mr. Calderón made the following statement:

This statement by the staff basically summarizes the previous paper on Fund policies with regard to CSFs. Hence, we will also recapitulate our main ideas and make some additional comments.

The basic prerequisites of a credible exchange rate based stabilization program are: first, that the appropriate level of the currency peg should be determined; second, that all monetary, fiscal and structural policies should be in place; and third, that any automatic indexation practices must be abolished.

These policies should be implemented before access to the CSF is granted. In this regard, we would like the staff to comment on one of the paper's "adjustment strategies": "It would be expected that a CSF would be activated at a relatively early stage in the process of reducing inflation, but only when the Fund can be confident that the member's policies are sufficiently strong and will be implemented and adapted as necessary." In particular, we would like to know what do they mean by "will be implemented."

Once the macroeconomic policies are in place, the idea is that the currency stabilization fund would provide additional support to the exchange based stabilization strategy. As the staff notices, in a successful program, little, if any, of the CSF resources would be used. We agree, provided that the size of the first tranche is adequate. In other words, a relatively modest first tranche would not instill confidence, and therefore the CSF resources would most probably be used.

The more difficult question is if a first tranche of 35 percent is sufficient or if it is too small. Staff agrees with the former; my intuition is that a bigger first tranche would be needed. The eventual use--or no use--of CSF resources would tend to give us an answer.

Another important issue is what happens beyond the first tranche. As we mentioned before--and also the current and previous papers on CSFs--in a successful program, the CSF resources would not be used. Consequently, the fact that the first tranche was used would most probably indicate that the program is not working well.

This points to the need to go beyond what the staff is suggesting for the second tranche: the paper tells us that "Decisions to make available CSF resources beyond the first tranche would also be made by the Executive Board and would take into account, inter alia, assessments of monetary, fiscal and exchange market developments, and sources of exchange market pressures; evaluation of past intervention operations and use of CSF resources; evaluation of the stance of monetary and fiscal policies..." I believe that in addition to this, an assessment of why the program does not seem to be working is needed; and more importantly, why access to a second (or third or fourth) tranche would contribute--as opposed to the first tranche--to the eventual success of the stabilization program and not only to a further deterioration of the countries' debt exposure.

Mr. Coumbis made the following statement:

We continue to maintain our theoretical objections, expressed during last July's discussion, to the staff's stand on the profitability of exchange rate based stabilization compared to a monetary-based one. Furthermore, at that time we stressed the fact that the economic debate on the pros and cons of fixed versus floating rate adjustment has not yet been settled. We also expressed doubts about the possibility of forming a definitive view as to the causes of strong pressures on the exchange rate. We supported the view that it is very difficult to say if these pressures were due to market misinterpretations about short-term speculative attacks or long-term market forces and/or inappropriate policies.

On the basis of this line of reasoning, we cautioned the staff against very early negotiations on CSFs. We still believe that the appraisal of the right moment to establish an exchange rate anchor is highly subjective and the risks implied by the failure of exchange rate based stabilization make a strong case for a cautious attitude in assessing when the appropriate conditions are in place.

We also warn the staff that an early currency peg in transition economies would entail a serious credibility problem concerning policy targets which are uncertain in an environment of distorted international relative prices, structural changes, and inadequate economic statistics.

In the staff's short statement before us today, I am glad to see that, both in general considerations and the operational characteristics, a conscious attitude has been adopted concerning the required policy preconditions for the activation of the CSF. Moreover, by adopting the window approach, more emphasis is given to the close links between additional financing and the conditionality embedded in the apparent arrangement. Furthermore, in the general consideration, it is stressed that the CSF would be activated only when the Fund is confident that a member's policies are sufficiently strong and that they will be implemented and adopted as necessary.

It is also stressed that careful consideration would be given to establishing the appropriate level at which to set the exchange rate peg. This means that the anchor should be realistic and sustainable on the basis of a member's policies.

I am also in agreement with the staff that the purpose of the anchor is not that it be maintained indefinitely. The appropriateness of the exchange rate would be kept under continuous review during the entire stabilization effort, and the Government

and the staff should decide upon the precise moment to exit from the arrangement.

Finally, with respect to the facility's operational characteristics, the case-by-case approach should be stressed in the determination of the access limits--not to exceed 100 percent. I agree with the staff view about the charges.

Also, the very detailed specification of the reporting requirements would help the Board to assess the appropriateness of requests for activation and availability of CSF resources. As for the operating procedures, there is no doubt that the Board has to react quickly to situations requiring immediate action. However, the circulation period for requests should have certain limits. In this regard, I am glad to see that the phrase "to allow afternoon Board discussions following morning circulation" is no longer included in the staff's statement.

Mr. Evans made the following statement:

In my previous statements on this subject I have indicated my support for the idea of currency stabilization funds in principle, while stressing the need for tight conditions. I am glad to be able to confirm this, despite a few reservations from my authorities. The staff statement before us does a very good job of setting out the necessary conditions for a CSF to be successful and addresses most of my concerns on operational aspects.

The statement rightly stresses the need for appropriate supporting policies and it underlines the importance of setting the exchange rate at a realistic level, and the need for contingency plans to allow for a quick policy response in the event of sustained exchange rate pressures. So the main burden of maintaining the rate falls on policies and not on intervention.

The guidelines also allow for the CSFs to be used in the case of a pegged rate or a predetermined crawl, which I think may well be right for a few situations. I would like to see a somewhat stronger presumption, than in the paper, that a successful CSF is one that is not used for intervention.

So far as the operational characteristics are concerned, I think in general they are appropriately tightly drawn. The reporting requirements are, rightly, strict, including the requirement expectation that information on key financial variables will be given to the staff on a daily basis and that monthly reports will be circulated to the Board.

I have two areas of concern remaining, and I want to suggest changes to adapt the guidelines to take these into account. When we discussed the systemic transformation facility, a number of Directors pointed out that the conditions in a country might well change between the time the Board approved a facility and its use by the member country. Indeed, if there were sustained pressures on the exchange rate, that in itself could well be a signal that conditions have changed. The same situation may apply to the CSF.

Sustained intervention, I think, should certainly be taken as a signal that all is not well and policies need to be altered. I am a little concerned that we might approve a first tranche of the CSF and a couple of months later see sustained intervention as a result of changed circumstances. So I suggest that the Board should be notified when a country uses CSF funds to intervene significantly in the exchange markets--for example, over half the level of the first tranche--with a possibility of any Director bringing it to the Board for a full discussion.

My second concern is that the process of negotiating a CSF will build up expectations in the markets. It may be difficult in these circumstances for the Board to reject a proposal without triggering something of a crisis. The management will be under pressure to issue a press statement. I think the Board, therefore, needs to be kept fully informed of progress in negotiating a CSF.

We might add something to the guidelines along the following lines: "because of the potentially damaging effect on confidence which could result from Board rejection of a CSF, the staff should inform the Board of its intention to start negotiating a CSF with a country." This could be done either in a staff paper or through issuing a statement which would give Board members an opportunity to discuss the proposal.

I have just one point about exit strategies. We have talked about the problem which countries face when trying to exit from a fixed exchange rate regime. I think it is important that these issues are discussed fully with the staff before an economy embarks on a stabilization program with the support of the CSF.

With these modifications, I think the staff statement sets out a very good description of the conditions required for a successful CSF. I believe these conditions are pretty demanding--appropriately so--and I do not expect to see many candidates. Indeed, part of my comment on Mr. Mesaki's interesting statement is that I would be worried if there were a lot of currency stabilization funds. I would only expect a few. I think that would carry the clear message that the Fund did not

have a preference for fixed exchange rates over monetary based or other stabilization policies.

I do share Ms. Lissakers's view that it would be useful to have a staff paper on the issue of the possibility of higher charges for all drawings on the Fund over certain levels. I think we would have to think about whether that should apply to the flow or the stock. I would not myself see this as a penal rate but as giving a signal to the country. It could also be seen as avoiding what I think one might see as the subsidy inherent in the present system.

The Acting Chairman said that he was concerned that, while the Board should be notified of negotiations with a country on a currency stabilization fund, too early a notification might lengthen the period during which the dangers of adverse expectations about a country's economic well-being could arise.

Mr. Evans remarked that an even greater danger would be that, once announcements had been made about the conduct of negotiations for the use of a currency stabilization fund, it would be difficult for the Board not to approve it without fueling adverse market expectations.

