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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/55

10:00 a.m., May 30, 1997

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman
S. Sugisaki, Deputy Managing Director

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
	P.-M. Fremann, Temporary
	M. Askari-Rankouhi, Temporary
	W.-D. Donecker
E.R. Grilli	
	L.J.F. Erasmus, Temporary
	R.F. Cippa, Temporary
A. Kafka	H.F. O'Brien
	A.L. Coronel, Temporary
	J. Prader
K. Lissakers	B.S. Newman
	M. Daïri
	S. Rouai, Temporary
A.V. Mozhin	
	J. Shields
A.S. Shaalan	Y.Y. Mohammed
	G.M. Iradian, Temporary
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	
G.F. Taylor	O. Won
	J. Guzmán-Calafell
J. de Beaufort Wijnholds	J.P. Leijdekker, Temporary
	D. Saha, Temporary
Y. Yoshimura	
	S. Joyosumarto
	Han M.
A.G. Zoccali	

R.H. Munzberg, Secretary
S.W. Tenney, Assistant

Also Present

External Relations Department: P.C. Hole, Deputy Director; C. Hellemaa. Legal Department: P. De Boeck. Policy Development and Review Department: T. Leddy, Deputy Director; G.A. Barnard. Research Department: M. Mussa, Economic Counsellor and Director; J. Santaella. Secretary's Department: K.S. Friedman, A. Mountford. Treasurer's Department: D. Williams, Treasurer; D. Gupta, Deputy Treasurer; G. Wittich, Deputy Treasurer; J.E. Blalock, K. Boese, W.J. Byrne, J.C. Corr, E. Decarli, L.U. Ecevit, R.H. Floyd, C.A. Hatch, D.K. Kar, K.M. Kenney, M.G. Kuhn, A.F. Moustapha, T.M. Tran, H. Treichel. Office of the Managing Director: J. Prust. Advisors to Executive Directors: T. Brizuela, S.S. Farid, C.M. Gonzalez, A. Guennewich, R. Kannan, M.-H. Mahdavian, M.F. Melhem, M. Sobel. Assistants to Executive Directors: M.A. Brooke, J. Chelsky, M.A. Cilento, H.W. Cocker, D.A.A. Daco, S. Fukushima, M.A. Hammoudi, T.-M. Kudiwu, D.G. Loevinger, D. Merino, I. Moon, L. Palei, J.L. Pascual, L. Pinzani, V. Rigász, S. Simonsen, Song J., V. Trivedi, A.G. Yakub.

1. FUND LIQUIDITY POSITION AND FINANCING NEEDS—METHODOLOGY USED IN REVIEWS

The Executive Directors considered a staff paper on the methodology used in reviews of the Fund's liquidity and financing needs (EBS/97/60, 4/2/97).

Mr. Newman made the following statement:

> The Fund, like any financial institution, must be able to accurately assess the adequacy of its resources to meet potential calls. The periodic reviews by the Executive Board of Fund liquidity provide the vehicle for a regular consideration of the supply and demand for the Fund resources in the near term. However, recent events and the staff paper for today's discussion suggest that the current methodology results in inaccurate forecasts and provides an incomplete basis for judging the adequacy of Fund resources.
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> There are legitimate concerns about possible modifications in the methodology used in liquidity assessments in the midst of a quota review. However, it is unfortunate that the staff has not seized the opportunity to propose more ambitious reforms that could be implemented following completion of the current quota review.
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> The semi-annual assessments of the Fund liquidity are intended to ensure that the Fund's usable resources are adequate to meet prospective requirements arising from the Fund lending, encashment of liquid claims, and administrative and other operational expenses. The projection of the Fund's liquidity ratio—defined as the ratio of uncommitted adjusted usable resources to liquid liabilities—over a 12–18 month period has served as the traditional tool for assessing liquidity. However, Appendix II of the staff paper, especially Table 8, indicates that the Fund projections have been wide of the mark and biased, especially for the critical next year forecasts.
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> The magnitude of the error has been rather large, nearly 25 percent. Moreover, the errors have also been persistently biased in the direction of underestimating Fund liquidity. Indeed, the problem would have been much greater had the large unanticipated Mexican purchase not resulted in a substantial off-setting correction. The staff attributes this outcome in large measure to the difficulty in forecasting commitments and, in particular, future purchases although this does not fully explain the magnitude and direction of the errors. The techniques used to calculate the liquidity ratio have also exacerbated these problems by relying on nontransparent procedures and gross adjusters that bear little resemblance to the Fund's actual experience.
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> The determination of the currencies considered sufficiently strong to be included in the operational budget is based on a staff assessment of members' balance of payments and reserve positions. Attention has focused rather narrowly in the past on members' reserves relative to other countries although greater emphasis is now being placed on overall balance of payments positions and exchange market developments. Some form of judgmental approach is inevitable and no assessment can be fool-proof. However, the current system is

rather nontransparent with the Executive Board given little information on the reasons for the staff's conclusion that Directors can draw upon in reaching their own judgments. This lack of transparency creates perceptions that decisions on inclusion or exclusion from the operational budget are based in part on noneconomic factors which inevitably raises issues about uniformity of treatment and the possible need for norms. Therefore, the staff's suggestion to make greater use of quantitative criteria as a supplement to staff judgments is welcome although it does not obviate the need for a greater role for the Executive Board in the process of assessment.

The poor forecasting record is also influenced by the 20 percent downward adjustment of usable currencies which the staff has traditionally made to take account of working balance requirements and potential balance of payments developments.

However, an adjustment for working balances is unnecessary, particularly a uniform percentage for all usable currencies. The bulk of the Fund administrative expenditures are in dollars, the demand for specific currencies by European countries for ERM purposes has declined significantly and will be virtually eliminated with the advent of the euro, and the guidelines on use of currencies in the operational budget already provide for retaining substantial balances as a result of the floor on the Fund's currency holdings.

Similarly, a uniform adjustment to take account of the possible deterioration in the balance of payments position of creditors is redundant since inclusion in the operational budget is already based on a medium-term financial assessment. It also overstates the probability that the currencies of the largest members would in practice become unusable.

Finally, the staff's simulation to justify the 20 percent adjuster is not persuasive and appears to rely on highly arbitrary assumptions that may be goal driven rather than a reflection of Fund experience. For example, over the past year, the U.S. and Japan have experienced substantial depreciations of their currencies at different times but both the dollar and the yen have remained fully in the budget.

The staff projections of future loan demand based on probability-weighted assessments by the area departments is a reasonable approach in theory although it suffers in practice due to the considerable uncertainties regarding the actual timing of programs and purchases. Consequently, the staff's suggestion and the proposal for a rolling 24-month forecasting cycle and the suggestion to use the aggregate approach as a check on the accuracy of the country estimates should help to improve the demand projections, although some caution should be exercised regarding the aggregate approach which has proven to be a poor forecasting tool the farther out projections are made.

The proposal for a 10 percent reduction factor in the projection of purchases is more problematical as it may not reflect the Fund's actual experience. A preferable approach might be to use econometric models of use of Fund resources. The models have not been as accurate as staff assessments in predicting use of Fund resources and therefore should not be used as a substitute for staff assessments. However, they provide useful information based on actual experience and therefore may prove to be a more useful complement to staff assessments than an arbitrary adjustment factor.

More broadly, the current system remains much like a black box, with the Executive Board provided little or no information on the staff's analysis of loan demand on a country-by-country basis. Concern that premature disclosure of country-specific assessments could create a self-fulfilling prophecy is understandable. Nevertheless, the Executive Board is being asked to take decisions on liquidity and financing needs, including possible recommendations on quotas, without a clear basis for reaching an independent judgment of loan demand. The time has come to demystify the process so that those with the ultimate responsibility for final decisions have a meaningful role in the assessment process.

As noted previously, the purpose of the Fund liquidity assessments is to ensure that adequate usable resources are available to meet projected demand, including the Fund lending and the encashment of liquid claims. However, the current liquidity ratio focuses only on the latter demand. It is important to provide creditors comfort regarding the liquidity of their the Fund claims as these claims constitute a component of monetary reserves albeit a relatively small proportion for most creditors with the exception of the United States. Moreover, creditors clearly have differences of views regarding the minimum liquidity ratio that is necessary. Some prefer a very high ratio, implying a Fund with lots of liquid resources but little lending. Others are content with much lower levels that reflect the Fund's actual experience regarding the modest encashment of reserve positions over the last 10–15 years. This diversity of views, however, has been lost in the tendency in recent years to view the long-term average of 70 percent as a lower boundary which signals both the need for and possible size of a quota increase.

Moreover, a liquidity ratio which focuses solely on liquid claims tells us nothing about the adequacy of Fund resources to meet prospective loan demand. A commitment or purchase ratio that relates the Fund's usable assets to projected commitments and/or purchases under programs or encashment of reserve positions should complement the existing liquidity ratio to provide a fuller picture. The staff's argument that such a measure is inappropriate for the Fund is based on a very narrow interpretation of the role of a cash management system. The Fund, like any other financial institutions, must be able to judge whether its liquid resources are sufficient to finance net cash requirements whether it borrows from the market, like the World Bank and private institutions, or relies on its own resources.

The staff paper reflects a view that the current method for assessing the Fund's liquidity and financing needs is operating satisfactorily and that only minor repairs are needed. However, the record shows that the current system produces forecasts of liquidity that are inaccurate, biased and incomplete. In these circumstances, a radical overhaul is required to improve forecasts, refocus attention on the central issues for assessing Fund liquidity, and enhance the transparency and credibility of the process.

Mr. Sivaraman made the following statement:

I welcome this opportunity to discuss the methodology used in reviews of the Fund's liquidity and financing needs. The staff paper raises a number of interesting issues and questions. The staff has to be commended for their candid statements on the variations in their projections from actuals and the difficulties they encounter. There is no doubt that it is important for us to make continuous efforts to refine and improve the current methodology with a view to ensuring that the staff projections of the Fund's liquidity are as precise and reliable as possible. I do admit that forecast is an imprecise exercise. Furthermore, for the Fund the cost of overestimating liquidity exceeds the cost of underestimating it. Hence, I would prefer to err on the cautious side.

The current process of assessing usable resources, commitments, and purchases involves a substantial judgmental element and the staff has always been erring on the side of caution. This is clear from Table 1 of EBS/90/60 which indicated wide variations between the actual and projected commitments except once in 1989 when there were unanticipated extraneous factors. In the case of purchases, the deviations were even larger.

In this regard the projection of usable resources could be more accurate as the imponderables are less. There could be errors in the adjustment factor used. In view of the freer flow of capital and more and more countries opening their capital account, there will be greater dispersal of usable international funds. This by itself could create uncertainties. But after the Mexican crisis, countries are expected to be more cautious in the management of funds so long as we, in our great enthusiasm for free movements of funds, do not push countries into relaxing their rules faster than what their fundamentals would warrant. As even now there are industrializing economies with very high current account deficits and considerable amount of short-term borrowings, it would be safer to keep this adjustment factor at a reasonable level.

While it is true that the globalization of financial markets has reduced the importance of international reserves as indicators of countries' relative external financial strength, we all must recognize that for a majority of Fund members, this global access is not adequate and they continue to depend on the international institutions for financial help. Hence, I would urge the staff not to unduly dilute the importance of international reserves in our forecast exercise. However, in assessing the strength of member countries' currencies, current account deficit should be given a higher weight than probably even the reserves, as the magnitude and composition of the latter could alter significantly even in a short period. If reserve accumulations are as a result of higher short-term borrowing, they could exit easily if there are signs of changes in fundamentals. It is of course assuring to note that reserves to current payments ratio has not changed significantly in the last two decades. We are happy to note that staff is giving increasing emphasis to current account developments. We agree with the suggestions contained in paragraph 10 as it takes into account all factors that affect the strength of a country's currency.

The staff has stated that the minimum working balance for usable currency is now set at 10 percent of quota and accounts for approximately two-third of the amounts by which the total of usable currencies is reduced by the application of the adjustment factor (paragraph 16). In my view, working balances of this size are not necessary in view of these factors, namely (a) a vast majority of members with currencies in the present operational budget, even if we assume that the remuneration is paid in their own currency, would require much lower working balances; (b) at present there is no obligation on the part of the Fund to meet payments of interest and principal in respect of borrowing agreements; and (c) request by members for specific currencies to enable them to obtain equivalent amounts of their own currencies offered by other members have been quite limited in recent years. Furthermore, in view of the current account convertibility enjoyed by majority of members, this particular process does not pose any problem to us. Hence, it may not be necessary under current circumstances to maintain working balance in each usable currency amounting to as much as 10 percent of quota.

Projections of demand for the Fund's resources will have to be necessarily based on a country by country assessment. We are not clear as to how the total financing requirement has been calculated in figure 2. If net reserve accumulation adjusted for non–debt creating inflows include long-term debt with moratorium on repayments, then there will be an overestimation of requirements. Many countries who access the Fund have extensive long-term borrowings from multilateral institutions as well as from bilateral sources. There are also long-term suppliers' credit available. We do not know whether this could be the reason for consistent overestimation of demand. Staff may please clarify. A reasonably accurate projection of demand for the Fund's resources will obviate the need to maintain a higher liquidity ratio or even fix a level of liquidity ratio.

To the many subjective elements involved in estimating country's requirements of funds, we should also add the factor of certain countries dropping out in the middle reducing the commitments required. To what extent calculations get affected because of this factor is not clear. On rare occasions, the Fund itself stops the release of funds due to unfulfilled conditionalities. In any econometric estimation, it may be difficult to account for so many subjective elements.

These difficulties in estimating requirements of funds and strength of currencies would naturally affect the calculations of usable reserves. As at every stage staff is cautious in their calculations, no wonder there has been an underestimation of liquidity right from 1985. We are not commenting on econometric techniques of projections as they have been rejected by the staff.

We suggest a better adjustment in calculating the requirement of funds and in the working balances. This to a certain extent would improve the calculation of liquidity.

In determining the level of liquidity, we must keep in view the uncertainties attached to increasing globalization of capital markets and the Fund's preference for capital account convertibility. We cannot push members to having capital account convertibility and at the same time deny access to it when they are in trouble owing to extraneous factors beyond their control.

In conclusion, I would say that while there has been wide variations between actuals and estimation in regard to liquidity, erring on the side of caution provided a safety net to the Fund. It is true that at times it has tended to exaggerate the requirements of resources. While we can make certain corrections to the calculations, it is safer to err on the side of underestimating liquidity rather than overestimating it.

Mr. Shields made the following statement:

I am grateful to the staff for this long-awaited paper. It contains a lot of useful information. I am not however convinced by some of the assertions made in the paper and I remain unhappy both about our use of the liquidity ratio and the ways in which it is calculated and projected.

I believe that in future we should: pay more attention to alternative indicators of the Fund's financial position; avoid identifying a 70 percent liquidity ratio (under current definitions) as critical; either reduce the "adjustment factor" for usable resources below 20 percent or make allowances only for working balances; look carefully at the use of objective criteria (including credit-ratings) for inclusion of currencies in the operational budget; and include a bias adjustment of 10–20 percent in the purchase projections underlying forecasts of the liquidity ratio.

Although I have no new definitions of liquidity to suggest, I was disappointed by the cursory dismissal of possible alternative options in the paper. In the year that it has taken to produce this paper, I would at least have expected better explanations to emerge of why the existing approach is superior. Ideally, we would also have seen some creativity in approach. I agree with Mr. Newman's arguments for additional supporting indicators.

During discussions of the Eleventh Quota Review, staff projections of a decline in the liquidity ratio to 70 percent were sometimes interpreted as sufficient justification for a quota increase. However, as Figure 5 on page 49 of the staff paper indicates, the 70 percent "benchmark" is approximately the liquidity ratio's long-run average: the liquidity ratio has as often been below this figure as above it.

A further reason the 70 percent ratio may not be of critical importance is that increased access to international capital markets may lead to a lowering of the aggregate demand for Fund resources. Admittedly, as paragraph 47 notes, there is no measurable evidence in support of this. But, equally, there is no evidence for the counter view—or at least no evidence has been presented in this or previous papers. Perhaps an examination should be commissioned on this issue from external academics?

Aside from these observations based on historical trends in the liquidity ratio, we need also to bear in mind that the current measure of the Fund's liquid liabilities—the denominator of the liquidity ratio—substantially overstates the likely total demand on the Fund's liquid resources. It is almost inconceivable that all creditor members would simultaneously face balance of payments problems and elect to draw down their reserve tranche positions.

I believe therefore that the Board should recognize that the Fund faces no operational problems with a liquidity ratio of 70 percent.

As set out in the paper, the adjustment factor for usable resources takes account of the need for working balances and the likelihood that the balance of payments position of some members might weaken to the extent that their currencies would not be fully usable. I have three concerns about the size of the adjustment factor: first, given that footnote 16 on page 10 indicates that uses of working balances have averaged 4.5 percent of quota over the past 20 years—when interest rates have been historically high—the current requirement for minimum working balances of 10 percent of quota seems unnecessarily high; second, I suspect that the Fund's working balance requirements differ significantly between currencies (with the U.S. dollar being the most frequently used currency); and, third, I am doubtful about the need to make a downward adjustment to the liquidity ratio to allow for the possibility that a country may drop out of the operational budget. Given that currencies are already rigorously assessed for "sufficient strength" in order to be included on the transfers side of the operational budget and that there must also be a chance that other members not included in the operational budget will experience a strengthening in their external positions sufficient for them to be included in the operational budget, the risks with regard to exclusion/inclusion of currencies are likely to be offsetting.