Mr. Fernández said that he could envisage the use of a currency stabilization fund under three possible circumstances. First, there could be a prior agreement with a country to negotiate a CSF element as part of a stand-by arrangement program. Second, a CSF could be activated on an emergency basis in the context of an existing stand-by arrangement. Third, there could be a situation in which a CSF was negotiated on a nonemergency basis during the course of a stand-by arrangement.

The Deputy Director of the Policy Development and Review Department said that the staff had envisaged all three possibilities. However, the negotiation of a CSF, for example, at the time of a program review, need not signal an emergency if the intention was simply to establish a fixed exchange rate regime.

Mr. Waterman made the following statement:

It is clearly important for many transition countries to get their rates of inflation down dramatically. But I remain very skeptical about the use of CSFs as a general way of doing that.

Inflation rates of 50/100 percent or more are a sign of policy failure and the difficulty of getting governments and electorates to accept the adjustment cost of bringing inflation down. And let's be realistic, getting inflation down from such levels is costly in terms of lost output, disruption and transition inequities. Part of the cost is that the authorities often lack the credibility to deliver the results. Markets will

remain skeptical until a country has put in a strong performance over an extended period. So I think we should not hold out any false hope that there is an easy way forward.

A commitment to peg to another currency or a particular band will not do much, the important thing will be the quality of the associated policies. And even with a dramatic tightening of policies, it is likely to be difficult to move expectations of people and markets. But it is the quality of the policies and the willingness to bear the short-term costs that will be the most important thing. Paradoxically, there would need to be a very strong political commitment to any rate or band, but coming off very high rates of inflation we know that striking an appropriate rate or band is very difficult. The policy demands and costs have been underlined by the recent experience of Argentina, where there has been a very strong commitment to the exchange rate peg and lower inflation; also a good example of where Fund support is appropriate. Any exit arrangement cannot be prepared for in advance and, if required, because inflation remains higher than expected or an incorrect exchange rate is selected, will be painful economically and politically.

Clearly if a country wants to peg its currency in some way to get inflation down and is prepared to introduce that on "an eyes open basis" and introduce programs to do that, the Fund must be prepared to consider assistance, particularly if there is impressive front loading. But that could be accommodated within a normal stand-by arrangement. That is, I am not convinced we need a new window. We should not encourage countries to go down this route; do not want to confuse possibilities and probabilities in terms of number of potential candidates.

So I cannot support a new window. But, if there is a majority for that, I would like to see a tighter framework in terms of access, tranching, and not extending the repurchase periods without penalties. I do not favor the use of an exceptional circumstances clause, but I could agree with Ms. Lissakers and Mr. Evans that, if it is employed, there would be a case for increasing the rate of charge.

It is also important that the Board be given adequate time to consider any proposal. In that regard, I can support Mr. Evans's suggestion that the Board be informed when negotiations get under way, and I can also support what he had to say about advice in relation to any significant drawings.

Mr. Kaeser made the following statement:

In our previous statements on this issue, we stated that a CSF could be useful under special and narrowly defined conditions.

This chair is satisfied with the tightened safeguards provided by the staff in its statement dated August 3. Like Mr. Evans, I think that the conditions for resorting to a CSF are quite demanding and that we cannot expect to have many candidates. We can support the establishment of CSF along the lines of the staff's blueprint. This being said, I would like to add first that we are in favor of Ms. Lissakers's idea concerning the introduction of a surcharge for drawing above the normal access limits, and, second, like Mr. Bergo, we ask the staff to elaborate on possible exit strategies from a CSF.

We think also that it would be appropriate to have an early review of this experimental feature. In an environment of globalized financial markets, one cannot exclude the risk that currency dealers would test the exchange rate policy of a member, especially if the size of the currency stabilization fund appears to be small compared with the size of the economy. In such a case, the CSF experiment would be doomed to failure.

Finally, I would appreciate it if the staff could elaborate on what is said under letter f. concerning repurchase and reconstitution.

If I understand well, Article V, Section 4, would be applicable if the purchase under a CSF agreement would cause the Fund holdings of the purchasing member's currency to exceed two hundred percent of quota. In such a case, the Fund has to grant a waiver, and the one year repurchase obligation is based on the discretionary powers granted to the Fund by Article V, Section 4. By the way, I think that the same solution could apply also to the emergency financing mechanism, if the use of Fund resources by a member goes beyond 200 percent of quota.

Going a step further I wonder on what legal basis relies the one-year repurchase expectation, which should apply on first CSF tranche purchases, which do not require a waiver. And on what legal basis relies the three-month purchase expectation for purchases going beyond the first tranche?

Are special majorities required to set up these terms of reimbursement?

I ask these questions in order to better understand the legal framework in which we are operating, but I do not question the appropriateness of these terms as such.

After adjourning at 1:00 p.m., the meeting reconvened at 2:40 p.m.

Mr. Tulin made the following statement:

I think the staff paper adequately captures the views expressed by the Executive Board in the course of two previous discussions on the subject. The staff has appropriately emphasized the experimental nature of this new confidence-building element of Fund support of members' worthy stabilization and adjustment efforts. It will certainly require a thorough examination of the members' particular circumstances on a case-by-case basis before a decision can be made by the Fund that a nominal exchange rate anchor is feasible and sustainable in the context of strong macroeconomic stabilization policies.

Given the expectations that CSFs will not be frequently employed and that, when employed, they will be only rarely used for actual exchange market intervention with an early repurchase obligation, CSFs, by definition, must be closely linked to the Fund's upper credit tranche conditionality within the framework of a fully financed program incorporating, inter alia, detailed built-in contingency financing mechanisms. Thus, precautionary and revolving features of a CSF would allow for establishing it both as a "window" within an upper credit tranche stand-by or extended arrangement, or parallel to an ESAF arrangement.

I broadly endorse the proposed general guidelines and operational modalities for CSFs which preserve considerable flexibility for the future determination by the Executive Board of many important aspects of a particular CSF, including access limits within the suggested maximum of 100 percent of quota, tranching, reporting and monitoring requirements, and other terms and conditions.

see any room for further discussion of general issues related to the CSFs, and, therefore, I have some difficulty in understanding those of my colleagues in the Board who are warning us against an early closure of this issue. Further general discussions are not likely to change the positions of the Board members by converting them into another religion. Those Directors who are now generally skeptical about the fixed- exchange-rate-based stabilization policies will never waive their criticism of the CSF approach unless they are given an opportunity to try to change their views by acquiring experience with some successful country programs. On the contrary, those Directors who now advocate the CSF approach will be looking forward to testing their views, also by experience. In this connection, may I propose to my colleagues to try to reach a compromise on the grounds of their highly professional, critical and severe appraisals of any individual country programs which may suggest an activation of CSFs.

Like the Chairman, I hope that today's meeting will finalize our work on the general aspects of establishing CSFs, apart from some unresolved issues on the technical side. Therefore, I shall conclude at this stage by expressing my authorities' belief that the new instrument will prove to be an additional valuable and powerful complement to other forms of traditional Fund support of macroeconomic stabilization efforts in the countries with entrenched inflationary expectations.

Mr. Autheman made the following statement:

I can share the premise of the staff paper but not its conclusions, and especially not the operational features of the proposed scheme. I agree that programs based on an exchange rate anchor and supported by tight financial policies can be very effective if the stringent conditions well identified in the staff papers are met. I agree that such programs may deserve high access to Fund resources on the basis of their strength and credibility. I also agree that such programs may require a front-loading of Fund resources, considering the need to strengthen the initial pool of official foreign reserves of the country. This, therefore, requires careful and tight monitoring.

As I have said before, and as Mr. Waterman, among others, reminded us this morning, I continue to believe that the Fund is fully equipped to respond to the needs of those members who would like to base their stabilization effort on an exchange rate policy. The stand-by arrangement and the extended arrangement are flexible enough. They can be adapted to evolving circumstances without being burdened by all sorts of cumbersome additions. I am ready to consider, if needed, high and front- loaded access for such programs.

I see the merit of incorporating in such arrangements mechanisms of close monitoring, such as monthly net international reserve performance criteria, and, of course, an understanding on intervention policy which would need to be monitored by the staff. But it remains to be proved that the instrument of the stand-by arrangement is inappropriate to fulfill these objectives, and this has not been done.

I am concerned that the creation of a specific mechanism called a currency stabilization fund could bias the choice of their exchange rate policy by some of our members who would be inappropriately attracted by the implied higher access to Fund resources. I am puzzled by the preference for complexity over simplicity and for ambiguity over clarity in the operational design of the proposal. Complexity may be a subtle tactic in order not to achieve any result. I think it is an inappropriate

strategy when what is at stake is helping some countries to use effectively the exchange rate anchor as a tool for stabilization.

Complexity in this case is very much related to the development of safeguards which are supposed to compensate for the risk which maybe should not have been taken, but I think that these safeguards are of an illusory nature. Let me elaborate on three specific features which I cannot support.

One is the ambiguity of access policy. I still fail to understand what the staff has in mind. According to the latest document, access under arrangements, including a CSF, would be subject to the limits applicable to stand-by arrangement and extended arrangement, but at the same time maximum access under the CSF alone would be 100 percent of quota, which is our present maximum access.

I am puzzled to hear several Directors develop a new concept which I have never heard of, namely the concept of normal access limits, ordinary access limits. So far as I know, the Fund policy provides for access limits, and under a clause designed for extreme cases, we maintain the possibility of exceptional higher access. I think that we should not design our policies with the expectation that they will imply active use of the exceptional access clause.

Second, I think that the design of the scheme introduces damaging confusion between the role of the Fund and the role of the authorities. Once a program is agreed between a country and the Fund, it is the role of the authorities to implement it themselves in accordance with the performance criteria, and it is the role of the Fund to monitor this implementation without entering some form of joint management by the authorities and the staff, and joint oversight of the staff by Board and management. I am well aware that these sophisticated proposals are meant to safeguard Fund resources. I think that they would lead to the opposite results. If we are no longer able to maintain a proper distance between the staff and the authorities, we are creating a reasonably high probability of confusion of responsibility and, therefore, incurring the risk of contentious relationships, or of ineffective control. Furthermore, I think that we should keep the proper distance between the responsibilities of management and those of the Board, which should not be involved, in my view, in assessing whether specific interventions in the foreign market was appropriate or not.

Third, I am puzzled, like Mr. Kaeser, by the expectation of short-term maturity of disbursements under the currency stabilization funds. This means that on an important issue, our relationship with the country would not be based on a clear legal

understanding, but on some political mutual commitment. I do not think it is appropriate to change the standard schedule of disbursement. What would indeed happen in cases of failure? Of course, our purpose is to succeed, but we cannot close our eyes to such an eventuality, which may come whether from external shocks or from policy mistakes. The affected member would most certainly be in need of a new stabilization program built around a completely different structure, but would be supposed to be able to benefit only from very limited, if not negative, financing support from the Fund. We would be drawn into the dangerous issue of considering a rescheduling of our claims. This is not a perspective which I can support. Therefore, I am looking forward to a clearer and simpler approach.

Mr. Koissy made the following statement:

First, I agree that the basic objective of the currency stabilization fund as conceived, is to serve as a confidence building mechanism. It is clear from experience, that under certain circumstances, a nominal exchange rate anchor could be a powerful instrument, when used in the context of a comprehensive adjustment strategy to achieve a rapid and substantial decline in inflation. Therefore, this chair continues to see merit in the role that the Fund could play, through the CSF, in assisting member countries implementing a strong anti-inflationary program.

Second, overall, I find the general conditions and the main operational characteristics set out in the staff statement with respect to currency stabilization funds appropriate. They reflect broadly the views of the Board, as stated during previous meeting on this subject, and appear consistent with the purposes of the Fund.

Third, I agree that to be effective, a CSF should be activated at an early stage and that it should be supported by a set of strong macroeconomic and structural policies. The outline of the policy conditions set out in the staff statement 95/78 appear appropriate. However, I wonder if the establishment of a high degree of current account convertibility and an open trade regime is not a measure that can retard the process. My problem is not so much with current account convertibility or openness of trade regime, as it is with the terms "High degree". Perhaps, the staff may wish to comment on what they mean by "high degree".

Fourth, on the operational features of the CSF, I welcome the fact that it could operate under a "window" within stand-by or extended arrangements and I am also pleased to note that ESAF-eligible member countries would be able to use CSFs through operations parallel to an ESAF arrangement.

With regard to access, I concur with the proposed limit of 100 percent of quota. However, like others, I wonder if four tranches are not too much. Three tranches with some front-loading of the first tranche would appear to be more suitable, especially as the purpose is to build confidence early on. In any case, a flexible approach should be taken, one that takes into consideration the members' specific circumstances and factors.

On the early repurchase issue and on the costs of CSF transactions, I can go along with the staff proposals. Nevertheless, I would like to emphasize that CSF resources be used only for short-term intervention operations, with an early repurchase obligation.

Finally, on the procedures for handling Fund operations under the CSF, I have no difficulty with the procedures as described in the staff statement.

Mr. Havrylyshyn made the following statement:

The document we have before us is an excellent reflection and reconciliation of issues and concerns expressed in several earlier discussions at the Board. I find, like Mr. Clark, that it provides the right balance between the potential needs for currency stabilization, and adherence to Fund procedural and risk considerations. While I can support it without further modifications, I am open to suggestions by this Board's members of possible changes in the text.

On the purpose and potential usefulness of a CSF, I will not repeat any of my earlier arguments, or the succinct advocacy in the staff statement. Let me only emphasize an additional dimension which, I believe, I now see more clearly in the document before us. The CSF is meant to add credibility; this requires "largish" amounts. The consequent potential risks have raised concern in past discussions and today. The response in today's document is in effect to strengthen conditionality beyond what is typical in a stand-by, which I believe is appropriate. Such additional conditionality is seen in the staff document's emphasis as follows: "economic policies would need to be sufficiently tight to deliver...the targeted exchange rate"; later it is said [in the event of difficulties] "policies would be adapted promptly," furthermore a whole series of very strong policy conditions is listed under 1.d.; and a demanding set of reporting requirements is elaborated under 2.d.; and, finally, a strong role for the Board is seen: i.e., to modify or supplement reporting requirements, to decide on second tranches, and perhaps require policy adaptations at that time.

This can be something that is seen as a positive thing by many Directors, but not necessarily all, as I understand from some earlier comments. The greater role of the Board, I do not think, would create a problem of micro management, but would, in fact, help to keep things on track. Because taken together, all of this clearly means that the currency stabilization fund has not only the conditionality of a stand-by arrangement, which is important from the conceptual point of view, plus a good bit of additional conditionality. In general, I would think that the Fund, the Board, and even governments when they are committed to reform, should welcome this additional instrument for keeping a program on track in certain situations.

Taken together, all of this clearly means a CSF has the conditionality of a stand-by arrangement plus a good bit of additional conditionality. The Fund, the Board, even governments when they are committed to reform should welcome this additional instrument for keeping a program on track in certain situations. Let me add to the common metaphor of staying on track. If a stand-by arrangement can be thought of as a set of parallel rails helping to keep the reform train on track, the CSF can be thought of as the addition of a cable such as the one that steadily pulls a funicular to its destination. The increased stability of the latter needs no explanation.

Having said this, I would not wish my analogy to imply need for a permanent or even long term anchoring. It ought to be clear and I believe the document is clear that an exchange rate anchor is not forever and a flexible attitude must be taken to eventual exit, that is, transition to another exchange rate regime in the words of Mr. Clark. The one-year repurchase expectation strongly and adequately signals this. Beyond such signaling, I am prepared to discuss a possible issues paper outlining various types of export strategies, but for now remain a bit of a doubting Thomas about whether it is a good idea to be very specific ex ante on the exit policy. This should be a case-by-case approach.

On modalities, I agree with the proposed guidelines, but would not see any difficulty, were it the consensus of the Board, to keep the tranches to three (with some front-loading), an option that is already in this text. I can also support the proposals of Ms. Lissakers for higher charges on excess drawings.