Hence, I would suggest that the adjustment factor should only take account of the need for minimum working balances. Furthermore, there may be some scope to reduce working balance requirements, and to differentiate working balance requirements by currency.

The downward adjustment to usable currencies to take account of commitments already made is excessive in the case of precautionary arrangements. Once a track record of nondrawing is established, much less than 50 percent of the undrawn balance should be deducted.

We continue to be concerned by the inadequate degree of transparency that surrounds many of the Fund's financial matters. The inequity of the current financial arrangements is also a matter of some concern. I therefore strongly support the development of a set of objective criteria which would trigger at least a presumption of inclusion or exclusion of a currency in the operational budget. I would suggest that a country's credit rating should play a significant role in this process. Furthermore, I believe that the Board should be informed about the considerations surrounding all borderline currencies and given greater opportunity to discuss these cases.

In addition, given that the operational budget is reviewed every quarter, I would suggest that there is scope to include a larger number of currencies, while maintaining the option to remove any currency at short notice. Such a procedure would ensure a more equitable distribution of the costs of Fund transfer operations between members who are in a stable macroeconomic position.

As we all know, economic forecasting is a delicate art. So we should never expect too much from projections of the liquidity ratio. But systematic bias is another thing. This should be avoided by regular reviews of forecasting performance. And it should be explained clearly to users of the forecast.

I was therefore disconcerted to find buried in Appendix II, Section B that "over the period 1990–96 . . . staff projections underpredicted the liquidity ratio, on average, by about 23 percentage points." This is a dreadful record. It should not have been hidden behind self-congratulatory comments in the main report about the much better record of forecasting commitments. It suggests that an external assessment might be needed. And that the incentives to the Treasurer's Department are too heavily weighted in favor of under-predicting liquidity levels.

The clear conclusion to be drawn is that the staff need to consider ways of adjusting their forecasts upwards to take account of under-prediction. In this regard I welcome the staff's intention to give greater emphasis to projections over a two-year rolling period; to develop techniques to reduce errors over the timing of programmes; and to adjust the projections of purchases downwards. In connection with this last aspect, I was surprised that the staff proposes to adjust their forecasts of purchases down by 10 percent when forecast errors in this area have averaged 19 percent. Surely a larger adjustment factor would be appropriate?

I think there is also a case for more use of ranges than point forecasts.

Mr. Wijnholds made the following statement:

When this paper was announced some time ago, my sense was that we would certainly find room for improvement, although I doubted that it would affect our work in a major way. My sense was confirmed by the staff paper.

Let me start with some general remarks. In my view, the liquidity ratio still captures the basic logic of the Fund's financial structure. The fact that this institution is financed by liquid liabilities for instance, prevents us from using the ratio that the World Bank calculates. Ignoring this fact can undermine the willingness of our members to finance the Fund, a risk that my authorities wish to underline. In addition, the fact that the Fund needs to stand ready at any time to assist a member with a balance of payments need, argues for a somewhat conservative assessment of the adequacy of the Fund's liquidity. These are the basic premises that I see, and they continue to be captured in the liquidity ratio.

Having said this, there is always room for improvement. In general, my impression of the methodology is that there is indeed a lack of transparency, as observed in the statements. Various adjustments and assumptions are made in the calculations, which result, in the end, in underpredictions of the liquidity ratio and overpredictions of purchases. As I said, it is appropriate to be conservative here, but we need to be able to see how conservative we really are. There is room for more transparency. In addition, I see a need for increasing the weight of members' access to international capital markets when assessing their external strength. Let me provide some more detailed remarks on these issues.

To start with, I see various reasons for reducing the working balances. First of all, it is rare that members ask for the payment of remuneration in their own currencies. Second, it only makes sense to accommodate interest or principal payments when we actually have loans outstanding. And if we do, we only need to retain working balances of the currencies in which these loans are denominated. Finally, the provision under Article V, Section 3(d) has not been used for a long time. On all these accounts, it seems to me that our provision for working balances might well be on the high side.

I do see a need to make provisions for the fact that members included in the operational budget might not always have a strong external position. But this provision could be done per currency, rather than a single adjustment factor across the board. Such a currency-specific adjustment should not only take account of members' reserves or exchange developments, as suggested by the staff. It would make sense to include indicators of members' access to international capital markets, as well.

Turning to the staff's projections of purchases, I think that some overprediction is inherent. Still, given the fact that the liquidity ratio has been underpredicted on average by 23 percentage points, we might be exaggerating the tendency to "err on the side of caution." The staff's suggestion to reduce projected purchases by 10 percent seems valid in this regard.

These are the basic refinements to the liquidity ratio that I would find useful. However, there may also be another approach one could think about to measure the Fund's relative liquidity. Taking into account the fact reserve tranches are seldom used, one could think of a measure that relates the stock of usable currencies to some scale variable, such as world trade or a broader measure of the volume of international transactions. This would not be a measure to replace the liquidity ratio so much as to supplement it. This measure might prove particularly useful when assessing the need for a quota increase. Rather than comparing quotas to the world economy, it is probably more relevant to look at the stock of usable currencies in such a comparison.

Having made these remarks on the liquidity ratio, I would like to end with some comments on the operational budget. Some recent anomalies suggest that there is clearly room for improving the selection process. As was pointed out during our discussion in December, members' access to capital markets deserves more weight in assessing their external strength, especially the terms of access and the stability of these terms over time. I think that if we give more weight to these factors, some of the recent anomalies in the operational budget can be avoided in the future. Another modification that could help is to allow some more fluidity with regard to both the in- and exclusion of members.

Let me end by saying that I expect more from these refinements than from the adoption of automatic indicators. Automatic indicators can help to improve the transparency of the selection process, but I would strongly urge to preserve room for some qualitative judgment as well. I basically say this because automatic indicators might well have precluded the inclusion of some industrialized countries that were added to the budget recently, and I thought rightly so.

Mr. Askari-Rankouhi made the following statement:

Let me begin by thanking the staff for a useful paper. It reflects the usual high standards of the staff's analysis, with ample documentation of procedures, and a thorough evaluation of forecasting accuracy. I am particularly grateful to the staff for pursuing this chair's suggestion last year to consider a probit model approach to estimating the demand for Fund resources.

Despite the high quality of the staff's analysis, we still have concerns about some aspects of the methodology that has led to systematic underestimation of Fund liquidity, and overestimation of the demand for Fund resources.

On the Fund's usable assets, the choice of the currencies to be included has usually not been very transparent. The strength and the degree of stability of a currency should be established on the basis of well defined variables. This would increase the transparency of the process, and provide the Board with additional information to evaluate the reliability of the Fund's asset base. I therefore welcome the staff's suggestion to develop a set of objective criteria for deciding which currencies are strong enough to be included in the operational budget.

The staff notes that there is no link between New Arrangements to Borrow (NAB) members and those members whose currencies are judged to be strong enough to be included in the operational budget. It is true that from a legal perspective, there is no formal link and NAB members are not precluded from using Fund resources should the need arise. However, from a practical point of view, the presumption has to be that NAB members have strong external positions and currencies, and therefore should be included in the operational budget. If, however, in certain circumstances, some NAB members experienced financial difficulties, then the staff should make a case for excluding them. This is also in line with the general point that Mr. Shields makes that given that the operational budget is done on a quarterly basis, we can afford to include more countries in the operational budget with the option of dropping them at short notice.

On the adjustment factor for usable currencies, I have three comments: First, the minimum working balance of 10 percent of quota appears excessive. For example, remuneration payments for countries extending resources to the Fund average about 2 percent of quota and are made mostly in SDRs. Could the staff provide information on the adequacy of working balances in the past? Secondly, the adjustment factor takes into account the risk of a weakening of some of the currencies currently regarded as usable, but does not weigh this risk against a possible strengthening of the external position of other countries. As Mr. Shields notes, the risks may be offsetting. Thirdly, I share Mr. Newman's reservations about the validity and robustness of the simulations in paragraphs 20 and 21 that were meant to provide support for the size of adjustment factor. For one thing, reducing the amount of a members currency that could be used by 50 percent if external reserves had declined by 10 percent or more seems quite arbitrary both in magnitude and application as countries may experience temporary shocks that often reverse themselves. Moreover, excluding a similar amount of resources for countries whose currencies had depreciated by 5 percent or more ignores the usefulness of flexible exchange rates as a mechanism to establish external equilibrium. In other words, the exchange rate adjustment could have strengthened the country's external position.

On the demand for Fund resources, the country-by-country approach appears the most relevant given the wide range of factors that have to be taken into account. Clearly, the use of probit models to estimate financing needs has not been successful. However, finding a systematic way of projecting the demand for Fund resources remains a valid objective. I therefore urge the staff to pursue further research in this area. We have highly skilled econometricians in this institutions who are certainly capable of finding ways to refine the models and the techniques to obtain more useful results.

But, as long as the current subjective approach provides better estimates than the econometric approach, it should be retained. It would be useful, however, to maintain a structured data base for research purposes, as well as for informing the Board on the key factors that motivated the staff's probability evaluations of financing needs.

Since, according to the staff, one main source of the overprediction of financing needs is the systematic error in projecting the amount of purchases, I think the staff's suggestion to use a fixed adjustment factor is a reasonable solution until a more robust methodology is found. But, I share Mr. Shields's view that a 10 percent adjustment may not be sufficient given the extent of overprediction.

On the liquidity ratio, the level of the ratio provides little information as to whether the Fund needs more resources or not. The long-term historical average of 70 percent used by the staff as a benchmark is arbitrary. Deviations from this historical norm do not reflect an excess or a shortage of liquidity, but only that the liquidity position is different from the historical norm.

Furthermore, the inclusion of total reserve tranche positions in the denominator of the ratio overestimates the potential liquid liabilities. The staff justifies this on the ground that it has to ensure members that their reserve tranche positions are usable by them at all times. Of course, every member has the right to use its reserve tranche, but that is not the issue. What is important is that the likelihood of a creditor country using its reserve tranche is obviously very low. To the extent that a prior assessment of the strength of the members' currencies has effectively identified a very low probability of some members using their reserve tranches, the liquidity ratio may be seriously overestimating the Fund's liquidity requirements. If we were to continue to use the conventional measure of the liquidity ratio, we suggest that the staff provide an additional measure which fully or partially excludes the reserve tranche of countries that are judged to have a strong external position.

Mr. Newman raises questions about the appropriateness of the conventional liquidity ratio and proposes another measure of liquidity. In fact, I think simple trends in usable resources and not the liquidity ratio might be a more useful indicator of the adequacy of Fund resources. The staff's comments on this issue would be appreciated.

Mr. Iradian made the following statement:

Unlike some previous speakers and the preliminary statements, we broadly agree with the present methodology used in reviews of the Fund's liquidity and financing needs.

With respect to the methodology used in projecting the demand for Fund resources, we concur with the staff's main findings that the country-by-country approach and the use of subjective probabilities are superior to both the more aggregative approach of making projections and to the results obtained from the application of econometric techniques. The staff clearly shows that the aggregative approach, which relies on estimates of the residual financing requirement of debtor countries as projected in the World Economic Outlook, produces estimates which deviate sharply from outcomes. This finding raises serious questions on the usefulness of this approach. Additionally, the use of econometric techniques, including the probit or logit model while useful, suffer from the difficulty in capturing the influence of noneconomic variables, such as social and political factors, that also influence a country's decision whether to request use of the Fund's resources.

We are therefore not altogether clear on what Mr. Newman is suggesting on how to improve projections of demand for the Fund resources. He notes that projections of demand for the Fund resources by area departments are biased upward and suffer in practice due to the considerable uncertainties regarding timing of programs and purchases. Consequently he agrees with the staff to use the aggregate approach to improve the demand projections. But then he acknowledges that this has proven to be a poor forecasting tool. So he favors using the econometric models approach. But then quickly he notes that these models have not been as accurate as staff assessments in predicting use of Fund resources. Mr. Newman may have a point but we are missing it.

Turning to the supply of usable resources, there are other factors besides the level of international reserves, developments in balance of payments, and exchange markets to assess the relative strength of a currency. While it would be difficult to use formulas or weights for the various indicators of strength of a member's financial position, we encourage the staff to develop a range of quantitative indicators, which when used with the current approach, could trigger at least a presumption of inclusion or exclusion of a member in the operational budget. Nevertheless, some form of judgmental approach will remain inevitable.

Finally, we believe that the present specification of the liquidity ratio is appropriate in light of its purposes, and that there is at present no evidence that the changes undergoing in the globalized economy would necessarily lead a decline in the demand for Fund's resources, or to lower the desirable level of liquidity of the Fund as compared to the past. Most low income developing countries are likely to continue having no access to the capital markets for some time. Few of those with access cannot count on the continued availability of private financing, certainly not on reasonable terms. As to the middle income major borrowers, experience has shown that use of Fund resources by these countries may well be a precondition to access to the capital market.

Mr. Newman said that there might have been some misunderstanding with respect to his opening statement. His statement was intended to put forward the need to improve transparency. He would have no difficulty accepting the use of alternative measures as a supplement to the methodologies presently used by the staff. However, the key issue was for the Board to be in a position to evaluate the staff's judgments concerning the likely demand for Fund resources. It was ultimately the responsibility of the Board to take final decisions concerning the adequacy of Fund liquidity. Therefore, the staff should explain—particularly in cases involving uncertainties—the basis for its judgments concerning the expected demand for use of Fund resources. Such explanations would enhance the Board's ability to determine the validity of the staff's projections.

Mr. Iradian stated that he agreed with Mr. Newman's suggestions concerning the need to improve transparency in the staff's projections of demand.

Mr. Yoshimura made the following statement:

As this chair has indicated on several previous occasions, we consider that the process of selection of currencies for inclusion in the operational budget should be more transparent and flexible. Therefore, I welcome the staff's intention to develop additional quantitative criteria for this purpose. I look forward to the discussion on the role of automatic indicators in assessing Fund liquidity.

The staff paper emphasizes that judgmental factors are involved in assessing the strength of currencies. I wonder whether automatic indicators could eliminate those judgmental factors. If not, it would be helpful if the staff could elaborate further on the judgmental factors involved and on how they are taken into account.

In light of the revolving nature of the Fund's resources, the guidelines on early repurchase should be reviewed so as to provide for a more systematic and effective implementation. The adjustment factor has been changed since its introduction, reflecting major changes in the financial circumstances of the countries in the operational budget. As the level of the adjustment factor has a sizable impact on the Fund's financial position, it should be determined in a more systematic and precise way.

With regard to the methodology used in projecting the demand for Fund resources, the evidence showed that the econometric models were less accurate than the current methodologies used by the staff, owing to the importance of noneconometric variables. Therefore, it would be best to maintain the current methodology, perhaps as modified by an aggregate approach, which would be more accurate for longer-term projections. The tendency to overpredict in the first year should also be avoided. Projections by the Fund should be based on its surveillance. In this connection, accurate information from member countries is as important as the Fund's projection skills; in other words, each member country needs to cooperate with the Fund in disclosing information in an accurate and prompt manner.

Compared with the alternatives presented in the staff paper, the current liquidity ratio seems reasonable. Although it has been suggested that a liquidity ratio of 70–80 percent is adequate, I would appreciate the staff comments on what it would consider to be an appropriate liquidity ratio. The current liquidity ratio is not the best indicator of the Fund's financial position. In analyzing the ratio, the long-term prospects of the Fund and of member countries should also be taken into account.

In this regard, it would be helpful for the staff to provide some background information of the demand for Fund resources on the occasion of the semi-annual reviews of liquidity in addition to the numerical projections currently provided. As I mentioned, the liquidity ratio is not the only indicator of the Fund's financial position. A review of methodology does not lessen the need for regular reviews of quotas. Quota increases are to restore the Fund's position in relation to the world economy to ensure that is will have sufficient capacity to deal with substantial capital outflows and to adjust quota shares to reflect members' relative economic positions. None of these purposes can be achieved through methodological changes.

Mr. Cippa made the following statement:

We welcome this discussion on the methodology used in reviews of Fund's liquidity and financing needs. We welcome a broader context that allows us to look at this issue more systematically than in semiannual reviews. We thank the staff for the excellent paper produced. We broadly share its view that the current methodology has served us well, and remains valid even if some improvements are warranted.