Mr. Kiekens made the following statement:

During our last discussion of this issue, I agreed that an exchange rate peg can be an effective transitional instrument for quickly bringing down inflation provided that the stabilization process has acquired a critical mass of credibility. I am sufficiently reassured that this critical mass will be present

before the Fund supports a currency stabilization fund, if all the policy conditions enumerated in the staff's August 3 statement are fulfilled. I also find appropriate the principles the staff has proposed to ensure that Fund policies are observed when cofinancing for Fund-supported CSFs is involved. These principles should nonetheless be flexible enough to attract cofinancers while protecting the Fund's financial resources. In addition, this pragmatism is well suited to the case-by-case approach envisaged for the Fund's support of CSFs.

The staff's proposed operational characteristics are also generally appropriate, including those on access, tranching, reporting obligations, activation and use of a CSF. However, I note that the treatment of members' repurchase obligations or expectations will vary according to how much a member has already drawn from the Fund. Apparently this does not conflict with the principle of uniform treatment for all members, since the variation in treatment is based on the Fund's holdings of the member's currency. I also support the proposed charges associated with CSF use. Concerning the sophisticated distinction between repurchase "expectations" and repurchase "obligations," I fear that members whose drawings are less than 200 percent of their quotas might be tempted to delay their repurchases. I therefore feel that requests to extend the repurchase expectations should be more strictly limited than the staff proposes. A single extension ought to suffice if we want to preserve the fundamental character of a CSF as a very temporary form of support during a short-term currency crisis.

However, I continue to have problems with the proposed structure under which a CSF would be established as a window within a stand-by arrangement, given the prevailing rules for stand-by arrangements. The revolving character and the shorter maturities of CSF drawings, and in particular the specific conditions of CSF activation, do not suit CSF financing for incorporation into a stand-by arrangement framework. Especially problematical is the fact that approval of drawing on the CSF would be based exclusively on the Board's judgment that the conditions are appropriate, and that this judgment is based in turn on various factors which provide ample room for debate and difference of opinion, which makes the Fund's financing of a CSF entirely different from financing under a stand-by arrangement. The absence of performance criteria guaranteeing the member access to Fund resources is particularly striking.

Following Decision No. 53/95 as later amended, a stand-by arrangement "give assurance that, during a fixed period of time, transactions up to a specified amount will be made whenever a member requests and without further consideration of its position." Paragraph 4 of the same decision provides that "A

member having a stand-by arrangement will have the right to engage in the transactions covered by the stand-by arrangement without further review by the Fund." Under the prevailing guidelines, reviews have a limited purpose and should be rather exceptional. Indeed, paragraph 10 of the guidelines on conditionality (Decision No. 79/38) provides "in programs extending beyond one year, or in circumstances where a member is unable to establish in advance one of more performance criteria for all or part of the program period, provision will be made for a review in order to reach the necessary understandings with the member for the remaining period. In addition, in those exceptional cases in which an essential feature of a program cannot be formulated as a performance criterion at the beginning of a program year because of substantial uncertainties concerning major economic trends, provision will be made for a review by the Fund." If we keep all these pieces of text in mind, it is clear that if we design now a facility which essentially depends on judgment, we have something entirely different than a stand-by arrangement.

For all these reasons, I would prefer to see all the justified special operational features embodied in a new special facility, although I recognize that in that case a qualified majority would be needed. Perhaps such a majority is warranted in any case, by the very special nature of the Fund's involvement in financing a CSF, which will extend the Fund's activities in one particular direction. And although my concerns are serious, they are to be seen as constructive. As I stated at the outset of this intervention, I support the Fund's financing of CSFs under the policy conditions set out in the staff paper, and except for the proposed stand-by window structure, most of the proposed operational features.

Indeed, if we allow Fund practices to evolve substantially away from the prevailing legal rules which remain unchanged, then even though the divergent practice is warranted and justified by the evolving features of the economic environment in which the Fund operates, I see a serious threat for one of the most precious characteristics of this institution--namely, that it is rule-based. I therefore insist that the Legal Department in cooperation with the Policy Development and Review Department review the continued appropriateness of the present rules on stand-by arrangement in light of the evolving practice. This will also provide an opportunity to examine whether more flexibility in the rules for the Fund's support of stand-by arrangements is not warranted, given the nature of the member's balance of payments problems.

During his intervention, Mr. Evans insisted on having or seeing the Board involved when we start discussing a currency stabilization fund, or when management starts discussing a

currency stabilization fund. I support this demand, and I believe there are clear legal rules obliging management to do so. Each time under the prevailing rules management and the staff discusses prior actions under a program, there is the obligation for management to consult with the Board. Here, again, I see that the practice is diverging more and more from the rules. So yesterday, finally, we could agree that in exceptional circumstances, where emergency is the case, management would consult with the Board. I draw your attention to the fact that, in each program where prior actions are discussed, the Board must be involved during the discussions.

Mr. Al-Tuwaijri made the following statement:

This chair's position has not changed since our last discussion. While I will consider proposals for Fund support for currency stabilization funds with an open mind, I am still hesitant to support Fund involvement in this area. The statement by the staff presented for today's discussion raises a number of issues that need to be considered further.

First, I am uncomfortable with the staff's statements with references to the exceptional circumstances clause. These references give the impression that the exceptional circumstances clause will need to be invoked rather frequently. Under such conditions, the exceptional circumstances clause will cease to be exceptional.

Second, the staff statement points out that there is no intention to maintain the anchor indefinitely. However, we have no clear exit strategy defined. Thus, we may find ourselves involved in the administration of a CSF for a much longer period than would be desirable or warranted.

Third, the difficulties in determining the appropriate level of the initial exchange rate in countries undergoing large relative price adjustments argue against the use of a CSF.

Fourth, the management of a CSF has significant budgetary implications. The costs of administering a CSF will be substantially higher than that of a Fund arrangement, as suggested in the staff paper, while the charges to the member will be the same. In these circumstances, it would be prudent to establish guidelines for greater country participation in helping defray the cost of the resident representative in these cases.

Having said this, it is important to recall, as mentioned by Mr. Autheman, that existing procedures provide ample assistance for countries wishing to use a nominal exchange rate anchor as part of their adjustment strategy.

Mr. Costa made the following statement:

I would like from the outset to reaffirm the position of this chair in support of Fund involvement in the implementation of CSFs. The past discussions gave us the opportunity to review the main issues and despite the many nuances that have been raised I believe a basic agreement and understanding on the characteristics and benefits of a Fund-supported CSF has been reached. The following comments are intended to highlight only a few aspects of our position in the hope that some of this may be reflected in the final version of the decision.

In this regard I consider that point C of the staff's statement on exchange rate arrangements should not make any mention of the fact that the nominal anchor is seen by the Fund as only a temporary arrangement. Since the "window" option implies that the CSF cannot outlive stand-by or extended arrangements, to mention the possibility of changing the anchor creates the expectation that will occur within the life span of the program which sounds to me as self-defeating.

On other matters, I consider that it should be stated that, since the main purpose of a CSF is to increase the credibility of an already strong and fully financed stabilization program, it would be normal to expect a success and, therefore, that no disbursements are foreseen under the CSF. This would help to dispel the risk that the authorities could see the CSF as an additional source of financing. Point 4 of the section on policy conditions of the staff's statement seems to contemplate only the case of capital outflows, which, if persistent, could mean the end of the stabilization effort. I believe that, under normal circumstances, the need to build up reserves in the event of large capital inflows should also be explicitly stated.

Regarding other policy conditions of the staff's statement, I would broaden condition number 6, and then I would place it second, right after fiscal and monetary adjustment because in the medium run and long run only a full-fledged process of structural transformation can bring about a sustained period of stability.

Regarding charges associated with the use of CSFs I agree that they should be the same applicable to stand-by and extended arrangements despite the short term and revolving character of the purchases under the CSF which could justify for example a reduction of the service charge. The amount of staff hours implied in the day to day monitoring of the financial and economic developments of members that use the facility would, on the other hand, fully justifies the maintenance of the prevailing charges. Regarding the idea of a premium on charges we consider that, on balance, there are systemic benefits to be derived from the timely

access to conditional Fund's resources, to which the Economic Counsellor alluded in this morning session, even if they exceed ordinary access levels.

Finally, I still remain concerned that not all the intended beneficiaries of the facility would be in a position to fulfill the strict reporting requirements that should accompany the implementation of a CSF in light of their institutional weaknesses. The presence of a resident representative may not be entirely able to make up for those deficiencies.

Mr. Esdar made the following statement:

During the past Board discussions concerning the general policy on currency stabilization funds, this chair agreed that the stabilization fund arrangements in very particular circumstances might provide an adequate instrument to support exchange rate anchors. We nevertheless stressed that we are not in favor of establishing a general new policy in this regard.

The proposed window approach seems to be somewhat a "Janus-head" type of solution. It is proposed to provide the financial support within the framework of existing facilities, and does not create new mechanisms. This is certainly to be welcomed. However, it establishes general guidelines insofar as it creates a new policy. This goes substantially beyond the approach which we would have favored, namely to establish stabilization funds only under very special circumstances on a case-by-case basis without establishing a new policy framework which will tend to generate demand.

I am concerned that the proposed approach will generate such demand for exchange rate anchors and the respective currency stabilization funds. I very much share the concerns of Mr. Autheman in this regard.

This chair has discussed our concern in detail during the informal session, and we do not want to repeat all the arguments in detail. However, I would like to summarize them as follows:

First, to provide financial support only for stabilization anchors will discriminate against alternative adjustment strategies and put too much emphasis on fixed exchange rate policies in general. The experience in the recent past has demonstrated shortcomings of exchange anchors, even though some were supported by comfortable reserve levels. I am, therefore, hesitant whether we should promote just one among other many adjustment strategies by establishing a general policy.

Second, even if an exchange rate anchor should be appropriate under certain circumstances, we should not generate the exception that it has to be supported the by additional resources. Countries choosing this exchange rate strategy should be aware that its success depends crucially on appropriate policies and not on interventions. Convincing and comprehensive adjustment policies will make stabilization funds obsolete. On the other hand, an appropriate policy mix cannot be substituted by the use of additional resources for intervention. In addition, we would expect that countries following anchor strategies generally should be equipped with appropriate levels of reserves.

To summarize, I share Mr. Evans's and other speakers' views that the establishment of stabilization funds should only be considered in very exceptional cases when, in spite of insufficient foreign exchange reserves, an anchor strategy would indisputably be the superior strategy. Therefore, I do not see the need for a general policy as this will send the wrong signals. Therefore, we cannot support this approach, and following Mr. Tulin's advice to close the books, we would like to be recorded as abstaining in this regard.

In the case that the majority of Board members will endorse the staff proposal, I would like to add some more technical remarks.

First, I support Mr. Evans's proposal that the Board should be informed at an early stage. I share his concerns that a critical debate on an agreed exchange rate anchor which is supported by a currency stabilization fund could undermine the objective of such programs, namely to create confidence. Therefore, we should be informed at a very early stage.

Second, Ms. Lissakers's proposal to levy surcharges on the use of Fund resources above the agreed access limits deserves further consideration, and I am looking forward to the staff's reactions, perhaps in the form of a short paper.

Third, I wonder whether the exceptional character of the use of currency stabilization funds as pointed out by Mr. Evans and others, should be adequately reflected in the summing up.

Fourth, I share the proposal of those Directors who suggest agreeing at an early stage on an appropriate exit strategy.

Fifth, while in many aspects I endorse the comments of Mr. Autheman, I do not share his concerns that the proposed reviews and controls lead to a mixing up of responsibilities of Board management, on the one hand, and the country involved on the other. I think the very special character of this currency

stabilization fund justifies a critical review of use of resources for intervention.

Mr. Kannan made the following statement:

We compliment the staff on the interesting and comprehensive statement placed before us for consideration today. We are happy to note that the present proposal incorporates all of the concerns, particularly in the areas of exchange rate arrangement, tranching, financing, and access that we have drawn attention to in the earlier discussions.

On one point the position is not quite clear. In the last two meetings, this chair has raised some concerns regarding the eligibility of countries to use this facility. Let me quote from this chair's intervention on July 19. "At the last meeting, we stressed the need for making available this facility to program countries only. The rationale was that the intimate association which the Fund would have had with the country concerned could have secured the success of stabilization programs and also protect the integrity of the Fund. Equally importantly, the clear association with the Fund would also have given an opportunity to the Fund's role in fixing the exchange rate at a level which is worked differently. This is very important, as it is one of the primary objectives of this organization, to ensure proper alignment of exchange rates. We should, therefore, not convey that we report to the Fund any exchange rate that a country may have when it seeks our support."

Hence, it is not clear whether the currency stabilization fund would be available to members who are already on one program or another with the Fund or to any member who MAY not be under any program. I would welcome the staff's clarification on this point.

Mr. Fernández made the following statement:

This is our third discussion on currency stabilization funds in less than one year. After reviewing our prior statements, the Chairman's concluding remarks of the last two discussions, and the statement presented for today's discussion, I feel that there are still important ambiguities regarding the purposes, the design, and the specific context in which a currency stabilization facility would be applied in a Fund program. Our views on this regard are similar to those of Mr. Mesaki, Mr. Autheman, Mr. Al-Tuwaijri, and Mr. Esdar, among others.

If a strong adjustment policy is already in place, existing Fund facilities and access limits (which could be modified, if necessary, and applied case by case) should be able to provide enough support for policies sustaining an exchange rate anchor, if

that were the desired policy course of the authorities in consultation with the Fund. With the CSF, we are asked to finance foreign exchange market intervention which is a different thing. It would be very risky for the use of Fund resources but especially for the prestige and credibility of the Fund to finance intervention in exchange rate markets, nowadays. Unanswered questions persist as to the appropriate level at which to initially establish an exchange rate anchor, the timing of its introduction in the context of a disinflation effort, and the appropriate exit strategy once it is established.

In this context, we feel that a possible alternative to a CSF could be the consideration of an increase in access limits for programs that are appropriately strong, including those that use an exchange rate anchor as stabilizing mechanism. But, if we are asked to choose between creating a special facility or establishing a window, we would favor the window option.

The remaining unanswered questions concerning the CSF facility or window are the following, among others:

The timing on the agreement of the CSF element of the program and the circumstances regarding its activation will be determined on a case-by-case basis. This approach is inappropriate, in our view, since they leave open important issues for ad-hoc considerations. The ambiguity concerning the ultimate purposes of the CSF facility or window is at the root of the ad-hoc approach chosen by the staff.

Several Directors have pointed out the difficulty to determine an appropriate exchange rate level to be supported by the Fund in a Fund's program. With the CSF we are not just making an statement on appropriateness of a certain nominal exchange rate level, but we take the responsibility to support it with Fund's financing.

Usually a balance of payments need must be demonstrated to use Fund's resources. How does the staff define the balance of payments need to justify the use of resources under the CSF facility or window?

We are told that the CSF facility or window would support a peg or a preannounced crawl regime. Does this imply that "corridors" or conventional target zones are excluded?

We have to recognize that a lot of improvement has been achieved concerning the specification of policy conditions, since we discussed the CSF concept for the first time at the end of 1994. The use of international reserves by the country concerned

to support the exchange rate target should also be included as a condition.

We agree with Mr. Evans and other Directors that it would be difficult to find a case complying with the policy conditions and, at the same time, requiring added credibility coming from a CSF facility or window.

Mr. Zhang made the following statement:

As we stated during the last discussion, we support the establishment of the CSF as a new Fund facility which would help member countries in bringing down inflation through adopting an exchange rate anchor in the implementation of their economic stabilization strategies, and is consistent with the purposes of the Fund. Since our views on the basic principles in establishing the CSF and its main operational features remain unchanged, I will only make a few brief remarks for emphasis.

First, with respect to the eligibility of access to CSF, I reiterate that, while we understand that the main purpose of CSFs is to support those countries who have chosen an exchange rate-based economic stabilization strategy, other members, irrespective of their exchange regime, should also be entitled to have access to this new facility; particularly those who might need Fund financial assistance while in the process of accepting Article VIII obligations or reforming the financial sector.

Second, we agree that it is not the purpose of the CSF to maintain the anchor indefinitely, and the appropriateness of the exchange rate and the exchange arrangement should be kept under continuous review by the authorities and the Fund.

Third, on cofinancing, basically we can support the idea of cofinancing and endorse the four principles mentioned in the paper. However, we propose to add a fifth principle, i.e., that cofinancing be considered only when the Fund's own resources are insufficient to meet the member's needs. This means that using resources provided under the Fund's existing instruments should always be the first choice. In the case of needing to seek cofinancing, I must emphasize that the Fund should mobilize such resources from its own member countries.