Most of the proposals of the paper aim at reducing the element of judgment and to strengthen the element of automatism. We support in principle, and when possible, this approach as it enhances transparency and improves equal treatment among Fund members. Some proposals also aim at reducing systematic forecast errors. The paper, however, deals exclusively with technical questions and addresses only marginally the crucial issue of the appropriate level of Fund liquidity in the new context of the globalization of financial markets and liberalization of capital accounts. We understand the intrinsic difficulties of such an analysis and that the adequacy of the Fund's resources is probably to a considerable extent a matter of judgment. Still we hoped that we could go beyond the use as benchmark of historical average levels of liquidity. Such an analysis would have been of some use for the still unfinished exercise of determining the size of the Eleventh Quota increase, although we clearly understand that for this purpose the observation of a much broader set of indicators and an assessment of the role of the Fund is necessary.

On the specifics of the paper, we have the following comments.

On the supply of usable resources, the current approach of determining whether a currency is sufficiently strong to be included in the operational budget is based on an assessment of the balance of payments and reserve position as well as exchange markets developments of a member country. However, since the assessment is complemented with a substantial element of judgment, the outcome is not very transparent. We, therefore, welcome the development of a set of indicators which would trigger more automatically a presumption of inclusion or exclusion of a currency in the operational budget. In order to prevent sharp fluctuations of usable currencies, there could still be a provision which ensures that currencies are only included or excluded if the external position has improved or deteriorated over a longer period of time. Such a provision could be that "automatic indicators" must be fulfilled for three to four quarterly periods in a row.

Regarding downwards adjustments of the Fund's usable currencies, we agree with the current procedures that take into account the commitments already made, the need for working balances and the likelihood that the external and reserve position of a country may substantially deteriorate. The various simulations based on changes in reserve or and in exchange rates, although not conclusive, indicate that the 20 percent adjustment currently utilized is not unreasonable. We favor a single adjustment factor for all currencies. Having different probabilities would introduce a nontransparent, judgmental element. On working balances, we can go along with the working balance of 10 percent of quotas in individual usable currencies, although, like Mr. Wijnholds, we also think that this can be on the high side.

Using a two-year rolling period rather than diminishing periods within a fixed two-year cycle when projecting the demand for Fund resources would most likely reduce the error rate of forecasts and we endorse this use. The other error elements in projecting demand for Fund resources concern timing and we fully support the staff's attempts to develop early signals, which could minimize such error.

The over prediction of purchases under existing arrangements of about 20 percent is substantial and does occur in both forecasts years. The actual Fund liquidity is, therefore, systematically much higher than predicted. The main reason is indicated as being the cancellation or expiration of arrangements with substantial undrawn Balances. We take this as a fact. Assessing why and to what extent programs are canceled would bring us too far. This is an issue that deserves a discussion on its own. To correct this systematic over prediction of liquidity, we support the incorporation of a reduction factor of about 10 percent for projections of purchases, keeping in mind that such a linear adjustment of the forecast is only a second best solution.

We think that the introduction of both a two year rolling period and a reduction factor improves the country-by-country assessment and see, therefore, no reason to go back to a more aggregative approach. As it has been done for quite some time, an aggregative approach can complement the country-by-country approach for medium-term projections.

And finally on liquidity ratios, as the experience earlier this year showed, the liquidity ratio can fluctuate sharply within a short period of time. However, this does not detract too much from its usefulness as an indicator of the availability of resources to meet reserve tranche liabilities and of the adequacy of resources for balance of payments assistance. We should retain it in our judgment and we do not see advantages in moving to alternative liquidity ratios such as the ones used by the World Bank. As stressed in the paper, the financing of the two Bretton Woods institutions is completely different, the Fund does normally not rely on medium-term borrowing. We do not support a probability weighted use of reserve tranche positions. It would introduce another judgmental element, and contradicts the monetary character of those positions.

Mr. Donecker made the following statement:

At the outset let me note that we should not confuse the technical question of how best to assess the short term liquidity of the Fund on the one hand, with the political decision about the proper size and the proper role of the Fund in the medium to long term, on the other hand. Thus, while certain methods can help us to analyze the various factors that have a bearing on the Fund's liquidity over the short to long term, this analysis has to be combined with a thorough assessment of the likely developments in the global economy. In this context, no sophisticated methods can release us from our obligation and need to come to a political judgment about the role we want the Fund to play in this new world of liberalized capital flows—and correspondingly to a judgment about the Fund's equipment with sufficient and liquid financial resources to do its job.

I think we all agree that even with increasingly globalized financial markets the role of the Fund as a guardian and centerpiece of the international monetary system and its ability to meet any "legitimate" credit demand of its membership must remain beyond any reasonable doubt. So much on the overall background to our discussion today about possible improvements in the measurement of the Fund's short term liquidity and financing needs.

Let me now turn to the technical issues raised in the staff document. Here we have an open mind about possible refinements of the present methodology, as long as certain proposals constitute real improvements and not the opposite. Let me confess, that in our view, the methods used by the staff, all in all, seem to have worked fairly well in the past. Certainly, with the benefit of hindsight, one can criticize that the staff's liquidity assessments have tended to be too cautious. But is this really a major failure or a sign of bad judgment on the side of the staff and the Board—or is it not rather the result of a prudent assessment of likely liquidity trends and the sensible desire to err on the side of caution to safeguard the Fund's liquidity in the best interest of all Fund members? But there appears to be some room for sensible improvements, and we have an open mind here, as I have said before. When we look at certain proposals for improvements of the methodology, we should of course, also weigh the cost related to possible changes of the methodology with their potential benefits. In this context, I would in particular caution against the introduction of highly sophisticated methods, which hardly facilitate our job, but only reduce the transparency of the exercise. Our American friends, who are well known for their pragmatic approach to all sorts of things have an interesting saying that may provide some sound advice for our discussion today, namely, "If it ain't broke, don't fix it"! Let us be realistic and prudent about what is really feasible or desirable in this context. To quote but one example of what I would find very difficult to accept as an improvement: Do we, the Board, really want to get involved in a difficult to realize and very problematic country rating exercise when it comes to the selection of currencies for the transfer side of the operational budget or with regard to the assessment of individual members probable and "legitimate" short term drawing needs?

On the assessment of the supply of resources, I think the approach how the staff comes to the judgment which countries should be included in the operational budget has worked quite well. It is a fact, that—so far—there is no commonly accepted theory or set of quantitative criteria which objectively reflects the strength of a members currency. In the end, we will always need a high degree of judgment here, that takes the existing large differences in the economic situation of member countries properly into account. This notwithstanding, we are open minded regarding possible improvements. If a range of indicators can be developed, that increases the transparency and objectivity of our selection process without turning the Fund into a rating agency, we would be inclined to support its inclusion in the Board's decision making process.

Since the staff's proposals on the inclusion and exclusion of a currency are based on the overall assessment of the economic situation of individual Fund members and appear to be well founded, the key question seems to me rather, whether the staff's assessment is sufficiently comprehensible for the

Board. In this context, the staff could and should increase the transparency of its proposals regarding the operational budget by furnishing the Board with some more information at least about proposed additions to or deletions from the list of countries used for the operational budget as the staff did during one of our most recent currency budget discussions regarding the inclusion of Italy and Sweden. Apart from this, it is also up to Executive Directors to contact the staff in order to seek additional information or even to request a Board discussion on such matters. The Board can hardly blame the staff for its own inactivity in this respect in the past. Regarding the coming operational budget for the period from June to August 1997, it certainly will be interesting to hear from the staff, why a country with considerable economic strength, like Australia, is not included.

On the deductions from and adjustments to total usable resources, here again, while open for sensible modifications, I would caution against the introduction of too sophisticated methods. We share the staff's view on the need to hold adequate working balances of each currency. We also would not preclude completely, that a member's currency may not be usable over a projection period—although this risk might be smaller than in the past. We continue to see a justification for an adjustment factor. While we could accept a reduction of this factor, we are not interested in a country weighted adjustment factor, since this would not only very much complicate the exercise, but also again carry the risk that the Fund slips into the role of a rating agency. The latter would be highly problematic.

On the projection of demand carried out by the staff, the country by country approach as well as the aggregated approach have obvious shortcomings. These shortcomings are related to the fact, that future developments are always uncertain. I have also the impression, that in the case of the Fund—as in almost every bureaucracy- organizational interests contribute to an overestimation of demand. However, so far, we do not see how more complex methods can lead to tangibly better results. I therefore prefer a continuation of the current approach.

We are of course open minded with regard to certain minor improvements, like the suggested incorporation of a reduction factor to the projection of purchases or using two year rolling periods for the projections. As far as feasible, we should also try to increase the transparency but we should be aware that there are obviously limits to how far we can go here.

On the liquidity ratio, we like others believe it is a useful indicator to assess the Fund's liquidity in the short run and to be more aware of medium to long-term liquidity trends. We regret, however, that the liquidity ratio has become the center of the discussion on the necessity for and the size of general quota increases. We do not consider a specific level of the liquidity ratio as a cogent trigger for general quota increases. Insofar I share Mr. Newman's criticism of the fact that management and some members seem to consider a long-term average of the liquidity ratio of 70 percent as a lower boundary which supposedly signals the need for a general quota increase. However, we also do not think that a specific liquidity level obviates the need for a general quota increase, in view of the inherent weaknesses of this indicator and—most importantly—since general quota increases should be considered more in a medium to long term context. After all, we have to keep in mind here that general quota reviews take a long time—usually at least three to four years—from the very start of the review until the coming into effect of an agreed general quota increase.

Mr. Al-Tuwaijri made the following statement:

The staff has provided us with a useful and thought provoking paper for today's discussion. While I agree with a number of points raised in the paper, I have a few comments.

The development of a range of quantitative indicators could provide a useful tool in assessing members' currencies to be included in the operational budget. These indicators, however, should only be used as an additional input into our current approach and not as an automatic determinant of inclusion or exclusion.

The paper illustrates that the current approach of projecting the demand for Fund resources is superior to a number of alternative approaches. At the same time however, the analysis indicates that there is a systemic overestimation in the projections, especially when it comes to purchases. Therefore, the staff's proposal to adjust the projections by a reduction factor of up to 10 percent is a step in the right direction. I believe that the 10 percent should be a minimum and not a maximum given the 19 percent overestimation.

While I agree with the staff on the importance of being cautious in estimating the Fund's liquidity, I believe that there may be room for some improvements in the way we calculate and present the liquidity ratio. Such improvements should provide a clearer picture of the Fund's ability to meet future demands on its resources without undermining prudence.

First, I am of the view that the adjustment factor may be too large. For example the staff adjusts downward the holdings of currency to account for working balances in individual currencies of 10 percent. However, the need to maintain such an amount of working balances is not obvious. As the paper notes remuneration payments are at present made almost entirely in SDR's and the Fund has no outstanding borrowing. I also remain unconvinced that globalization of capital markets will increase the likelihood of large reserve tranche purchases.

Second, I fully agree that the Fund should err on the side of caution in maintaining an appropriate liquidity position. However, the rationale for including the total reserve tranche positions in the Fund's liabilities for the purpose of calculating liquidity is not clear. Here, it is important to keep in mind that none of the leading creditor countries have mobilized their reserve tranche position since 1988. More importantly, even if a creditor member needed to mobilize its reserve tranche position, it is obvious that not all members will need to do so at the same time. Therefore, for liquidity calculations, these liabilities could be reduced by a factor, without reducing their liquidity or the ability of members to call upon their Fund positions in times of need.

Third, I found the suggestion of using the ratio of liquid assets to cash requirements over a given period, worth exploring. While I agree with the staff that this method has some shortcomings, I believe that it will be a useful additional indicator. Moreover, the staff could improve on the applicability of this ratio to the Fund by including an estimation of reserve tranche positions that may be mobilized during the period in the same fashion that demand for Fund credit is estimated.

Mr. Guzmán-Calafell made the following statement:

I welcome this discussion on the methodology used in reviews of the Fund's liquidity and financing needs. In addition to the insight provided by the staff paper and the discussion itself on this important issue, this meeting also gives us the opportunity of enhancing the usefulness of the indicators serving as the basis to evaluate the adequacy of Fund resources, and of dispelling the doubts that have been expressed by several Directors on the approach followed by the staff in assessing the demand for and the supply of Fund's resources.

I would like to start my intervention with a comment of a general nature. A recommendation very frequently heard during Board discussions is that it is better to err on the side of caution. I am convinced that this recommendation is especially relevant for the issue we are discussing today. Under the current characteristics of the world economy, particularly the globalization of markets and the unprecedented size and volatility of capital flows, both the availability of resources to support the Fund's operations and the demand for the institution's financial assistance from member countries may be subject to large and sudden shocks. Therefore, the Fund must adopt a prudent stance and caution must be deemed as the guiding criteria in evaluating the adequacy of the Fund's liquidity and its financing needs. It is important to bear in mind that any adjustments to the methodology under discussion must not depart from this basic principle.

Let me turn now to some specific comments on the different sections of the report. On the assessment of the strength of a member's currency, I agree that the globalization of financial markets, among other factors, has obscured the meaning of international reserves as an indicator of relative financial strength. There are indeed cases of countries holding relatively low levels of reserves because of their potential access to capital markets, and also others in which the level must be relatively high as a result of inadequate access to these markets or uncertainties regarding the terms and permanence of such access. It is natural, therefore, to ask for the consideration of a number of elements in trying to determine the vigor of a country's currency. It is not clear that this can lead to the establishment of a set of automatic indicators of strength. As the staff explains, this process will invariably involve a substantial element of judgment. However, it is also true that it is worth trying to develop criteria, complementary to the current one, to trigger consideration of exclusion or inclusion of member countries in the operational budget. Only after the delineation of this criteria, and the accumulation of a minimum of experience with its functioning, will we be able to determine if the adoption of automatic indicators of strength is a feasible option.

I wish to take this opportunity to remind the stance of this chair in relation to the use of those currencies included in the operational budget. In our opinion, the use of a given currency should be proportional to the quota of the issuing country, so that the intensity of obligations goes in parallel with the enjoyment of voting rights. We would like this principle of equilibrium to be seriously considered by the staff in their assessment of usable currencies.

As explained in the paper, members expected to make early repurchases are evaluated on the basis of the same criteria used to select members for inclusion in the operational budget and designation plan. It is logical to expect, therefore, as the staff notes, that any changes in the criteria for early repurchases will also have implications for the use of members' currencies under the operational budget. This is a relevant issue, and it is a remainder that in the forthcoming review of the early repurchase policy, we must avoid approaches which disregard a significant strengthening of the external sector as the basic rationale behind the request for early repurchases to the Fund.

While the deductions from and adjustments to the total of usable resources described in the paper are understandable, there are margins for improvement. The deduction of undrawn balances of resources already committed from the total of usable resources should not be the subject of much controversy. This is obviously not the case of the adjustment factor. As I said at the beginning of my statement, I believe that prudence must be the guiding criterion in managing the Fund's liquidity position. However, for a number a reasons, including the need to enhance the credibility of our estimations, it would be very useful to supplement our judgments on the adjustment factor with other criteria. Clearly, the consideration of a broader range of elements in the process of evaluation of a currency's strength may allow a reduction of the adjustment factor.

I broadly share the staff's analysis on the projections of the demand for Fund resources. The country-by-country approach currently used for this purpose is subject to many uncertainties and to subjective calculations. This method can be refined to improve its accuracy, as shown by the proposals to give greater emphasis to two year rolling periods and to incorporate reduction factors to take account of the systematic overestimation of purchases. However, it is difficult to think of a totally different alternative that may lead us to more precise estimates of the future demand for Fund resources. In fact, the disappointing results obtained through the use of econometric techniques provide revealing evidence in this respect. This is not very surprising given the forward looking and country specific nature of the staff's approach, vis-a-vis the backward looking one of econometric techniques.

Finally, I have three comments regarding the liquidity ratio. First, it should be evident from my previous comments that I do not share the view that the increased possibility of borrowing in international capital markets suggests lower potential demands on the Fund in the future, and therefore a liquidity position below the long run average without the need for increased resources. In this respect, it is worth recalling that in 1994 the liquidity ratio stood at nearly 170 percent; in the absence of these margins of liquidity, the support provided to Mexico in 1995 would have not been possible and the costs of the crisis in Mexico and abroad would have been much larger. Second, prudence supports the continuation of adjustments to take account of the need to maintain adequate working balances and the potential mobilization of reserve tranche positions by some creditor countries. Third, I share the staff's view that the present specification of the liquidity ratio is reasonable in light of its purposes.

Mr. Erasmus made the following statement:

The staff paper provides us with a candid review of the methodology that is currently used to review the Fund's liquidity and financing needs. In view of the importance of the Fund to the ongoing process of economic reform, I agree with Mr. Sivaraman that it would be appropriate to continue to adopt a cautious approach to the review of the Fund's liquidity position. This review of the methodology identifies some important limitations, but at the same time also make some proposals that would improve the results that could be expected.

The assessment of a member's external position in the context of a review of the Fund's liquidity and financing needs is in practice guided by a substantial number of factors to ensure an accurate determination of the strength of the external position of members whose currencies are to be included in the Fund's usable resources. The staff also displays an appropriate caution in recommending the inclusion or exclusion of a currency in cases where doubt exists about the sustainability of a member's external position. However, while the methodology that is currently used to assess members' external strength remains broadly satisfactory, it contains a significant judgmental and consultative element that makes the assessment of members' external position increasingly difficult in the context of a globalized economy. There is thus a need to develop some objective indicators that could be used to complement the current methodology.

With regard to the adjustment of usable resources, I support the continued maintenance of working balances for prudential reasons. However, as indicated by other Directors, it might not be necessary to maintain the balance at the level of 10 percent of quotas. With regard to the adjustment factor, I welcome the proposal to develop some criteria that could be used to complement the subjective judgment of the relative strength of members' external positions.

Any method that is used to estimate the prospective demand for Fund resources will be subjected to some uncertainty and errors. The method that is currently used to assess the potential demand for Fund resources, i.e., the country-by-country approach, makes appropriate use of the extensive knowledge of the staff that are closely involved in discussions with authorities. It, however, contains many uncertainties and in the past has tended to overpredict the use of resources by a relatively large margin. However, the results of the two alternatives, i.e., the aggregate approach and econometric modeling do not appear to be more promising. The short-term results of the aggregate approach have deviated sharply from actual outcomes, and the use of econometric techniques to assess the potential demand for Fund resources would have led to a substantial underestimation of actual demand. I therefore welcome the proposals to improve the accuracy of the current approach, i.e., attaching greater emphasis to projections over a two-year rolling period, the development of techniques to reduce errors in timing and the incorporation of an adjustment factor to reduce the upward bias of the current methodology.

In view of the need of the Fund to be able to meet its liabilities and the financing needs of members in weak external positions, it is important to have some indication of the adequacy of its resources. In this regard, I believe the liquidity ratio, as calculated at present, provides a good indication of the availability of Fund resources and should therefore continue to be used in reviews of the Fund's liquidity and financing needs.

Mr. Taylor made the following statement:

At this stage of the discussion, I will try to reflect on what has been said and written rather than repeat a lot of it. When I looked at the three preliminary statements last night, I had some sympathy for all of them, actually. The point that I particularly took from Mr. Sivaraman's paper was: "for the Fund the cost of overestimating liquidity exceeds the cost of underestimating it." With the perfect vision of hindsight, it is easy to criticize the experts for failure to forecast the future more accurately. If I were sitting in Mr. Williams's seat, I would feel that very acutely. A number of other Directors have made the same points, such as Mr. Donecker and, of course, Mr. Guzmán-Calafell and some others.

At the same time, in the end, this has to be a matter of judgment and degree. I think both Mr. Shields and Mr. Newman have made a number of points, supported by a number of other speakers, that seemed to me to be pretty well argued and pretty well taken. As the newest boy on the block, I am a bit reluctant to declare a position in too much detail, but my sense of this is that there is somewhat too much conservatism, and too much rigidity, and not enough transparency in what is going on. Just to give one example of that, I thought what Mr. Wijnholds said at the beginning of the discussion about the inclusion of currencies—that is, that access to capital markets should be very much part of the overall picture; that terms of access and stability of access should have more weight—is a point well taken, as is that there should be more fluidity in the inclusion and exclusion of currencies and generally somewhat more qualitative judgment involved. I think that would be a better approach than trying to rely on automatic indicators as such. I think you could probably draw similar examples, as some other people have, in other parts of the exercise. But rather than go on with that, I would like to make a different point.

As a new member of the Board, I am a little bit disturbed by the strength of the language in a couple of the statements. It seems to display a bit of a gap between some members of the Board and the staff—a bit more than I would have thought was desirable. I might be misreading that. I might be wrong about that. I do not know how much consultation there was in the long period that this paper was developed.

Mr. Newman's statement finishes by proposing revolution. I am not quite sure exactly how you propose to conduct the revolution. But this should be, as far as possible, a technical discussion, and I wonder whether there is not a case for some more technical discussion of a more informal character in reaching a final conclusion than perhaps is possible sitting around this Board.

Mr. Prader made the following statement:

The staff has provided a very informative paper on the methodology used in reviewing the Fund's liquidity and financing needs. It has illuminated the complexities of the process by which the staff predicts the supply of and demand for Fund resources, and gives us a new perspective for assessing trends in the Fund's liquidity position. The paper also contains several novel suggestions for improving the overall staff projections, which we fully endorse.

First, on the supply side, we support the suggestion to develop a range of quantitative indicators that would govern the inclusion or exclusion of a member's currency in the operational budget. Although it would only be used in conjunction with present methods, the new approach offers the possibility of improving the process by which the strength of members' currencies is assessed, and might help obtain more precise measurements of short- and medium-term trends in the Fund's liquidity supply. It could also provide a useful benchmark for countries that wish to self-evaluate their external positions. In this connection, we noticed that the paper on the operational budget for June–August 1997 already contains an annex on the selection of currencies for the budget that includes several of the indicators used by the staff to evaluate the overall strength of member countries. This is already what we expected would be one of the outcomes of today's review of the current methodology. We urge the staff to continue in this manner, and hope that our discussion of a paper on the role of automatic indicators in the methodology for assessing Fund liquidity will produce a similar adjustment in the staff's presentation.

The staff also needs to address the data issue. When we compared the data used for the analyses of 15 countries presented in Table 6 of the paper on the operational budget, with the data included in the designation plan, we discovered that six country analyses had been based on data older than the March 1997 claimed by the staff, with the data in one case even dating back to September 1995.

We also support developing a set of criteria for determining the adjustment factor in a more automatic fashion. The results of the staff's simulations presented in Figure 1 of the report on methodology are quite encouraging. We note that the implied adjustment ratios tend to be more stable if we increase the number of criteria used, although the level of the implied ratio itself ultimate depends on a parameter that is determined by judgment. Although we recognize the advantages of automatic procedures in terms of transparency, consistency, and systematic presentation, we also realize it cannot completely replace the judgmental factor in the staff's calculations. We hope that the paper on the role of automatic indicators will try to find the right balance between calculation and judgment.

The staff is also correct that the present method for forecasting the demand for resources is superior to the alternatives presented here. However, we feel that these alternatives were not always optimally designed. For example, the alternative models for projecting the liquidity ratio given in part B of Appendix II include only two naive models and some badly fitting trend models. Since these models incorporate only a very limited amount of information, it should not be surprising that the results are inferior to those produced by the existing method. The staff could have tried to develop alternative models incorporating some of the information on which the present procedure is based. The same remark applies to the probit model in Appendix III. The list of explanatory variables includes none which tries to capture what was described elsewhere as the most important element, namely signs that a member intends to start discussing a future use of Fund's resources. Here again, it is not surprising that the econometric model cannot compete with the present approach.

Despite the shortcomings of the proposed alternatives, the staff paper provides ample evidence that the present method of forecasting the demand for resources does not need to be drastically changed. But as in the case of the adjustment ratio discussed earlier, we feel that the right balance should be found between the use of the present approach and econometric techniques, with regression analyses playing a more supplemental role. Table 14 in Appendix III reveals that the margins of error of the staff's August projections for next year are comparable to those of the regression model used. That should encourage the staff as it continues its work in this area.

As for the liquidity ratio, the results of the staff's analysis point to a significant downward bias in all liquidity ratio projections, which results from the compounded effects of errors in projecting commitments and purchases. While we do not question the general usefulness of this ratio for indicating the availability of resources to meet the Fund's reserve tranche liabilities, we think that the presentation of its long-term trend needs to be viewed more cautiously. Once or twice the staff mentions "a persistent downward trend of the ratio." But if we look at Figure 3 of the document, which captures the period 1978–1996, we will see that this "downward trend" is difficult to find. Since the liquidity ratios for the period 1966–1978 had to be estimated using an adjustment factor as large as 30 percent, the question arises whether this period should be considered in our derivation of the long-term trend of the liquidity ratio.

Also, though the current definition overemphasizes the importance of this use of the Fund's resources compared to their more frequent use as balance-of-payments assistance to debtor countries, we wonder whether it would be worthwhile to develop such a ratio for the Fund in parallel to the existing ratio in order to correct for the current ratio's overemphasis on the real, but unlikely to be exercised right of creditor countries to use Fund resources.

One final remark. In questioning the liquidity ratio targets, a number of speakers have pointed to an increase in countries' access to the international capital markets. I wonder why this argument about increased capital market access was not considered more relevant when we were discussing possible reforms of the present distribution of the financing of the Fund's operational budget, and why so many countries with abundant access to the capital markets prefer to maintain the present distribution. Our problem is not with the way the Treasurer's Department manages the Fund's financing—in fact, it is pretty efficient and appropriately based on very conservative assumptions—but with those who have an interest in perpetuating a somewhat unfair distribution that is not consistent with our otherwise quota-based system. However, more transparency and more discussion can help advance the cause of reforming this imbalance in the Fund. For this reason, Mr. Newman's point about more transparency is well taken.

Mr. Saha made the following statement:

I would like to commend the staff for its comprehensive paper on the methodologies used to review the Fund's liquidity and financial needs. I broadly support this methodology. However, I recognize that it contains a significant judgmental factor and raises a number of issues that need to be addressed. Therefore, I would like to make the following comments.

The current methodology for determining the Fund's holdings of usable currencies appears broadly satisfactory. Indeed, the relevance of the factors to be taken into account in assessing the strength of currencies to be included in the operational budget remains appropriate. In particular, as mentioned in Table 1 of the staff paper, even in the context of more integrated financial markets, international reserves continue to be important in assessing a member's relative external strength. Nevertheless, I agree with the staff that greater attention should be given to developments in members' balance of payments and exchange markets in order to detect changes in members' external positions at an early date. Moreover, given the increasing difficulties involved in the current assessment process, I would support greater use of quantitative criteria to enhance transparency.

I agree with the staff that a downward adjustment in the calculation of usable currencies is justified. However, a question remains as to whether the size of the present adjustment factor is appropriate. This is all the more important in the present context, where remuneration payments are mostly made in SDRs and the Fund has no outstanding borrowing. Therefore, I would welcome a further assessment of the adjustment factor, with a view to reducing its size below 20 percent. I agree with previous speakers that there is a need to reduce working balances to a minimum.

Turning now to the projections of the demand for Fund resources, I note that for liquidity purposes a country-by-country assessment, weighted by subjective probabilities, is superior to other possible techniques. However, the systematic tendency to overpredict purchases, which has resulted in an underestimation of the liquidity ratio, is a cause for concern. Therefore, I welcome the staff's proposal to improve the projections on the use of the Fund's resources through the adoption of a two-year rolling period and greater efforts to reduce errors related to the timing of programs.

I agree with previous speakers on the need to reduce the bias in the projections for purchases. A reduction factor commensurate with the average errors made in recent years would be more reassuring than a 10 percent reduction factor. I would appreciate the staff comments on this point.

I welcome the clarifications provided in the staff paper on the calculation of the liquidity ratio and its usefulness. It would be useful to develop additional indicators that could help enhance assessments of the Fund's financial situation.

In conclusion, forecasting is a very difficult exercise. While continued improvements in the current methodology used to calculate Fund liquidity are always desirable, it is important to err on the side of caution.

Mrs. Coronel made the following statement:

We find that most of the ideas suggested in the staff paper are innovative and could be helpful to improve the accuracy of the review of the Fund's liquidity and financing needs. We agree that the methodology currently used by the Fund involves some subjectivity in the calculation of each component of the liquidity ratio, but—like other speakers—we would add that judgmental considerations would persist even if we decide to introduce a greater deal of quantitative analysis in the measurement of liquidity, and we find this obvious because any criteria ought to be applied with flexibility and caution.

Having said this, we believe that the use of more transparent procedures and less reliance on gross adjusters would result in better projections of the Fund's liquidity position and financing needs.

Going into the different calculations analyzed in the paper, we agree that the development of some relatively simple but relevant criteria to determine the inclusion or exclusion of a member in the operational budget, to be used in conjunction with the current approach, would be useful. The role of capital movements in the balance of payments as well as the position of credit ratings are elements that have been gaining importance over time, and that should be included in the calculations. We would favor further work by the staff on the development of these or other criteria so that the Board could have the opportunity to discuss the details further. At the same time, we would like to support Mr. Newman's position about the need for a greater role for the Executive Board in the process of assessment of the currencies to be included in the operational budget.

A more systematic application of agreed quantitative criteria in the determination of a member's relative strength could complement the current use of the adjustment factor. In this way, we could try to find a more appropriate balance between calculations and judgment.

Regarding the demand for Fund resources, we would support the idea that projections should continue to be based on a country-by-country assessment, and that the aggregative approach would have some usefulness only to check the accuracy of the projections. The staff's intention to give greater emphasis to the projections over a two-year rolling period rather than for a period which varies between 16 and 22 months seems reasonable.

We are not yet convinced, however, of the recommendation to adjust the projections of purchases by incorporating a reduction factor, by up to 10 percent of the projections of purchases, to account for the possibility that undrawn balances may remain when current or prospective arrangements expire or are canceled. While in the past there has been a systematic overestimation of purchases, we are not sure that this somewhat arbitrary adjustment would improve the quality of the projections. Until a more convincing technique could be developed by the staff, perhaps it would be better to continue to err on the side of caution.

As to the liquidity ratio, we believe that it is an appropriate indicator of the adequacy of the Fund's resources to meet its potential demands, and, therefore, we see no need to introduce modifications to its current specification. Nonetheless, we would not have a problem in accepting, in addition to the current liquidity ratio, the introduction of another indicator that relates the Fund's usable resources to projected commitments and purchases under programs or encashments of reserve positions.

Finally, I would like to support Mr. Cippa's requirement for a staff analysis on the appropriate level of the Fund's liquidity ratio in the present circumstances.

Mr. Zoccali made the following statement:

We are grateful to the staff for the clear description of the methodological issues involved in projecting the supply and demand of the Fund's usable resources.

Regarding, the supply of resources, the current approach has the appearance of being backward looking and centered on the most recent level and changes in a member's gross international reserve position.

Given the more widespread use of flexible exchange rates, the wider array of exchange rate regimes, the broader access to international capital markets and the increased role of private markets, the determination of strength for inclusion of a specific currency in the Fund's operational budget justifies a broader interpretation of Article V, Section 3(d) and makes resorting to judgment as well as the introduction of a consultative element inevitable.

The difficulty with the current methodology for currency selection lies in reconciling the minimum of transparency needed for a Board decision with a robust determination of "sustainable strength" in a member's external position. In this regard, it is difficult to envisage a credible projection of supply of usable currencies that is not based on a country by country analysis. At the same time, operating on the basis of a set of fixed indicators or norms to automatically trigger a presumption of inclusion or exclusion of a member's currency in the operational budget would be unnecessarily restrictive and possibly even counterproductive.

The criteria presently being used by the staff to determine usable currencies is not always clear. Table 6 of EBS/97/87 "Relative External Indicators of Selected Members" provides some historical and prospective data for 17 members, which are not in the group of 30 countries judged sufficiently strong for inclusion in the designation plan and in the transfer side of the operational budget for the quarterly period June–August 1997. On the other hand, Tables 1 to 3 in EBS/97/85 provide historical international reserves data with differing degrees of currentness for all members. A cursory reading of the two tables would lead to contradictory conclusions, for example in the case of Thailand which was reported on in our recent country matters meeting.

This situation, therefore, suggests the usefulness of a more explicit presentation to the Board of the indicators of strength which the staff actually uses for inclusion in conjunction with the judgmental approach under the current methodology. In addition to the criteria mentioned by the staff in paragraph 10 of EBS/97/60, the member's exchange rate regime (fixed or variable), the level of domestic public debt and the depth of the domestic financial market, the degree of access to international capital markets and the openness of the capital account should also be explored. The use of members' credit ratings for this purpose, however, could create a perverse incentive for countries which may be excluded at a given point in time and which are making strides in restoring creditworthiness. A commercial credit rating, in our view, cannot substitute judgment derived from firmer Fund surveillance.

Although the size of a minimum working balance for each usable currency could in some cases be seen as somewhat excessive, the concept and the application of an adjustment factor have served the Fund well. Moreover, the staff make a clear and convincing case based on experience showing that the adjustment factor is not as large or arbitrary as suggested. Nevertheless, we would be amenable to reviewing it closer to the European monetary unification, in view of the importance of this structural change for the supply of Fund usable currencies.

With respect to the projection of the demand for Fund resources, we support maintaining the country-by-country approach, supplemented by periodic consistency checks of aggregate financing needs based on the World Economic Outlook updates. While the World Economic Outlook projections are themselves subject to uncertainty, its baseline scenario has the advantage of providing the medium-term perspective, that almost seems absent from our liquidity reviews. We would not favor the circulation of any negative list of countries singled out for prospective use of Fund resources based on probability weights as this would de facto convert the Fund into a rating agency. Adoption of the proposal to move to two-year rolling periods for estimates would give further assurance that the projections would remain superior to the more aggregate approach or to the results derived from application of econometric models, given the well-known shortcomings of such techniques.

The Fund must be prepared to meet potential demands in the new environment of sizable capital movements, integrated financial markets, and rapid propagation of shocks. Like Mr. Sivaraman and other speakers, we consider that the costs for the international monetary system of underestimating future liquidity needs far exceed those associated with a possible overestimation of the call for Fund resources. In addition, short-run liquidity motivations should not lead to the promotion of early repurchases. Member country authorities should be given confidence that adjustment programs supported by Fund resources, often involving substantial and prolonged fiscal retrenchment as well as deep structural reforms, will not give rise to unanticipated unilateral changes in repurchase terms. The Fund should avoid penalizing, through its policy on early repurchases, member countries for good performance or give signals that it is less concerned with countries' medium and long-term financial solvency.