Fourth, concerning the operational characteristics, I support that the CSF be established as a "window" within a Fund upper credit tranche stand-by or extended arrangement. We support the tranches being limited to three, with four as a maximum. The flexibility through the front-loaded tranches certainly would make the CSF better able to fulfill its role in assisting member countries in need.

Mr. Munthali made the following statement:

During the Board meeting in July, this chair endorsed the broad operational features of CSFs. Since the staff statement before us captures the full thrust of the concluding remarks of that discussion, we have no difficulty in supporting the general conditions and modalities specified.

One important consideration is the fact that CSFs operations would be underpinned by a comprehensive adjustment program that is credible enough to support an appropriate exchange rate anchor in order to achieve rapid reduction in inflation. Obviously, the emphasis would be on the expeditious implementation of fiscal and monetary policies. Hence, while structural and institutional reforms would be important prospective arrangements under CSFs should not be unduly held back if the implementation of such reforms require satisfying legal requirements or setting up of new institutions that may take time to put in place.

There is an appropriate reference in the staff statement regarding potential parallel arrangements with the use of ESAF resources for low-income, eligible countries. However, it still remains unclear to us as to the precise conditions that would trigger possible recourse to CSFs in the case of the low-income, ESAF-eligible countries. A number of countries in sub-Saharan Africa which are implementing ambitious programs are still experiencing high inflation and the use of an exchange rate anchor could add the needed potency to the measures already in place to stem these price pressures, while minimizing the impact of disinflation on production. Perhaps the staff could elaborate on the circumstances under which these low-income, African countries could usefully utilize Fund resources under CSFs.

While strong reporting requirements as regards key financial variables would not generally impose undue burden on member countries, problems may arise, in some cases, in part because of institutional weaknesses. The Fund may need to exercise some flexibility, taking into account specific circumstances in such countries.

The use of a resident representative would, indeed, enhance the program implementation and monitoring. Hence, in the case where the position of a resident representative did not exist prior to these developments, the Administrative Budget would have to be provided with sufficient flexibility to allow for such a position to be created at short notice.

Mr. Mohammed made the following statement:

We were among those few Directors identified in the Managing Director's concluding remarks of August 2 as supporting the view that CSFs could be useful not only in cases in which rapid disinflation from high levels was being pursued. This continues to be our position, as we still believe that by providing a powerful complement to appropriately tight financial policies, a CSF could contribute significantly to bolstering confidence in the prospects of continued exchange rate stability in general, and not only in cases of high inflation.

This said, I recognize that our view on this matter is a minority view, and we need to move on. Accordingly I can go along with the consensus in the Board on this issue, but I wish to have my reservation noted in the record.

Last, I can go along with the operational features of CSFs as outlined in the staff statement.

Mr. Rouai made the following statement:

During our previous meeting on CSFs, we indicated our support in principle for this mechanism as this policy could constitute for some limited number of countries an important vehicle for reinforcing confidence in members' exchange rate policy in the context of a strong stabilization and anti-inflationary program.

The statement prepared by the staff deals with the prerequisites for Fund support under CSFs and we can therefore support both the general considerations as well as the operational guidelines for CSFs.

The only point we would like to reiterate at this stage is the need for the authorities and the staff to closely monitor the nominal exchange rate anchor supported by a CSF and to be prepared to implement, when warranted, an exit strategy.

Finally, I welcome the staff clarifications with regard to access limit. My understanding is that, as the access under arrangement, including a CSF element, is limited to 100 percent of quota, the maximum access of 100 percent of quota indicated by the staff refers to two cases. First, when a CSF element is part of a precautionary stand-by arrangement or extended arrangement without use of Fund resources. Second, when access is under the exceptional circumstance clause.

The Deputy Director of the Policy Development and Review Department confirmed that, before bringing a proposal for a country's use of a CSF operation to the Board, the staff would examine alternative approaches to

stabilization as well as alternative forms of Fund support. The staff would also discuss contingency measures and appropriate exit strategies from a CSF operation, and would produce a short paper on the possible use of special charges for the CSF. It was important to note that the staff expected utilization of the CSF to be rare.

In considering the question of access in upper tranches, there would be no need for the Board to consider why a program might not be on track, the Deputy Director added. The very purpose of tranching was to avoid the need for such Board discussions.

The staff had suggested a 100 percent access limit on CSFs, the Deputy Director confirmed. There would also be the possibility that the exceptional circumstances clause could be invoked.

The staff's stress on "convertibility" essentially revolved around convertibility of the current account, particularly for interest and amortization as a way of helping to clear the way for capital inflows, the Deputy Director observed. In addition, the stress on convertibility implied an emphasis on the role of market forces and solid policies in a country's adjustment strategy.

Countries utilizing Fund-supported currency stabilization funds would be subject to standard review procedures and Board approval of successive tranche releases, the Deputy Director remarked. The purpose of those reviews would be to take stock of a country's adherence to performance criteria, assess the need for corrective measures, and to monitor policies that might not be subject to quantifiable performance criteria.

Countries that already had arrangements with the Fund would be entitled to request a CSF operation, the Deputy Director confirmed. However, there might be a need to make substantial modifications to an existing program should a currency stabilization fund be considered. Parallel CSF and ESAF arrangements would also be possible.

It was not considered unusual for the Fund's financial support to be used for exchange market intervention, the Deputy Director added. In the past, financial support had manifested itself in many forms, but was often used for reserves accumulation to support exchange market intervention.

The staff had made clear that it anticipated exchange rate pegs or exchange rate crawls in the context of CSF operations, the Deputy Director said. However, the use of exchange rate bands of any substantive width were not anticipated. It should also be borne in mind that the type of exchange rate regime that a country adopted had very little to do with how a central bank made use of its resources. Intervention in the foreign exchange market could take place directly, or through the expenditure side by, for example, importing or making amortization payments directly.

Mr. Kiekens noted that, with regard to the Board being informed of progress in discussions with members, the current practice seemed to have diverged substantially from the rules of the institution. One of the major roles for the Policy Development and Review Department was to ensure that divergences of that kind did not occur.

The Deputy General Counsel made the following statement:

The 100 percent limit on the CSF element is intended to be a sublimit within the overall access limit. It is not intended to provide additional room, but to be a sublimit within the access policies which include the exceptional circumstances clause.

Several references were made in yesterday's and today's meeting to surcharges and the service charge for CSF operations. These two issues should be taken separately.

The appropriate level for a service charge on CSF operations is an issue that is directly related to the CSF characteristics, namely, the revolving nature, and the repeat use of resources. We have addressed the legal aspects of the service charge in the paper issued on June 30. Differentiations can be made in the service charge. The question is, what are the reasons for them, and what are the objectively definable criteria that allow these differentiations to be made. The Board has commented on these issues in its last meeting on the subject.

Regarding the surcharge, there is a broader issue of the level of periodic charges in relation to access or to holdings. We have in fact heard that question in several different contexts: yesterday in the context of emergency financing procedures, and earlier in the context of the discussion on the new financial structure, and we will come back to it in the latter context. The paper on the issue is nearing its final stage. The surcharge is not an issue only related to the CSF or to the emergency access. It is a broader issue related to the structure of Fund charges.

Let me then focus on the issue of expectations versus obligations. A number of questions were raised on the legal basis for expectations, what are we exactly proposing to the Board, why are we using only expectations, why are we not using obligations, and are they uniform or discriminatory.

Obviously, one choice has been made, and that choice is reflected in the staff's proposal for guidelines on the window approach. That choice was not to adopt a special facility--which would have made a number of issues much easier or much more structured and focused with respect to the CSF. But that was not the choice that was made. It would have made, however, other issues more difficult.

Under a facility, special, shorter, tailor-made repurchase obligations on a uniform basis for all purchases could have been established. An 85 percent majority would have been required. Any delay in making a repurchase would have been a breach of obligation under the Articles and could have led to expulsion and other consequences of that breach. This was one of the reasons why the Board did not favor that approach, but preferred to rely, in the first place, on expectations which give more flexibility.