Regarding the liquidity ratio, while we would have welcomed a further explanation of what constitutes the appropriate level of liquidity for the Fund in the present circumstances we, nevertheless, share the staff's views that it is a reasonable indicator of adequate usable resources to meet the encashment of liquid claims and potential demand. Rather than concentrating on the merits of point value estimates of liquidity, the usefulness of this ratio should be found in its medium-term trend behavior, as pointed out by Mr. Donecker.

Reserve tranche positions should continue to be treated as Fund liabilities in order to preserve the integrity of the Fund's monetary character. The introduction of the concept of probability weighted use of reserve tranche positions would alter the basic definition of international free reserves and, in our view, only serve to create doubts regarding the availability of reserve tranche positions in the future.

In conclusion, we see scope for improving the methodology for reviewing the Fund's liquidity and financing needs by enhancing the transparency of the current process, by giving greater emphasis to projections over a two-year rolling period and by working-in the concept of ranges instead of point forecasts. The bottom line, however, is that the exercise will need to resort to judgment in order to serve its purposes. We would not be comfortable with a process for determining the strength of members' external financial positions based solely on automatic triggers for inclusion or exclusion of currencies in quarterly operational budgets. Such an approach would be tantamount to ignoring the privileged information afforded to the Fund in the exercise of its surveillance responsibilities.

Mr. Rouai made the following statement:

On the issue of assessment of member's currency strength for inclusion among usable assets, my preference is for the continuation of present practices based on the assessment of the balance of payments, reserves position, and developments in the exchange markets. This method could be further enhanced by including some selective criteria to trigger the presumption of inclusion, or exclusion of a member's currency in the operational budget. However, the application of such criteria should be flexible, and I look forward to specific staff proposals on this issue and to the review of guidelines on early repurchases.

With regard to the application of adjustment factors to total usable resources, I have the following comments.

On committed resources, I have no problem with the method applied in the existing operative or inoperative arrangements. Regarding precautionary arrangements, I consider the ratio of 50 percent, by which undrawn balances are reduced, to be on the low side. I could support a higher ratio, for example 75 percent. On a related issue and in order not to penalize countries that are willing to embark on precautionary arrangements, I wonder if the staff could comment on the possibility of reducing the commitment fee levied on such arrangements.

On the adjustment factor, I could support a lower ratio for working balances than the current ratio of 10 percent. Could the staff comment on the impact on the adjustment factor of the planned euro introduction? My understanding is that after the introduction of the euro, there will be a lesser need to hold working balances for participating European currencies.

With regard to the methodology applied to project demand for Fund resources, I agree with the staff's conclusion to maintain a country-by-country approach. I can also support any proposal that could improve the forecasting exercise, including the recommendation to reduce projected purchases, although I could support a higher than the 10 percent adjustment factor proposed by the staff.

Finally, the liquidity ratio, particularly its trend over the medium to long term, remains a good indicator of the adequacy of Fund's resources. I do not see a need for a fundamental change at this time.

Mr. Han made the following statement:

I join previous speakers in thanking the staff for its informative paper on this important subject. It is very important for the Fund to have a very clear idea about its financial structure in order to carry out its responsibilities according to its mandate. We are principally in agreement with the main thrust of the staff's findings and analyses. I would like to make brief comments for emphasis for today's discussion.

We believe that the use of the current liquidity ratio continues to provide the Fund with a practical indicator of the possible adequacy of the Fund's resources, and the current long-term average liquidity ratio of 70 percent is an appropriate target. While the availability of borrowing windows has created possibilities for the Fund to avail itself of supplementary financial resources in exceptional circumstances, those mechanisms should by no means be regarded as substitutes for its quota-based resources. Therefore, the Fund's liquidity position should be maintained at its current level.

The Fund's liquidity ratio reflects developments in the demand for and the supply of the Fund's resources. There is a crucial need to ensure the adequacy of Fund liquidity if it is to play an active role in the stabilization of the international financial system and help ensure the current and prospective strength of its members' external accounts.

While there is no evidence to indicate that a globalized economy will lead to a lowering of the demand for the Fund's resources, the globalization of capital markets may tend to increase the uncertainties facing the monetary authorities of member countries, because movements of capital are influenced by various factors. It is necessary for the Fund to hold sufficient usable resources to help members meet the challenges associated with the movement toward greater capital account convertibility.

The concentration of the Fund's resources in a specific group of members emphasizes the need to improve the Fund's financial structure and the need for the Fund to keep additional resources available. Even if proper consideration is given to the balance of payments requirements and the strength of the adjustment programs on the part of the member countries, there is still a need for the Fund to be financially strengthened. The Fund is also expected to assist its members in cases of financial emergency, especially when systemic implications are involved. Therefore, we support the cautious approach currently employed by the Fund in projecting the possible demand for Fund resources as it leaves appropriate room for unexpected and unforeseeable demands. However, in light of recent experience, we encourage the staff to make further efforts to develop techniques to reduce the errors between the projections and the drawings under Fund arrangements in order to raise the efficiency of the management of Fund resources.

In conclusion, we do not see a good case for changing the liquidity ratio into an indicator of the availability of resources to cover only expected needs under financing commitments over a three-year period. We regard the current specification of the ratio as reasonable.

Ms. Srejber made the following statement:

I would like to start my statement by commending the staff for having produced a paper that in a clear and instructive way presents the rather technical methodology presently used for assessment of the Fund's liquidity and financing needs. In particular, I welcome their frank and open comparison of estimates and actual results.

The appendices reveal that the staff's estimates for the period 1985–1996 have been biased and, as Mr. Newman points out, this finding would have been even more obvious had the Mexican case in 1995 not blurred the picture. This should, however, come as no surprise, taking into account that we all agree that it is better to err on the side of caution. It should also not be a matter of great concern if forecasts were only modestly biased or if the risk factor included in the estimates were small, well known, or stable over time. I am, however, not convinced that these requirements are met. Mr. Sivaraman and I had a look today at pages 29 and 45 in today's paper and, compared with the figures provided in EBS/90/60, it seems as if the margin of error is increasing over time from the earlier 4–5–6 percent to the present much higher level.

This raises some rather important questions on whether the system needs a major overhaul in order to serve its purpose or if it is enough to refine the system. The staff paper touches rather lightly on these important questions. Other speakers have suggested interesting complements to the liquidity ratio.

First, there is the issue of the need to reduce the very large element of subjectivity involved in the forecasting process. Under the present system the staff makes assessments on which currencies are deemed sufficiently strong to be included in the operational budget, assessments that are, to a large extent, subjective, and we have several times recently been reminded of the subjectivity of these assessments. Then the staff makes subjective estimates on the demand for Fund resources, and then applies several corrective adjustment factors which all are of a subjective nature to add some extra cautiousness to the estimates.

The bottom line of all these subjectivities and cautiousness is that we get estimates with a rather broad confidence interval.

Second, there is the issue on how to introduce more transparency into the system. Even if we should be able to reduce the level of subjectivity in the present system, its construction means that it will continue to be heavily dependent on subjectivity assessments by the staff. The important issue is then, as others have said, that the basis for the staff's assessments should be clearly spelled out so that—as Mr. Newman phrases it—those with the ultimate responsibility for final decisions have a meaningful role in the assessment process.

Third, there is the issue on whether the staff's cautiousness is stable over time. I am unable to read this from the staff paper, but it is tempting to speculate that some human factors may influence the forecasting so that the subjective safety margin added to nonbiased estimates tends to vary over time.

These issues, combined with a belief of mine that the increasing globalization of capital markets makes the present criteria less relevant as an indicator of the ability of a country to contribute to the Fund's operational have convinced me that we should strive for a larger change of the system rather than only minor refinements of the forecasting methods.

Let me now add some specific comments to the present methodology.

On supply estimates, so far, the main factors determining staff estimates have been changes in individual countries' reserve levels. This is true even if the importance of several other factors like exchange market developments, current account prospects and capital account factors gradually have increased. The quality gained by including more factors has, however, been at the expense of less transparency and more subjectivity.

The reserve position as an important criterion has probably lost much of its actual value as an indicator of financial strength, but it still has a strong symbolic value on financial markets. It might however be argued that strong economies have ample opportunities to raise reserves in international capital markets should need arise, and that all things being equal, countries with low access to capital markets would need to keep more reserves than countries with high access and good ratings. This would lead to the assumption that countries with higher ratings rather than lower should be included in the budget, but other speakers have pointed to the problems for us using ratings as one criterion. A possible way to improve the process might be to introduce as one indicator the ability to borrow in international capital markets at or below some threshold interest rate, say, LIBOR + x basis points. To secure some stability in Fund financing, countries should only be deleted from the budget when their borrowing rate exceeds another and higher threshold. Admittedly, there are several problems related to such a system, both with regard to choosing the threshold and also with regard to the treatment of countries which are not active in international capital markets. I would nevertheless like to raise the idea, and would be interested to hear the staff's views on this.

The use of adjustment factors in the budget seeks to take account of two separate considerations; first, a perceived need to maintain adequate working balances for all countries and, second, to guard against the risk that one or more strong currencies are deleted from the budget. Gradually, the adjustment factor has been changed from 40 percent in 1980 to 20 percent now. I agree that the reduction has been warranted, but even if the staff has informed about changes in the adjustment factors, comparison over time of the liquidity ratio is hampered by these changes as already mentioned by Mr. Prader. Given the subjectivity of these factors, I would prefer a system where unadjusted supply estimates are supplemented by written assessments of additional risks. Such assessments would facilitate the Board's assessment of risks involved.

On demand estimates I agree with the staff's finding that the country-by-country approach gives better estimates than alternative aggregate approaches presented to us. The relatively substantial bias toward overestimating demand makes it, however, important to supplement the present method of country-by-country estimates by some aggregate approach as a general check against the projection of demand obtained from the country-by-country approach. As pointed out by Mr. Prader, the aggregate approaches could be developed considerably. There is also a strong need to improve the way the estimates are presented to the Board, with a special view to the need to emphasize and spell out subjective assessments that are made.

Finally, the problems demonstrated both with regard to making reliable supply and demand estimates should be used as a warning against attaching too much significance to the level of the liquidity ratio or to changes in it when assessing the need for a quota increase. The need for a quota increase should, as expressed well by Mr. Donecker, be seen in a medium term context and involves a political decision on the role and the size of the Fund. The view of this chair is that the Fund should be well-capitalized.

Mr. Mozhin made the following statement:

I have read with interest the paper on the methodology used in reviews of the Fund's liquidity and financing needs. Even if today's discussion does not lead to significant changes in methodology, it will still be a useful step toward better understanding our ability to forecast the Fund's activities.

Let me begin by offering several comments on projecting the demand for Fund resources.

The errors in projecting the demand are largely determined by a few cases where the amount of resources involved in the programs is large. During the most recent review of the Fund's liquidity position this chair pointed to the need for an increased role for sensitivity analysis. The staff may wish to use its expertise for more than assigning the probability to specific disbursements. Indications for the most likely range for demand could benefit Board discussions. If any particular, well defined events might significantly affect the demand for Fund resources they should be described in the forecast in greater detail.

The staff claims that the switch to two-year rolling periods, as opposed to the current practice, may improve the projections. I do not think that the elimination of the forecasts for shorter periods would improve the quality of projections, but it will certainly limit the amount of information available for discussion by the Board. Therefore, I am hesitant to agree to any changes in the established practice.

Overall, I tend to agree with the staff that the currently used approach to forecasting the demand for Fund resources is preferable to the econometric techniques explored in the paper.

Let me now turn to several comments on the supply of usable resources and the liquidity ratio.

Several Directors question the size of the adjustment factor. I found the three illustrations presented by the staff on pages 13–16 rather interesting, especially the stability discovered in the implied adjustment factor. At the same time, the staff admits that the assumptions underlying these illustrations were rather arbitrary. One question I have is about the use of the basket of 62 currencies as a starting point. It hardly corresponds to the number of currencies actually used in the operational budget, currently 32. Perhaps, the basket of currencies used in the staff's simulations could more closely resemble the actual one.

In fact, the staff proposes to develop some relatively simple quantitative criteria that could play a supplementary role in deciding on usability of a particular currency in the operational budget. I would support this initiative. This criteria could be used for illustrative purposes in the above mentioned simulations. And I would be open to discussing the practical use of such indicators.

Changes in the size of the adjustment factor or in the 10 percent limit for working balances of individual currencies directly affect the very definition of the liquidity ratio. And I am not sure if the revision of this definition is warranted and desirable. How would these changes affect our judgment on the liquidity position of the Fund? Are we going to revise the time series for the liquidity ratio going back to the 1980s or 1991? Are we going to put differently defined percentages on the same graph and claim that the liquidity position has improved? This chair has previously pointed out the problem with comparability of a liquidity ratio calculated with different adjustment factors. In reviews of the liquidity position and financing needs, the staff routinely compares the liquidity ratio based on a pre-1991 adjustment factor of 25 percent with one based on 20 percent. Any change in the definition of the liquidity ratio should necessarily lead to a revision of the time series, otherwise comparisons of different periods lose their meaning. We cannot speak of a meaningful persistent trend in the liquidity ratio or the long-term average of 70 percent if we do not have consistent definitions of this parameter.

I view the paper prepared by the staff as a very useful one. I hope today's discussion can lead to improvements in methodology as well as to a better understanding by the directors and the staff of the inevitable limitations of our semiannual reviews.

Mr. Grilli made the following statement:

At the very start we want to state our bias in the direction of adequate capitalization and liquidity for the Fund on grounds of prudence. The maintenance of a relatively comfortable long-term liquidity level is justified by the need to cope with the unexpected demands in addition to expected ones. At the same time, we do see the disadvantage of overestimating systematically the Fund's liquidity needs, as a result of less than fully adequate estimation methods, which has happened in the past. It is, therefore, with great interest that we have examined the paper before us, which has carefully explained the methodology used in reviews of the Fund's liquidity position and highlighted some of its weaknesses and some ways to remedy them.

We will make here only technical—methodological remarks, even if we are fully aware of the broader consequences and implications of technical judgments in this area. Let me make some comments in three sets of issues.

The assessment of "sufficient" strength of the currencies to be included in the operational budget. We understand the need to maintain an adequate level of flexibility in such an assessment and a central role for judgment in it, but we feel that some objective indicators can be used to integrate the current ways to assess "sufficiency." Indicators of members' balance of payments results achieved over time seem particularly relevant, among which we would put the structure of capital movements and trends in the ratio of current account balance to GDP, can assist in better assessing the strength of member countries' external positions. We look forward to staff proposals in this area.

Deductions from and adjustments to the total usable resources. We find it hard to justify several of the deductions and adjustments made up to now, on the basis of valid prudential considerations. Past experience shows that the deductions of undrawn balances of resources is a big source of underestimation of usable resources. The practice of not drawing from resources already available under operative arrangement appears to be more widespread than is envisaged in the current approach. The 10 percent the deduction from undrawn balances under existing and operative arrangements and the 50 percent deduction under precautionary arrangement are far too conservative. The latter, in particular, should be increased since the member country's intention not to draw, backed by the judgment of the Board that the arrangement is precautionary in nature, should yield better than even a chance of not drawing.

The current adjustment factor of 20 percent is too large for at least two reasons: 1) The inclusion in the factor of an element that takes into account the probability that a member's currency may not be usable over the period for which the Fund's liquidity position is being projected is over conservative, since the inclusion of a currency in the operational budget is made only after doubts about the sustainability of the member position are considered to be very small; 2) on the basis of the simulations made by the staff to determine the adjustment factor in a more automatic way (p.13, para. 20), the only significant results, i.e., those that assess the strength of a usable currency by jointly taking into account both the changes in reserves and in the exchange rate. These simulations yield an average implied adjustment factor of 17 percent. This result is obtained, moreover, despite a) the high (and admittedly arbitrary) discount factor used (50 percent reduction in the amount of currency usable by the Fund if member experienced a decline in reserves by 10 percent over

6 months period) and b) the fact that total amounts of currencies assigned for working balances plus the balances calculated as usable are taken, until now, as proportion of total usable currency holdings, i.e., automatically. To be recalled here is also the fact that minimum working balances are calculated on the basis of equal probability of demand for each currency, which is clearly overly conservative.

Projections on the demand for Fund resources. On this issue, we welcome the decision to keep the country-by-country approach, provided it is refined by appropriate checks on the accuracy of the projections. However, we wonder whether the proposal to pursue such checks on the basis of a simple aggregative approach based on a moving average of the ratio of purchases to financing requirements is really helpful, since the data on financing requirements are difficult to calculate and may be subject to considerable error. On the contrary, we fully support—in order to take into due account the fact that undrawn balances are very common—the notion that the projections of purchases should be adjusted for their generally systematic upward bias. The proposed reduction factor of 10 percent to the projections of purchases under existing and projected nonprecautionary arrangements goes in this direction, even if it is probably too small. On the same grounds, we also agree to make projections over a two-year rolling period of 24 months, rather than for diminishing periods within a fixed two-year cycle.

We have other, more detailed, comments on the paper, which we will discuss bilaterally with the staff.

Mr. Fremann made the following statement:

The conclusion of the paper is that it would be difficult to improve significantly the methodology of the Fund's liquidity review and that the professional judgment of the staff, in the Treasurer's and area departments, remains the best way to project the Fund's liquidity. This conclusion, in my view, applies both to the measure of demand for Fund's resources and the identification of the countries able to participate in the operational budget.

This conclusion is not surprising. As the staff has access to a wealth of internal information and is by nature well-equipped to identify risks, it would be awkward to replace its judgment with apparently scientific but less reliable methods. Furthermore, the periodic discussions of the Board act as an incentive for the staff to exercise its best knowledge and judgment. In this context, the calculations of automatic indicators could play a role but only as their divergences with a more judgmental approach can signal the need for further analysis.

On demand for Fund resources, I do not share the concerns of other Directors about the frequent overestimation of the demand for Fund resources as it is a welcome indication of the prudence of the staff and a guarantee that the Fund is able to accommodate unexpected events. As long as the current methodology does not entail a risk of underestimation, there is no major reason to change a robust practice. Nevertheless, I am open to some of the specific amendments suggested by the staff to the current methodology.

Conversely, on the resource side, I acknowledge that the question of the number of participants in the operational budget has some repercussion since inclusion of additional countries will reduce ipso facto the cost for other members. Nevertheless, I can understand why the staff is reluctant to include certain currencies prematurely in the operational budget or avoid, for practical reasons, too high a turnover of currencies. This could warrant, from time to time, a discussion within the Board. In this regard, the background annex on selection of members which has been included on the last operational budget review is a welcome improvement of our practice.

As regards the liquidity ratio, as other speakers, I think its relevance could be questioned. This is certainly true for short-term operational purposes. But, in addition, when considered as an indicator of medium-term adequacy of Fund resources, I share some of the views of Mr. Newman about its limited informational content. Indeed, the liquidity ratio could be seen as a "legal ratio" since it checks to what extent the liquid liabilities (i.e., reserve tranche positions) are indeed liquid. However, in order to assess the adequacy of Fund resources to meet prospective loan demand, we need to supplement the current liquidity ratio by additional indicators. In this regard, the proposal of Mr. Wijnholds deserves further attention.

The Treasurer said that the staff would immediately begin work on the development of additional quantitative indicators to be used in determining the strength of currencies for inclusion in the operational budget. It should be noted, however, that additional quantitative indicators could be used as a complement to, rather than a substitute for, the indicators currently used by the Fund in order to engage the Executive Board more closely in the selection process. Under the present system, the staff relied on the quantitative indicators called for under Article V, Section 3(d) of the Fund's Articles of Agreement and the guidelines on the use of currencies and SDRs in the General Resources Account—rather than subjective or judgmental considerations—to the fullest extent possible.

The practice of adjusting downward the Fund's total holdings of usable currencies in the measurement of Fund liquidity had, historically, been a matter for debate, the Treasurer commented. Prior to the 1970s, the Fund had successively underestimated its holdings of usable currencies and, thus, had had to resort to the General Arrangements to Borrow (GAB) on several occasions. The last time the Fund had resorted to use of the GAB, it had been to provide for a reserve tranche purchase. To the extent that the international financial system had relied primarily on flexible exchange rates at that time, reserves arguably should not have played a significant role in assessing the strength of individual currencies. Nevertheless, the burden of fluctuations in international market conditions had fallen largely on exchange rates. At one point, only six participants in the GAB had had currencies that were usable, and the Fund had had only limited holdings of those currencies. Thus, the Fund had found that it could never be completely confident that the currencies in the operational budget would remain usable for an extended period, or that currencies would be able to enter into or exit from the operational budget smoothly. That experience had given rise to the use of the downward adjustment in calculating the Fund's total holdings of currencies and the Fund's liquidity position.

The current discussion was timely, the Treasurer considered. There was a need to consider whether—and the extent to which—recent developments in the international monetary system, particularly those stemming from the globalization of markets, called for changes in the methodology used in reviews of the Fund's liquidity and financing needs. For example, could the globalization of markets justify eliminating the downward adjustment used to take into account possible adverse changes in members' balance of payments and reserves positions, which could negate the use of their currencies in the Fund's operational budget? Given the experience prior to the 1970s, a move to eliminate the downward adjustment in calculating the Fund's holdings of usable currencies would call for the use of more stringent, rather than less stringent, criteria in the selection of currencies for inclusion in the operational budget.

Caution should be used in considering the appropriate size of the minimum working balances for each currency, the Treasurer stated. Although remuneration payments were currently being made almost entirely in SDRs, and the Fund had no outstanding borrowing, that situation could change. Also, although no country had recently requested drawings in specific currencies, under Article V, Section 3(d), it was important to remember that the last time a country had done so, the Fund had had to resort to use of the GAB to respond to the request. Moreover, it was not yet clear how developments in Europe with respect to the establishment of the euro in 1999 might impact on the Fund's liquidity position.

Directors had raised a number of useful points for consideration related to the methods used to project the demand for Fund resources, the Treasurer noted. The staff would try to follow up on those points in continuing to develop aggregative approaches, including econometric analyses, that could be used to complement the staff's country-by-country approach. The current country-by-country approach had evolved as a result of close collaboration among the staff of area departments and the Treasurer's Department. Experience showed that the projections were far more accurate with respect to the amounts of expected purchases than with respect to their timing. Thus, the adoption of a two-year rolling projection period should go a long way toward improving the accuracy of projections on the demand for Fund resources.

The suggestion for the staff to prepare a list of countries that might be expect to draw on Fund resources within a two-year period could give rise to difficulties, the Treasurer commented. Most of the indications from members concerning possible requests for the use of Fund resources were made informally, at least in the initial stages, and often on a highly confidential basis. Moreover, the actual amounts of access that might be involved in individual arrangements were not determined until the economic adjustment programs concerned were nearing completion. Thus, soliciting departments for such information prematurely could prove to be counterproductive, to the extent that area department staff might tend to either withhold information that had been received on an informal or confidential basis or overestimate likely access. Nevertheless, the staff of the Treasurer's Department would consult with the area departments in an effort to obtain more detailed information for use in estimating Fund liquidity. The staff paper for the current discussion, which was based on the projected use of Fund resources by geographical areas, showed that countries with large quotas and, thus relatively large amounts of potential access, could have a significant impact on the overall demand for Fund resources. In that respect, it would be more appropriate for the Board to make judgments concerning individual countries than it would be for the staff to provide a list of individual countries that had indicated an intention to make drawings on the Fund along with probability factors determined by the staff.

The assessment of the Fund's liquidity position was dependent on both the measurement of its usable or "liquid" assets, based on currencies in the operational budget, and potential demands, including the need to "back" members' reserve tranche positions and provide for Fund arrangements, the Treasurer stated. In that respect, the liquidity ratio was not intended as a trigger for any policy actions, although it could serve as a warning signal to the Board by indicating whether or not the Fund would be in a position to finance the expected demands on its resources over the medium term or to respond to unexpected shocks in the international monetary system. The liquidity ratio had never been used to trigger reviews of Fund quotas. General reviews of Fund quotas took into account a much broader range of indicators, such as the size of the Fund in relation to that of the world economy and whether or not the present distribution of quotas adequately reflected members' relative positions in the world economy.

Ms. Srejber recalled that the staff paper for the current discussion indicated that the assessment of a currency's strength was based on the member's balance of payments and reserve position and developments in the exchange markets. However, it also explained that weaknesses in one of those areas could be compensated by strength in the other. In weighing those factors together, did the staff base its final assessment on some sort of equation or on the use of judgment?

The Treasurer responded that the staff focused its assessment on members' balance of payments positions and the current levels and changes in their gross reserves. To that extent, the assessment was based largely on quantitative indicators. However, the analysis was comparative in that it involved a ranking of members. As the staff moved further and further down the list of members in order of their gross reserves positions in relation to Fund quota, imports, and other current payments, the assessment of strength became less certain and more judgmental. The development of additional quantitative indicators would help to engage the Board more closely in weighing the relative strengths and weaknesses and in coming to a collective judgment on the selection of currencies for inclusion in the operational budget.

Mr. Shields considered that some use of judgment was inevitable in the selection of currencies for inclusion in the operational budget. Directors had clearly expressed the view that the Board should have a greater role in the selection process. Most Directors had also agreed that the downward adjustments made in calculating the Fund's total holdings of usable currencies should be smaller.

Mr. Newman said that, although the role of the liquidity ratio in providing creditor countries with assurances about their claims on the Fund was clearly important, its merit as a basis for judging the overall adequacy of Fund resources was questionable. He wondered whether the staff could comment on the possibility of using other measures of Fund liquidity.

The Treasurer responded that the staff would examine the possible use of other benchmarks for Fund liquidity, such as the relationship between the Fund's holdings of usable currencies and changes in world trade, or the Fund's holdings of usable currencies in relation to payments imbalances. However, experience suggested that the current methodologies had served the Fund well thus far, especially in terms of providing assurances that the Fund could back members' reserve tranche positions. While the liquidity ratio was not intended to trigger any specific policy actions, it had played a useful role as an indicator of the Fund's ability to meet the demands that might be placed on it over a given period. The liquidity ratio did not, however, underlie a judgment as to the adequacy of Fund quotas, which needed to be looked at in a medium-term context.

Mr. Newman suggested that the staff consider using a comparison of usable assets with projected commitments within a given period as a means to complement the Fund's existing liquidity ratio in assessing the Fund's financing needs.

Ms. Srejber said that she supported Mr. Newman's suggestion. A more transparent system was needed to make it easier for the Board to form its own judgments about the adequacy of Fund liquidity.

Mr. Shields noted that there was a tendency in the Fund to focus on the long-term average liquidity ratio of 70 percent as a benchmark to be maintained at all times. However, in the current circumstances, it was clearly unlikely that a large number of members would simultaneously make drawings on their reserve tranche positions. Therefore, he wondered what level of Fund liquidity the staff would consider desirable at the present stage.

The Treasurer stated that the long-term average liquidity ratio of 70 percent was just an average; the actual level of Fund liquidity had varied between ratios of 35 percent and ratios of 170 percent in the past. Determining an optimal liquidity ratio was an extremely difficult and subjective exercise and was of doubtful relevance in the Fund's operations. While it would be important over the period ahead to ensure that the Fund would be able to back members' reserve tranche positions—as some Directors had emphasized—it would also be important to ensure that the Fund would be in a position to meet additional or unexpected demands on its resources. Given recent developments in the world economy, including the increased mobility of capital, changes in capital markets, and the greater possibility for unexpected financial market shocks, it might be desirable for the Fund to maintain a higher liquidity ratio, say, on the order of 90 percent, but obviously this could not be regarded as an operational floor, rather it could be a warning sign regarding the trend in the Fund's liquidity position.

Mr. Donecker noted that the liquidity ratio could only pinpoint the status of the Fund finances at a given point in time. In that respect, it could not be used an accurate indicator of the adequacy of Fund resources in the context of general reviews of quotas, which covered a fairly long period, of five or more years. Nevertheless, the liquidity ratio was a fairly reliable indicator of short-term trends in Fund liquidity, which could guide the Board in assessing the adequacy of Fund resources for specific periods.

The Acting Chairman said that, for the current discussion, Directors had placed strong emphasis on the need for greater transparency in the selection of currencies for inclusion in the operational budget. Two major considerations seemed to guide countries' positions on whether or not they wanted their currencies included in the operational budget. On the one hand, inclusion in the operational budget was expensive; on the other hand, it carried a certain amount of prestige. A shift seemed to have taken place between those two considerations over recent years. While, in the past, many countries had not wanted their currencies included in the operational budget, owing to the expense involved, some now seemed to want the prestige associated with inclusion. Countries' positions also could be guided, at least to some extent, by the actions that were taken with respect to other countries. For example, a country had once indicated to management that it wanted its currency included in the operational budget because the currencies of some other countries had been included; however, that country otherwise would not have wished to bear the costs associated with the use of its currency in the operational budget.

Against that background, it should be borne in mind that greater transparency on the part of the staff would tend to shift the burden of taking decisions regarding the selection of currencies to the Board, the Acting Chairman considered. That would, in turn, require the Executive Board to make very frank comments on the relative strength of individual currencies. The need to take decisions of that type could make the Board, in effect, act as a rating agency. While it was important to clearly explain the factors used in the selection of currencies for inclusion in the operational budget, it was also essential to ensure that the Fund would have sufficient liquidity to meet the demands placed upon it.

In assessing Fund liquidity, there was a need to take into account not only likely events, but also events that were not immediately probable, the Acting Chairman noted. Although the probability that Fund liquidity would fall below acceptable levels in any given period was low, the costs such an event would entail were very high. Those costs underlined the need to take into account the possible emergence of unforeseen events, such as the Mexican crisis. In that context, it was worth recalling that for 20 years prior to 1995, the forward markets had been criticized for overpredicting the possibility of a peso devaluation. The question of how the probabilities of such events could be included in econometric models remained unanswered. Indeed, if taken over time, it was not clear that the staff's forecasts regarding possible demands on the Fund were biased. Although only one event such as the Mexican crisis had occurred in recent years, the debt crisis of the early 1980s had placed extremely heavy demands on the Fund and, at that time, it had had far too little liquidity by any estimate.

All of those considerations should be carefully examined in deciding whether it was better to opt for maximum transparency on the part of the staff with tough decisions to be taken by the Board, or to opt for allowing the staff to make the necessary judgments in ways that were trusted, because the bases for those judgments were as clear as possible in light of the complexities involved, the Acting Chairman said.

Mr. Shields noted that the projections currently prepared by the staff provided useful indications of the usual demand for Fund resources that might be expected in fairly normal periods. Although there was always a risk that something unexpected, in terms of a systemic shock, could happen, it might be reasonable to take that risk into account in a different way. For example, it might be appropriate to have a forecasting procedure for dealing with the possible need for a quota increase that would take into account the normal demand for Fund resources, but also allow for the possibility of unforeseen shocks. In that respect, it was appropriate for the Fund to err on the side of caution in assessing the adequacy of Fund liquidity. However, it was necessary to avoid a system that would continue to add incremental allowances for unforeseen shocks over time, without standing back occasionally to look at the system as a whole. Although it was important for the Fund to be able to handle crises, there were mechanisms—other than permanent increases in quotas—like the GAB and, more recently, the New Arrangements to Borrow (NAB) that the Fund could use in dealing with such unforeseen events. While those mechanisms could not substitute for quota increases, their availability to the Fund should be taken into account, especially as the GAB and the NAB were devised specifically for the purpose of addressing large, unforeseen shocks. There was no need for the Fund to double or treble its projections on the possible demand for Fund resources in order to allow for all possible risks.

Mr. Newman commented that he agreed with the Acting Chairman on the risks involved in moving toward greater transparency. However, under the current methodologies, the staff was, in effect, acting as a rating agency, and Executive Directors based their recommendations to national authorities concerning the adequacy of Fund resources and/or the need to replenish its resources on the staff's findings. It was important for those who had the responsibility to advise national authorities to also take responsibility for the selection process and the tough decisions that might entail. The fact that greater transparency would likely force the Board to take tough decisions should not lead Directors to abdicate their responsibility to be directly involved in the selection process.

Mr. Wijnholds considered that the Acting Chairman had provided a good summary of individual countries' motives for wanting their currencies either included or excluded from the operational budget. The somewhat contradictory considerations involved could confront the Board with many delicate judgments. However, the fact that the balance in countries' considerations was weighing more toward the desire for prestige might help to reduce the burden on the Board, at least to the extent that it should be easier to include more currencies in the operational budget, which would be desirable in itself. Of course, countries might have a tendency to place too much weight on prestige factors. In such cases, the Board could, on fairly short notice, determine that a currency was no longer sufficiently strong to be included in the operational budget. There was clearly a need to make the process of entering into and existing from the operational budget more fluid and less dramatic. By clarifying the issues at stake, greater transparency should facilitate that goal.

The Acting Chairman made the following concluding remarks:

> Executive Directors welcomed the opportunity to review the methodology used by the staff in making its periodic assessments of the Fund's liquidity position and financing needs over the medium term. Directors noted that this was the first review of this topic since 1990. The period since then had witnessed major changes in the functioning of the international monetary system, in particular the increasing globalization of markets and the increased role of private capital markets in balance of payments financing for both creditors and debtors. It was, therefore, generally agreed that an updating of the methodology followed by the staff in measuring the Fund's liquidity position was overdue.
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> Most Directors focused attention on the procedures followed by the staff in determining the total of the Fund's usable currencies. That aspect of the liquidity methodology was, of course, closely connected with the selection of currencies for inclusion for net transfers in the operational budget and depended fundamentally on the assessment of members' external financial strengths. Formal criteria to be used in making that assessment had been introduced in the Articles through the Second Amendment in 1978, and the staff had basically relied on a few essentially quantitative criteria in making its assessments since then. Those assessments were the basis for consultations in the Executive Board concerning the inclusion of currencies in the budget. Most Directors agreed to further explore whether the current procedures followed by the staff should be supplemented by a wider range of indicators that would bear on an assessment of members' external financial positions. Several Directors, while agreeing to consider the possible use of such indicators,

emphasized that an element of judgment would necessarily be involved in the final assessment. Those Directors felt it would be useful for the staff to produce a short paper outlining a number of such indicators and the way in which they might be used in the assessment. The staff will issue such a paper in July for consideration prior to the Board discussion on the next operational budget in late August for the period September to November 1997.