The expectation approach is a longstanding practice. Its first demonstrations took place in the mid-1970s in the context of compensatory financing and buffer stock financing. Later, guidelines on misreporting and noncomplying purchases were adopted and, most recently, the debt strategy contained a window for use of resources under an arrangement, for instance, for set-asides under special conditions. In the latter contest, if the resources were not used for a certain purpose within a certain time there would have been an expectation of repurchase. If that expectation was not complied with, there was a possibility of a prolongation. If that prolongation was not complied with the member's access to resources from the Fund would be suspended. Obviously, it would not be a breach of obligation, and it could not lead to compulsory withdrawal from the Fund. Formally, the legal basis is Article V, Section 3 which states that the Fund shall adopt policies on the use of its resources, and may adopt special policies regarding special balance of payments problems. The window is a policy within the credit tranche policy or within the extended Fund facility.

On the question of Article V, Section 4, and the possibility of converting an expectation into an obligation or establishing an obligation in individual cases, there is no general policy. Only in cases where the level of holdings exceeds 200 percent of quota on the basis of committed resources do the Articles authorize a reaction to a particular situation of the individual member in that form. Therefore, since the obligation is individually targeted, the issue of uniformity does not arise.

Obviously, if this approach is adopted in one case, or certain aspects are taken into account in a particular case, one would have to draw the consequences in other similar or identical cases. But the need for uniform treatment does not prevent the adoption of the measure in an individual case. The Articles provide that in a situation of a high level of holdings, special conditions may be required. This approach has been contemplated several times in the past. Admittedly, it has not yet been adopted.

On Mr. Kieken's questions, in general one has to distinguish between history and practice over time. I think his concern is about the guidelines of conditionality.

First, these are guidelines, and they were adopted in the late 1970s. Guidelines do not act as strict decisions. The staff is complying with them, and the Board is complying with them. But obviously, there is flexibility and scope for adaptations. Second, the Fund regularly reviews the appropriateness of the guidelines on conditionality, including for instance, the issue of reviews.

The changed scope of reviews, as the Deputy Director of the Policy Development and Review Department has explained, was addressed by the Board on several occasions in the context of these conditionality reviews. It is true that reviews have become broader and more frequent than originally contemplated, subjecting more purchases to reviews than at the beginning. Reviews are not limited to establishing performance criteria, and the use of resources under a stand-by arrangement is not only limited to compliance with performance criteria.

On the prior actions, there is a reference in the guidelines. But they do not require that the Board be consulted beforehand. There is a reference to information, but it does not mean that if the Managing Director wishes to have a prior action adopted by the member, he needs to consult with the Board before.

The question that seems to be raised is whether we need a formal change in the guidelines, or whether we can apply them in light of these developments and practices which broaden the scope of some of the instruments. My answer is that this is a Board decision in the context of the biannual conditionality reviews. Up to now, the Board has found the guidelines adequate, knowing the practice.

I think the Fund cannot be prevented from adapting instruments to new developments and to new needs as long as the policies that are developed remain within the framework of the Articles.

The statute is rather broad, gives flexibility, but has constraints. The proposals before you breach neither uniformity nor other basic principles. However, they are innovative in the sense that they have not been adopted before.

It is for the Board to decide whether it wants to embark on a particular activity. We will have to make sure that the response and the legal framework for it will then be consistent with the statute. I do not start by looking into the history, but if there

is a question as to whether something is new, I always go back specifically to 1974 and 1975, namely, the time of the Second Amendment. And there I did find references to some of the issues that were discussed in that case, for example, stabilization issues.

The Acting Chairman said that it was hard to define the precise timing of consultation with the Board in the case of discussions of a CSF. In the event that management, or the staff, was convinced there was no sense in pursuing a CSF, the matter would likely not be brought to the attention of the Board. However, prior consultation with the Board before the issuance of a formal paper might prove appropriate.

Mr. Kaeser queried whether it would be possible to introduce a repurchase expectation different from the standard applied to stand-by arrangements.

Mr. Calderón said that he saw a fundamental difference between a second tranche in a normal program and in the CSF case. In a stand-by arrangement program, the disbursement of a second tranche implied that the program was working well. In the CSF case, there was a presumption that something was not working well. He also queried under what conditions the Fund's legal framework was binding.

The Acting Chairman made the following summing up:

The discussion today has built on our two earlier discussions on the general principles of Fund policies that might be followed with regard to currency stabilization funds as well as the operational features of the proposed policies. Directors in their majority have supported the conditions and operational characteristics outlined in the statement by the staff. However, some Directors continued to express doubt about the need for a special policy in this area, and some have mentioned areas of concern. Some of you indicated a preference for a special facility, but some of those were prepared to support a consensus on the window approach. Among the main concerns raised today were the fear that establishment of a CSF would appear to signal a Fund preference for a fixed exchange rate, the possibility of too frequent use of the exceptional circumstances clause and the importance of ensuring that use of the exceptional circumstances clause would be very rare, the inherent difficulty of assessing the appropriate level of the exchange rate to be supported by a CSF, the timing and circumstances of possible adjustments to the exchange rate arrangement, and the need to provide for adequate safeguards and suitable procedures, including close involvement of the Board at all stages.

With respect to the framework for CSF operations, all Directors stressed the importance of the country's having a sound track record, of keeping the exchange arrangements under continuous review both during and after the disinflation effort, and of ensuring that CSF resources were used as intended--that is, to provide a temporary supplement to reserves for confidence building and short-term intervention if needed, and not for general balance of payments support. In this connection, Directors attached importance to the frequent reporting of relevant data, and close monitoring by the staff and the Board, as well as the tranching and repurchase/reconstitution provisions.

Although the sense of the Board is clearly that we should move cautiously in this area, it has been broadly agreed that under certain conditions the Fund should be prepared to support CSFs within the context of upper credit tranche stand-by or extended arrangements. The conditions and modalities outlined in the statement by the staff provide an appropriate framework for this purpose. Accordingly, the amended text of that statement, which is attached to this summing up will provide guidelines for the use of Fund resources under a CSF. Executive Directors do not expect that there will be frequent recourse to CSFs, nor would the Board wish, by establishing CSFs, to signal any preference on the part of the Fund for fixed exchange rates or exchange rate based stabilization. The staff will discuss alternative approaches and forms of Fund support with members and, where a CSF is recommended, will clearly explain the rationale for the approach that is being followed in the documentation for the Board. Where a CSF is being considered and at an appropriate point, recognizing the particular sensitivities of this kind of situation, management will consult with the Board. It is understood that any such operations will be approached in an experimental fashion, kept under close review in light of Directors' concerns and, if necessary, adapted on the basis of experience.

The Managing Director will make a progress report to the Interim Committee on the basis of the outcome of today's discussion.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/95/85 (9/12/95) and EBM/95/86 (9/13/95).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/95/148 (9/11/95) and by Assistants to Executive Directors as set forth in EBAM/95/145 (9/7/95) is approved.

APPROVAL: March 24, 1997

REINHARD H. MUNZBERG
Secretary

Guidelines for Fund Support for Currency Stabilization Funds

1. General considerations

a. Framework and purpose

Experience has shown that under certain circumstances a nominal exchange rate anchor can be a powerful instrument, when employed in the context of strong macroeconomic stabilization policies, in bringing about a rapid decline in inflation. In the framework of a Fund upper credit tranche stand-by or extended arrangement, Fund financial support for the specific purpose of providing a precautionary pool of resources to supplement reserves for a transitional period--that is, a currency stabilization fund (CSF)--could provide an important element of additional confidence in support of an exchange-rate-based stabilization strategy and, under appropriate conditions, would be consistent with the purposes of the Fund.