Many Directors commented on whether downward adjustments should be made in the assessment of the stock of usable currencies apart, of course, from taking into account existing undrawn commitments of resources under current arrangements. A number of Directors questioned the need for the Fund to hold minimum amounts of currencies for working balances or to maintain those balances at 10 percent of members' quotas. The staff will come back to that issue in the light of Directors' comments.

Directors expressed different views as regards the need for a downward adjustment to take into account the possible weakening in the external financial position of a member already in the budget. Several Directors emphasized that that issue was closely related to the approach of using a wider range of indicators to judge members' relative external financial strengths, and some Directors felt that the use of the adjustment factor could become more limited. Others felt that the adjustment factor was a useful device that helped avoid overstating the Fund's liquidity. We should come back to the need for such a downward adjustment and the role of working balances after Directors have reviewed the paper on the possible role of objective indicators in the assessment process.

As regards projections of the demand for the Fund's resources, while some Directors made reference to alternative methods, most felt that the current country-by-country approach should be maintained. Nevertheless, a number of Directors noted that errors in projections made on a country-by-country basis had been significant and that there seemed to be a bias toward overestimating demand. They felt the staff should make further efforts to reduce or eliminate the bias in those estimates.

In order to improve our projections, some Directors suggested that the staff should carefully reassess the probability factor attached to the conclusion of arrangements, and in particular should attempt to use its econometric work, including the possible use of members' past propensities to use Fund's resources, as important counter checks to its country-by-country projections. The staff will examine the possibility of combining the different approaches because, while it is important not to overstate the use of the Fund's resources, it is of equal significance that the Fund's liquidity position not be understated. Indeed, as several Directors noted, the cost for the Fund of overestimating its liquidity needs would be less than that of underestimating them. In that connection, Executive Directors also generally endorsed the staff's suggestion on using a two-year rolling period for its projections. We will attempt to refine the procedures used to determine the likely probability of members using the Fund's resources, although it could be counterproductive, as suggested by a few Directors, for the staff to identify in the liquidity reviews which countries were regarded as likely users of Fund resources over a two-year period.

Some Directors emphasized that the Fund should always have a substantial margin of capacity to meet unexpected needs, and were not concerned about erring on the side of prudence. The real issue was how large that margin of prudence should be. Many Directors agreed with the staff's suggestion that projections of purchases under nonprecautionary arrangements be further reduced by 10 percent, so as to eliminate the upward bias noted in the staff's evaluation of past projections of demand, while some Directors felt that the reduction should be larger.

Most Directors commented on the use of the liquidity ratio in Fund operations. Directors generally felt that too much emphasis should not be given to this ratio as an operational concept. Its main usefulness was as an indicator of the trend in the Fund's liquidity. The absolute level of the ratio was also useful, because it showed the long-run average liquidity ratio and deviations from that average. In that sense, it gave an idea of the margin of capacity available in the Fund, just referred to. Several Directors, however, cautioned against the use of the liquidity ratio as a too-mechanistic trigger in the context of quota reviews. Some Directors encouraged the staff to make alternative presentations on the liquidity ratio.

As regards the specification of the liquidity ratio, most Directors felt it would be appropriate to continue to include in the ratio the Fund's total liquid liabilities in the form of members' positions in the Fund. However, some Directors noted that the reserve tranche positions of industrial countries had not been mobilized in a decade. Nevertheless, the backing of members' positions in the Fund was a major factor in their willingness to have their currencies used and, in most cases, converted by the Fund in its operations with other members. Some Directors suggested that an indicator that would compare the availability of resources with the projected demand for balance of payments assistance by members over a given period—as in, for example, the ratio currently used by the World Bank—could be used as a supplement to the staff's existing calculations of the liquidity ratio. There was little support for attaching probability coefficients to the likely use of reserve tranche positions, and some notes of caution were expressed regarding predictions on likely use in individual cases.

In its future work in this area, the staff will take into account Executive Directors' comments on this important topic. As noted previously, it will come back soon with a short paper on the possible use of a broader range of objective indicators in assessing members' balance of payments strengths and, in that connection, will also consider the role of the adjustment factor. In projecting the possible demand for the Fund's resources, the staff will attempt to refine its approach in determining the probability factor, and the country-by-country estimates will be presented over a rolling two-year period, while drawing, as appropriate, on the more aggregate approaches described in the staff paper.

Many Directors agreed that more transparency in the process would be desirable. As put by one Director, it was a matter of reconciling the need for enough transparency for a Board decision with the need for a robust determination of the sustainable strength of members' external positions.

The Executive Board recessed at 1:00 p.m. and reconvened at 2:30 p.m.

2. SDR DEPARTMENT—DESIGNATION PLAN FOR JUNE–AUGUST 1997; AND OPERATIONAL BUDGET FOR JUNE–AUGUST 1997

The Executive Directors considered staff papers on the SDR Department—designation plan (EBS/97/85, 5/20/97) and on the operational budget (EBS/97/87, 5/20/97) for the quarterly period June–August 1997.

The Treasurer noted that the reserves data used in the operational budget, as shown in Table 6 of EBS/97/87, were the same as those used in the SDR designation plan, as shown in Appendix Table 1 of EBS/97/85. However, as they were the latest available data for each country, the data were for varying time periods. The data used in the operational budget were taken from the most recent data available for the *International Financial Statistics*. For some countries, the available data were dated 1995.

Mr. Prader asked whether the area departments in the Fund could supply data that was more up to date.

The Treasurer responded that, for the purpose of the operational budget, the Fund policy was to rely on the data that were used for the *International Financial Statistics*, and, thus, were in the public domain, rather than on staff estimates.

Ms. Srejber commented that she had requested the current discussion to seek clarifications on some of the assessments made by the staff. From the data contained in the staff papers, it seemed that the currencies of some countries might fall on the borderline in terms of being sufficiently strong for inclusion in the operational budget. The annex to EBS/97/87, which was a welcome addition to the staff papers on the operational budget, outlined the factors underlying the staff's assessments on the relative strength of members' currencies. Nevertheless, she wondered whether the staff could offer further comments on how it had arrived at its decisions to exclude the currencies of Australia, Brazil, Greece, and Kuwait from the operational budget for the quarterly period June–August 1997.

While the Fund policy to base its assessment on the official data included in the *International Financial Statistics* was appropriate, Mr. Prader was correct to point out that some of that data was clearly out of date, Ms. Srejber said. She wondered whether the staff could comment on why it took so long to process data for inclusion in the *International Financial Statistics*.

The Treasurer stated that Mr. Prader and Ms. Srejber were correct to point out that it was extremely important to have the most up-to-date data possible in trying to assess the relative strength of members' currencies for inclusion in the operational budget and the SDR designation plan. The current account data provided by members were often subject to substantial revision in collaboration with member country authorities, the staff working on the *International Financial Statistics*, and the area departments concerned. Nevertheless, experience over recent months showed that members were substantially improving the timeliness of data submitted to the Fund and the process of reviewing current account data was speeding up. The Treasurer's Department would consult with the Statistics Department and area departments to consider whether it might be appropriate to incorporate some estimation of data in the process for selecting currencies for inclusion in the operational budget and the SDR designation plan.

It was important to note, at the outset of the current discussion, that the assessment of currencies for inclusion in the operational budget and SDR designation was ultimately a decision of the Board, the Treasurer said. In that respect, the staff paper for the current discussion put forward a proposed list of currencies for inclusion in the operational budget and the SDR designation based on the data contained in the staff papers.

At first glance the data for Kuwait suggested that its currency was relatively strong, the Treasurer noted. The current account surplus was high relative to GDP. While Kuwait's total gross reserves were historically low in terms of imports and current transactions, they were relatively strong. However, in consultation with the area department and the Executive Director for Kuwait, the staff had found that two factors needed to be taken into account in assessing the longer-term strength of its currency. First, the dramatic fall in oil prices that had taken place over the past six months had not yet been reflected in the data on the current account. Second, Kuwait was still in the process of recovering from the Middle East crisis and from a domestic stock exchange crisis. Therefore, the reserve ratios might appear higher than they were in practice. For that reason, the staff, in consultation with the area department and the Executive Director, had not recommended inclusion of the Kuwaiti dinar in the operational budget presently under consideration.

The data for Brazil were encouraging, as they reflected the strong recovery under way, the Treasurer said. However, as Brazil was currently indebted to the Fund, it would fall under the early repurchase provisions. Moreover, in consultation with the area department and the Executive Director for Brazil, the staff considered that the ongoing changes in Brazil, including with respect to the exchange system and the privatization program, could have significant effects on capital flows over the period ahead. Therefore, the staff considered that it would be best to allow more time for the continued improvements to solidify before including the Brazilian real in the operational budget.

While Greece's reserves were very high compared with the historical average and the reserve positions of other countries, it was important to note that its current account deficit was rising in relation to GDP, the Treasurer commented. In addition, the Greek drachma had recently come under pressure in the exchange markets, requiring substantial intervention on the part of the authorities. In the circumstances, the staff considered that it might be appropriate to avoid placing any additional financing burden on the Bank of Greece for the time being.

Mr. Rouai considered that the information contained in Table 6 of EBS/97/87 was very helpful. He wondered whether similar information could be provided for all countries in future staff papers on the operational budget.

The Treasurer responded that the staff could issue a table similar to Table 6 containing relevant data for all countries in due course. The staff would also include that data in the staff paper to be prepared on supplementary indicators to be used in assessing the strength of currencies for inclusion in the operational budget.

Mr. Grilli asked whether the staff consulted with Executive Directors in making assessments for all countries, or whether such consultations were considered necessary only in so-called borderline cases. His office had not been consulted by the staff with respect to either Greece or Italy. In addition, he wondered whether the staff could comment on when the Greek drachma had come under substantial speculative pressure.

The Treasurer responded that the staff had contacted Mr. Grilli's office to discuss the case of Italy. However, in light of the information available for Greece, the staff had not considered it to be a borderline case. According to the most recent information available to the staff, the heaviest intervention in the exchange markets by the Greek authorities had taken place over the past two weeks.

Mr. Grilli remarked that, based on the information made available to his office over the past two weeks, he would not characterize the intervention by the Bank of Greece as heavy. Nevertheless, he could continue his discussion with the staff on that issue on a bilateral basis.

The Treasurer recalled that the Australian authorities had indicated to the staff on previous occasions that the Australian dollar should not be considered for inclusion in the operational budget unless its current account deficit was below 4 percent of GDP. While the most recent data showed that Australia's current account deficit was somewhat below 4 percent of GDP, the current account data had not improved substantially over the past year. Moreover, Australia's total gross reserves were low in terms of both imports and total current account transactions. That fact, taken together with Australia's relatively large external debt, seemed to indicate that it should not be recommended for inclusion in the operational budget at the present stage.

Mr. Newman noted that the current discussion seemed to focus on the currencies that were not being recommended for inclusion in the operational budget. He wondered whether there were any currencies currently in the operational budget that should be considered for exclusion.

The Treasurer replied that Indonesia had been experiencing an increase in its current account deficit/GDP ratio over recent years. Although its reserves coverage, at about six months of imports, was close to the historical average, there might be a need to carefully monitor developments in Indonesia over the period ahead.

At the same time, although there had been no further deterioration in Korea's current account deficit/GDP ratio over the most recent period, it remained large and its reserves amounted to less than three months of imports, the Treasurer noted. On that basis, the staff saw Korea as a borderline case.

The staff had not recommended excluding the currencies of Indonesia and Korea from the quarterly operational budget currently under consideration, because the data on those countries suggested that their situations were more stable than that of Thailand, the Treasurer said. Also, the staff considered that such a move at the present stage could reduce confidence in those currencies and, thus, subject them to more strain. As Directors had noted at the previous discussion on the methodologies used in the measurement of Fund liquidity, once currencies were included in the operational budget, it was difficult to exclude them, because their removal could subject them to increased pressures in exchange markets

The staff had recommended that the baht be excluded from the operational budget in the light of the severe exchange crisis that Thailand was undergoing, the Treasurer stated. Although the staff had recommended continued inclusion of the Thai baht in the operational budget, over the past six months or so, the staff had opted not to use the baht on the transfer side of the budget in order to avoid subjecting the central bank to any additional financial burden.

Mr. Taylor made the following statement:

> This matter having been listed, my Australian authorities have instructed me to seek the inclusion of the Australian dollar in this operational budget. In short, the view of the Australian authorities is that Australia and the Australian currency are quite strong enough to be included on the basis of the current criteria, notwithstanding the fact that we also consider that the criteria need to be reviewed.
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> I will try to be as brief as I can, but I think I need to begin by saying how Australia sees the situation in the broad and work toward the particular position of the staff. In my view, I am putting a case which is essentially consistent with my reading of the staff appraisal of the recent consultation with Australia, but I will put it in my own way.
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> First, and foremost, and this certainly is consistent with the approach taken by the staff, is the question of fiscal retrenchment, a process which actually began under the previous government but is now center stage with the new government. The deficit, as a percentage of GDP, has fallen for four successive years to now about 1 percent, and will continue in the next several years into surplus. In fact, the government will be retiring debt now to the tune of about $5 billion a year into the next millennium.
>
> The government reacted extremely vigorously to some sizable underestimation of revenue in the past six months, and has maintained this fiscal consolidation on track, which also I might say is based entirely on a reduction in outlays rather than changes in the incidence of taxation. Also, the figures are free of asset sales and other special effects, even—were it to one day—arise, the value of gold. I suppose I could summarize the overall situation by saying that, in our estimation, Australia is eligible to enter the EMU forthwith and has been for some time (but do not mistake this for an application).
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> I will try to summarize what I want to say next by saying that, in terms of wage and price formation, the combined effects of several years of competition policy, wages policy, tariff policies and industry policy—has seen a decisive shift in inflation over the 1990s to the bottom of the reserve bank range of 2–3 percent. In fact, there is a recurring tendency for the rate of inflation to fall below that range. This decisive break in inflation occurred a number of years ago, and is enduring.

This is not an Article IV consultation, so I will deny you all the benefit of listening to what is involved in competition policy and some of the other policies, but I would like to say that tariff and industry policy has now been taken in Australia to the point where Australian industry, to all intents and purposes, is unprotected and unassisted. The only significant exceptions are two sectors—motor vehicles and TCF—where further progress, in my guess, will depend on what happens with trading partners. But, by and large, Australian industry is now unprotected and unassisted.

I realize that these developments have been occurring in a number of other countries, but for the Australian case these favorable developments set in several years ahead of trading partners. The result has been a period of sustained growth in the economy, 3½ percent, tending to be higher than that, for three years at least; macroeconomic evidence, and certainly supported by direct anecdotal evidence, that there has been a sustained lift in productivity in the economy after a long period of microeconomic reform; and because of those factors and because of the reduction in inflation, a substantial reduction in interest rate differentials traditionally several percent above comparable rates in the United States, now less than 1 percent in terms of long rates and less than a half percent in terms of short rates and still closing.

I am not saying that there are no problems in the Australian economy, and it would be wrong to say that the government is comfortable or relaxed about the external situation or, indeed, anything else to do with the Australian economy, because the reforming zeal within the economic management group in Australia lives on and is moving on to new reforms, pretty much those pointed to in fact in the last staff appraisal. (In that respect, I must say it is very helpful having cousins across the sea showing how to reduce unemployment below 8 percent. Plenty of things out there still to emulate.)

The Australian authorities are perfectly comfortable with their freely floating exchange rate system. Any hypothetical external shock would be taken now quickly into domestic adjustment if that were appropriate. It follows from that reason and several other reasons that a high level of reserves is neither warranted nor wanted. As to the current account deficit, Australia has always had a current account deficit and, as far as I know, will for the foreseeable future. The economy has always been, and is now, very open to long-term investment from abroad.

I am not saying that in the past the current account deficit has not been, on occasions, higher than would be appropriate in the long term, but in the short term there has never, even in those circumstances, been any difficulty in financing the deficit. The better way to look at the current account position in Australia is that the deficit is a necessary counterpart to productive investment which is welcomed from overseas.

It obviously follows from all that that the Australian authorities regard single-minded concentration on two or three measures to assess the external situation as really rather wrong-headed, wrong-headed because it ignores the underlying fundamentals I have been trying to describe, it ignores desirable and enduring structural differences between countries in those measures, and because it discourages or distorts judgment.