In particular, for CSFs to play their intended role, economic policies would need to be sufficiently tight to deliver an inflation path compatible with the targeted exchange rate anchor--that is, the anchor would need to be realistic and sustainable on the basis of the member's policies, so that little, if any, use of the CSF for exchange market intervention would be expected; it would need to be understood with the authorities that economic policies would be adapted promptly as necessary in response to changing conditions, so as to ensure the maintenance of the nominal exchange rate objective; and the underlying program would need to be fully financed (i.e., without taking account of the resources of the CSF).

b. Adjustment strategy

Fund support for CSFs would be considered in cases of high inflation where a nominal exchange rate anchor is adopted as part of a credible, comprehensive adjustment strategy to achieve a rapid and substantial decline in inflation and where close monitoring is possible to ensure that the exchange rate anchor and supporting policies continue to be appropriate. It would be expected that a CSF would be activated at a relatively early stage in the process of reducing inflation, but only when the Fund can be confident that the member's policies are sufficiently strong and will be implemented and adapted as necessary; activation could take place at the outset of an arrangement or during the course of a review.

c. Exchange rate arrangement

The most appropriate exchange rate arrangement to be supported by a CSF would be an exchange rate peg with relatively narrow margins, or a preannounced crawl, that would limit the discretionary use of the exchange rate. Careful consideration would need to be given to establishing the appropriate level at which to establish the exchange rate peg (or crawl), avoiding a real exchange rate that is excessively low or high relative to historical levels or other relevant indicators. It would not be the purpose to maintain the anchor indefinitely, and the appropriateness of the exchange rate and the exchange arrangement would be kept under continuous review by the authorities and the Fund, both during and subsequent to the disinflation effort.

d. Policy conditions

The policy conditions necessary to ensure the success of an exchange-rate-based stabilization, and thus essential to Fund support for a CSF, include: 1) fiscal adjustment and credit creation consistent with targeted inflation; 2) appropriate measures to deal with backward-looking automatic wage and other indexation schemes; 3) establishment of a high degree of current account convertibility and an open trade regime, and other measures to encourage a return of flight capital; 4) contingency plans for dealing with large capital outflows or inflows, which would depend on full interest rate flexibility and should also involve contingency fiscal measures; 5) establishment of integrated operational management of foreign exchange reserves and intervention policy; and 6) other structural and institutional elements supportive of the effort to reduce inflation sharply. More specific conditions would depend on the particular circumstances of each country.

e. Co-financing

It would be possible to consider co-financing of CSFs; however, certain basic principles would need to govern Fund policies with regard to co-financing for Fund-supported CSFs. First, the Executive Board would retain control over all use of Fund resources in support of CSFs. Second, co-financing should not unduly complicate the operations of CSFs. Third, terms associated with resources provided through co-financing should be at least as favorable to the borrower as those associated with Fund financing. Fourth, resources made available through co-financing procedures should not in any way affect the safeguards of Fund resources and the Fund's preferred creditor status. If co-financing were judged to be feasible and beneficial in a particular case, specific features would need to be determined at that stage.

2. Operational characteristics

a. Structure

A CSF would be established as an element (or "window") within a Fund upper credit tranche stand-by or extended arrangement and would have revolving features permitting repeated use under specified conditions. ESAF-eligible member countries would be able to use CSFs through arrangements in the General Resources Account that would operate in parallel to an ESAF arrangement.

b. Access

Access under arrangements including a CSF element would be subject to the limits (annual and cumulative) applicable to stand-by and extended arrangements. Maximum access under the CSF element would be 100 percent of quota; this would be a sublimit within the access policy. Access under the CSF element would be determined on a "net" basis--that is, outstanding use of CSF resources could not exceed a specified percentage of a member's quota (not exceeding 100 percent in any case), taking account of the repurchase and reconstitution procedures set out below. The determination of access levels for individual cases would be guided by the usual criteria of need, strength of policies, and capacity to repay the Fund, taking into account the adequacy of precautionary reserves to instill confidence in the member's exchange rate regime. In practice, access under CSFs would be expected to vary considerably on a case-by-case basis, depending on the degree to which the assessed need for reserves was already met from other sources.

c. Tranching

Normally, a CSF would have four equal tranches, with flexibility to raise access under the first tranche to a maximum of 35 percent of the size of the CSF with offsetting reductions in the third and fourth tranches (i.e., 25/25/25/25 percent or 35/25/20/20 percent of the size of the CSF or other variations in between) depending on the particular circumstances of each case. There would also be flexibility, where warranted by the circumstances, to vary the number (and consequently the size) of tranches within a range of three to five tranches.

d. Reporting requirements

The documentation establishing a CSF would specify the precise details of the reporting requirements. These would need to be sufficient to enable the Board to assess the appropriateness of requests for activation, availability of resources and extensions of repurchase expectations under a CSF. Daily

reporting of key financial variables (such as exchange rates, interest rates, exchange market turnover, intervention, and reserves) would be expected. Reporting requirements could be modified or supplemented by the Executive Board during the operation of the CSF as a condition for approving the availability of CSF resources or completing reviews under the arrangement. It would normally be expected that a Resident Representative would be in place to facilitate close monitoring and compliance with the reporting requirements.

e. Activation and use of CSF

Activation of the CSF element of an arrangement would be based on a determination by the Executive Board that the conditions are appropriate. In assessing whether to activate the CSF element, the Executive Board would consider whether the exchange rate policy was realistic and sustainable; whether the exchange rate policy would be firmly supported by fiscal and monetary policies, including rapid policy adjustments, as necessary; whether the program is fully financed; and, whether adequate monitoring and reporting procedures are in place and functioning properly.

Upon activation, access to the first tranche would become available. The first tranche would represent a form of working balance, which could be purchased and held for the duration of the CSF or drawn, repaid, and redrawn again without the need for further review by the Executive Board so long as the member remained in compliance with the arrangement, including supplementary measures (objectively defined) as might be required by the Board in connection with the CSF element, such as reporting requirements. Decisions to make available CSF resources beyond the first tranche would also be made by the Executive Board and would take into account, inter alia, assessments of monetary, fiscal, and exchange market developments and the sources of exchange market pressure; evaluation of past intervention operations and use of CSF resources; evaluation of the stance of monetary and fiscal policies, including adherence to performance criteria under the arrangement; continued compliance with the conditions of integrated foreign exchange management; continuous adherence to reporting and monitoring requirements; and any other conditions set out at the establishment of the CSF. Policy adaptations could be required. Upon approval, resources in the upper tranches would remain available for purchase for a period of two weeks. At any given point in time, if the member's outstanding credit under the CSF fell into a particular tranche, the maximum size of a request for availability of resources would be equal to any amount remaining unused in that tranche or the size of the subsequent tranche, which ever is larger. Drawings beyond the first tranche would normally be for the purpose of

replenishing some pre-established proportion of the member's own reserves used in intervention.

f. Repurchase/Reconstitution

CSF purchases would be subject to a one-year repurchase obligation in those cases where Article V, Section 4 is applicable. A one-year repurchase expectation would apply to those first CSF tranche purchases that are not subject to Article V, Section 4. In addition, CSF purchases beyond the first tranche would be subject to a repurchase expectation that would provide for repurchase within three months; requests for extension of such three-month repurchase expectations would be permitted, with approval of the Board, up to three extensions, so long as the CSF remained in operation. Consideration of requests for extension of repurchase expectations would take into account the same factors relevant to requests for availability of CSF resources. Failure to comply with a repurchase expectation would preclude further use of the Fund's general resources until the repurchase expectation had been satisfied. Failure to comply with a repurchase obligation would result in an overdue obligation to the Fund with all the usual consequences.

Repurchase of a purchase under the CSF element of the arrangement would reconstitute the member's right to request the availability of resources under that element, subject to the conditions for such requests noted above.

g. Charges

Charges associated with CSFs would be the same as those that pertain to stand-by and extended arrangements.

h. Operating procedures

Procedures for handling Fund operations under CSFs would include:

On establishment of a CSF element within a Fund arrangement, a monthly report would be circulated to the Board providing a one page summary of recent developments and prospects, a table of selected CSF-related economic indicators, and a brief assessment of whether the member remains in compliance with all terms and conditions of the CSF and the related arrangement; updates would be provided between monthly reports if CSF resources were used for sustained intervention. If called for, these reports would be supplemented on occasion by somewhat longer reports for discussion. All data and information circulated in these reports would be treated with the utmost confidentiality. CSF-related

material would also be covered in the staff reports for reviews under the arrangement.

The Board would be notified immediately of a member's intention to request availability of CSF resources. The minimum circulation period for the Board to act on a member's formal request for the availability of CSF resources would normally be five working days. Under emergency circumstances this could be compressed to 48 hours or, possibly, in informal consultation with the Board, a shorter period.

After a request for the availability of CSF resources is received, the staff would circulate as soon as possible an updated summary of the economic situation and a staff assessment of compliance, to be supplemented as necessary by a briefing at a Board meeting. Under normal circumstances, the period between circulation of the updated summary and the Board discussion of the request would be at least 48 hours. However, under exceptional circumstances, the circulation period could be abbreviated. Disbursement procedures would be in keeping with the Fund's Rules and Regulations, i.e., normally requiring three business days from initiation of a purchase.