The fact is that there is no problem foreseeable in the next three months or the next year or any other particular period, threatening the viability of the external sector or the viability of the Australian currency. However, even on the relatively crude measures that have been in vogue, and looking not at those other countries that have not been included but looking at the countries that have been included in the current budget, Australia is by no means at the bottom of the table on any account. It is ahead of several other countries on the current account deficit which have been included in the budget, despite the structural situation that I described. It is ahead of several more countries in terms of gross reserves to imports.

The trend in both of these measures is for a strengthening to occur. The current account this year and forecast next year is about 3.7 percent of GDP compared with more than 5 percent the previous two years and below the historical average. And over the past 12 months, the increase in the reserves that has accrued in the hands of the reserve bank is actually larger than two-thirds of the other countries included in the budget. Finally, the exchange rate is one of the strongest of those included in the budget, reflecting the improved fundamentals that I have been talking about in the Australian economy, and the focus of policy.

The Chairman referred before lunch to prestige. This is not about prestige. The inclusion of the Australian currency in this budgetwould not make one jot of difference to anything in the market place. The Australian authorities see inclusion as a logical outcome, now rather overdue, of the developments in policy and developments in the economy over several years. Those are the reasons the staff position to date has not been accepted and is not accepted. I have to say that my authorities feel unusually strongly about this. They are not relaxed about this issue in any way, I am afraid I have to say.

Mr. Shields said that he fully supported Mr. Taylor's request that the Australian dollar be included in the operational budget, especially given the current strength of the Australian economy and its past performance.

The currencies of all Fund members should be included in the operational budget if they were sufficiently strong, Mr. Shields stated. Inclusion in the operational budget should be a presumption of membership in the Fund. Against that background, it should be possible also to incorporate the currencies of several other countries on the transfer side of the budget.

A comparison of the recent performance of the Australian economy with that of some other countries already included in the operational budget seemed to suggest that the staff might be applying stricter criteria in assessing the strength of currencies seen as "borderline" cases than it was in assessing whether some currencies should remain in the operational budget, Mr. Shields considered. That practice might be understandable if the objective was to ensure the stability of the list of currencies included in the operational budget. However, if the objective was to achieve greater transparency and greater fluidity in the movement of currencies into and out of the operational budget, a more consist treatment of currencies should be sought. That latter objective would seem to indicate that the staff's assessment of currencies should focus on the periods of individual operational budgets, which spanned roughly three to six months, rather than on a longer period. Given the uncertainties related to all economic forecasts, it might be desirable to take into account longer-term projections in making assessments of the relative strength of currencies, but final decisions should be based on the shorter-term horizon.

Mr. Shaalan asked whether the staff would agree with Mr. Taylor's assertion that the current criteria used to assess the relative strength of currencies would suggest that the Australian dollar should be included in the operational budget. He also wondered whether there was reason to believe that the standard criteria used by the Fund should be reviewed.

Mr. Askari-Rankouhi commented that he agreed with Mr. Taylor that, taking into account a broader set of indicators, Australia's economic fundamentals were very strong. Given Australia's history of sound macroeconomic policy and stability, its currency should be included in the operational budget. Such factors should be taken into account in the selection of currencies for participation in the operational budget. It was also important to take into account the source of current account deficits. In the case of Australia, the current account deficit was largely attributable to increased investment, which should make the overall current account position more—not less—sustainable. Also, as Australia had a fully flexible exchange rate, a high level of reserves should not be necessary for the inclusion of its currency in the operational budget.

Mr. Donecker said that, given the considerable strength of the Australian economy, its current account deficit should be seen in a different light from some other countries' current account deficits. Also, it was important to recognize the important role Australia had played in the establishment of the NAB. On that basis alone, he could support the authorities' request that the Australian dollar be included in the operational budget.

Mr. Newman considered that Mr. Taylor had put forward a persuasive case for including the Australian dollar in the operational budget. He welcomed the authorities' willingness to assume the full responsibilities that went along with the benefits associated with membership in the Fund.

From the staff's comments for the current discussion, it seemed that the Fund might be paying too much attention to the particular desires of national authorities in the selection of currencies, Mr. Newman noted. As the case of Thailand suggested, an action by the Fund to exclude a currency from the budget might come long after markets had already reacted to changes in the situation of the member concerned. Given the desire for greater fluidity in the currencies entering into or exiting from the operational budget, the Fund should be willing to move faster both in excluding currencies from participation in the operational budget and in including the currencies of those countries willing to assume the obligations and responsibilities associated with participation in the operational budget.

Mr. Prader stated that Australia had played a very important role in the establishment of the NAB. Moreover, Australia had traditionally been a strong force in the policy making of the Fund. Therefore, its currency should be included in the operational budget. He welcomed the authorities' willingness to contribute to financing the Fund's operations.

Mr. Yoshimura said that he would welcome the inclusion of the Australian dollar in the operational budget.

Mr. Leijdekker commented that his chair joined others in supporting the inclusion of the Australian dollar in the operational budget. In assessing the relative strength of individual currencies, the staff should take into account the relationships that countries had with capital markets and the degree and stability of their access to those markets.

As the Fund was not a credit rating agency, it was surprising to note the considerations that had been involved in the staff's decisions on whether or not to recommend the exclusion of certain currencies from the operational budget, Mr. Leijdekker said. He wondered whether such decisions regarding the relative strengths or weaknesses of individual currencies could become self-fulfilling prophesies.

Mr. Grilli stated that he supported Mr. Taylor's request that the Australian dollar be included in the operational budget.

The Treasurer noted that the criteria used to assess the relative strength of currencies, as described in Article V, Section 3(d) of the Fund's Articles of Agreement and in the guidelines on the use of currencies and SDRs in the General Resources Account, had not changed since 1979. According to those criteria, Australia was clearly a borderline case. A comparative analysis of members' gross reserves and balance of payments data showed that Australia would rank 24th on a list of 30 countries and it would be reentering the operational budget for the first time since 1989. Although the quantitative criteria used by the staff would suggest that it might not be appropriate to include the Australian dollar in the operational budget at the present time, those criteria did not take into account the important qualifications provided by Mr. Taylor—which could come only from the member concerned. Mr. Taylor's observations helped to put the most recent data into proper perspective.

As the question of whether the current methodology used in the selection of currencies for inclusion in the operational budget had been a focus of the previous discussion that morning, he would not go into much detail on that question now, the Treasurer commented. As the staff had indicated at the previous discussion, it would try to develop additional quantitative indicators that could complement the current criteria used in assessing the relative strength of members' currencies. The staff was obliged under the Articles to take into account the data on members' balance of payments and reserves positions as well as recent developments in exchange markets. The Board did not seem to wish to depart from the use of those criteria.

Mr. Donecker suggested that, in developing additional quantitative indicators to be taken into account in assessing the relative strength of currencies for inclusion in the operational budget, the staff should consider whether it would be appropriate to presume that participants in the NAB should be included in the operational budget, unless there were strong indicators to dictate otherwise.

The Treasurer stated that membership in the NAB could not be used to override the criteria called for under the Articles. Therefore, it would be for the Board to decide whether or not to use membership in the NAB as a supplementary indicator of a currency's strength. The presumption of inclusion in the operational budget had never been considered in the discussions leading to the establishment of the NAB, nor had participation in the GAB given rise to such a presumption. It should be noted that Thailand was a member of the NAB, and the staff's assessment, based on recent developments in exchange markets, suggested that the Thai baht should be excluded from the operational budget for the quarterly period June–August 1997.

Mr. Shields said that he agreed with Mr. Donecker. The intention was not to suggest that there should be legal presumption, based on specific commitment from members, that the currencies of the countries in the NAB would be included in the operational budget. However, it would seem reasonable to assume from a member's participation in the NAB that its currency was strong enough to be included in the operational budget. Clearly, there would be exceptional circumstances, such as in the case of Thailand, where it might not be appropriate to include a particular currency in the budget for a given period.

The Treasurer recalled that in the period leading to the review of the GAB that had proceeded discussions on the establishment of the NAB, the Fund staff had drawn up a list of 45 countries that were projected to be long-term creditors to the Fund. That list had been a focal point of the discussions on the NAB, which had begun in Toronto, Canada in July 1995. While participants at the discussions on the NAB had clearly felt that the list provided by the Fund—which was based on the standard criteria used in operational budget exercises—served as a good starting point, they had applied additional criteria to reduce the list by 10–15 countries. Subsequently, other countries—not on the original list—had been added as participants in the NAB, although their currencies were relatively weaker than others. The question of participation in the Fund's quarterly operational budgets had never been an issue at the discussions on the establishment of the NAB. Therefore, it would not be appropriate to presume that the currencies of countries participating in the NAB should more or less automatically be included in the operational budget.

Mr. Grilli commented that, while he would not wish to prolong the current discussion, it would be fair to presume that countries that were willing and able to lend resources to the Fund in exceptional circumstances would be candidates for inclusion in the operational budget in normal circumstances. Of course, there could be exceptional cases where a currency might be precluded from participation in the operational budget for certain periods.

The Acting Chairman stated that the staff applied the criteria called for under the Articles and under the guidelines on the use of currencies and SDRs in the General Resources Account to all 181 members of the Fund in assessing the relative strength of currencies for inclusion in the operational budget. In that respect, Directors must have meant to indicate that the presumption of inclusion, with respect to participants in the NAB, could apply only in situations where their currencies were seen as borderline cases. Alternatively, Directors might have meant to suggest that the Board should bring moral suasion to bear on those participants in the NAB that might wish to avoid being included in the operational budget, owing to the costs involved.

Ms. Srejber considered that the current discussion highlighted the need to proceed with the development of additional quantitative criteria to be used in assessing the relative strengths of members' currencies. In that respect, it was important to bear in mind that the standard criteria used by the staff, which had been adopted at least 20 years previously, might not fully take into account recent changes in the world economy, including the globalization of markets. Perhaps the work related to the criteria used by the staff would automatically address the issues related to the members in the NAB, as the additional criteria might better take into account the strength of their economies.

The comments put forward by the staff and Directors for the current discussion were enlightening, Ms. Srejber commented. Greater transparency would clearly make it easier for the Board to take insightful decisions on matters related to the operational budget. If possible, the Board should hold discussions on the quarterly operational budgets during the period in which additional criteria for the assessment of members' currencies were being developed.

Mr. Kafka said that he was grateful to Ms. Srejber for requesting the current discussion. It was pleasing to note that the Board had accepted Mr. Taylor's request that the Australian dollar be included in the operational budget.

The Secretary noted that two decisions had been proposed for consideration. The tables accompanying the decisions on the operational budget for the quarterly period June–August 1997 and on the SDR designation plan for June–August 1997 would need to be adjusted to take into account the Board's acceptance of the proposal to include the Australian dollar in the operational budget. The staff would circulate to Directors the amended decisions along with those tables in due course.

The Treasurer stated that the staff would also circulate to Directors a table showing the relative external indicators for all members.

Mr. Newman asked whether the amendment of the operational budget for the quarterly period June–August 1997 would include adjustments for all the currencies included in the operational budget.

The Treasurer replied that the amendment of the operational budget could be effected in two different ways. It would be possible to increase the overall size of the operational budget and the SDR designation plan to take into account the participation of the Australian dollar. Alternatively, it would be possible to retain the overall size of the operational budget and SDR designation plan as originally proposed, but reallocate the use of currencies on the basis of the proposals in the budget. The staff would recommend the later option. Such a reallocation would include a reduced amount of sales of U.S. dollars from 25 percent of the total to 20 percent of the total.

Mr. Newman remarked that, if the Board agreed to add currencies to the list recommended by the staff in future operational budgets, it would be useful to reallocate the entire budget among the currencies involved. Under the method of reallocation proposed by the staff for the current discussion, the United States would not realize either the benefits or the costs associated with the inclusion or exclusion of other members' currencies.

The Treasurer noted that the current budget proposal recommended that the proportion of transfers allocated in U.S. dollars be reduced from 25 percent of total transfers of currencies to 20 percent, in order to bring the Fund's holdings of U.S. dollars in relation to quota more closely in line with the average Fund holdings of other usable currencies. That recommendation had been necessitated by the relatively large administrative expenditures in U.S. dollars over the most recent period and the increasing tendency among members to make repurchases in SDRs rather than in currencies.

Mr. Donecker remarked that the United States was benefiting from the exceptional treatment of the U.S. dollar recommended by the staff for the current discussion. Such ad hoc treatment of the U.S. dollar might not be warranted in future operational budgets, as the Fund's holdings of the currencies of several countries in relation to quota were out of line with the average of its holdings of other usable currencies.

The Acting Chairman made the following concluding remarks:

> Today's discussion on the operational budget was timely, as it immediately followed the Board's discussion on the methodology underlying the staff's assessment of members' balance of payments and reserve strengths for the inclusion of their currencies in the operational budget and, hence, as the basis for periodic reviews of the Fund's liquidity and the adequacy of its financial resources.
>
> In the light of our discussion, it would seem that this budget may well be the last that would be drawn up on the basis of the criteria developed in 1978, in the light of the second amendment of the Articles. As recent discussions on the budget have illustrated, the staff has been facing increasing difficulties in applying the 1978 criteria in assessing the overall external positions of members. Furthermore, our procedures have been increasingly questioned by Executive Directors, particularly in light of the increasing globalization of markets and the growing role of private capital markets in providing balance of payments financing for creditor as well as debtor members.
>
> As a consequence of these pervasive developments, the relevance, for example, of the reserves/current payments ratios and current account/GDP ratios that have been uniformly applied as a basis for assessing members' external positions have changed, although they remain relevant and, as indicated earlier, they will be further developed. Undoubtedly, other aspects of the assessment, such as taking into account developments in the exchange markets, are tending to increase the relevance of other, including more important qualitative, considerations that increasingly bear on the external financial situations of members. These changes underscore the importance of the consultation process that is required with the Executive Board as regards the inclusion or exclusion of members' currencies in the operational budget.
>
> The assessments in the proposed budget have been based on the traditional quantitative criteria. However, the Australian authorities have emphasized the recent improvement in Australia's external position, including the narrowing of the current account deficit, the increase in reserves, and the strengthening of the exchange rate, as well as the improvement in the fiscal situation. In addition, the authorities have highlighted Australia's good standing in the international financial markets and, given that the Reserve Bank of Australia does not intervene in the exchange markets, argued that a high level of reserves is not warranted. In the light of these important considerations, the Executive Board has agreed to include the Australian dollar in the budget, at the request of the Australian authorities. The staff will issue

promptly a revised table showing the new allocation of currencies to be used in the forthcoming quarter.

It is clear that we need to look carefully at the issues raised in today's discussion, which have implications for a number of countries, both in the light of the outcome of the Executive Board discussion on the liquidity methodology this morning and, as requested in the recent discussion on the work program, the role of a wider range of objective indicators and their possible application in making assessments of balance of payments and reserve strength and developments in exchange markets as a basis for Board decisions on the inclusion of currencies in the operational budget.

I would like to stress the application of two principles that must guide us in this area. First, as widely stressed in this morning's discussion, it is inevitable that there will be a judgmental factor in making our assessments. Whatever the range of statistical indicators Directors feel it appropriate to develop as the basis for assessing the strength of members' external positions, a judgmental factor will have a major role in these exercises. Second, and closely related, the Board's judgment must be based on technical and economic considerations alone, and not, for example, on political considerations or considerations of mutual forbearance. We cannot politicize the process of securing the Fund's financial resources, for we need to give confidence to the membership that the Fund's financial resources are fully available to support their adjustment efforts and as backing for their positions in the Fund.

The Executive Board took the following decisions:

SDR Department—Designation Plan for June–August 1997

The Executive Board approves the designation plan for the quarterly period June–August 1997 as set out in Table 1 of EBS/97/85, Supplement 1 (6/3/97).

Decision No. 11510-(97/55) S, adopted
May 30, 1997

Operational Budget for June–August 1997

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/97/87, page 2, footnote 3, as amended by the inclusion of Australia, and the operational budget for the quarterly period June–August 1997 as set out in Table 1 of EBS/97/87, Supplement 1 (6/3/97).

Decision No. 11511-(97/55), adopted
May 30, 1997

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/54 (5/28/97) and EBM/97/55 (5/30/97).

3. GUINEA-BISSAU—ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4

The Fund notes with satisfaction that, with effect from January 1, 1997, Guinea-Bissau has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement. (EBD/97/56, 5/23/97)

Decision No. 11512-(97/55), adopted
May 29, 1997

4. EXECUTIVE BOARD COMMITTEES—NOMINATIONS

The Executive Board approves the nominations by the Managing Director for the vacant positions on the Committee on Liaison with the World Trade Organization as set forth in EBD/97/57 (5/23/97) and EBD/97/58 (5/23/97) and for the vacant position on the Committee on the Budget, as set forth in EBD/97/58 (5/23/97).

Adopted May 29, 1997

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 96/57, 96/62, 96/67, 96/86, and 96/97 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/84 (5/28/97) and by Assistants to Executive Directors as set forth in EBAM/97/81 (5/22/97) and EBAM/97/82 (5/23/97) is approved.

APPROVAL: February 2, 1998

REINHARD H. MUNZBERG
Secretary