December 9, 1998
Approval: 12/16/98

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/123

10:00 a.m., December 17, 1997

Contents

Decision Taken Since Previous Board Meeting

Executive Board Attendance

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

Executive Directors	Alternate Executive Directors
A.A. Al-Tuwaijri	S.M. Al-Turki
	R. Fernandez
	H. Paris, Temporary
T.A. Bernes	C.X. O'Loghlin
R.F. Cippà	A. Abdychev, Temporary
B. Esdar	W.-D. Donecker
	W. Merz, Temporary
	N. Coumbis
	A. Giustiniani, Temporary
	J.P. de Morais
A. Kafka	H.F. O'Brien
W. Kiekens	J. Prader
K. Lissakers	B.S. Newman
A. Mirakhor	
A.V. Mozhin	A. Vernikov
	B.M. Lvin, Temporary
G. O'Donnell	J. Shields
A.S. Shaalan	
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	B. Andersen
G.F. Taylor	J.L. Pascual, Temporary
	J. Guzmán-Calafell
J. de Beaufort Wijnholds	L.B.J. van Geest, Temporary
K. Yao	A. Barro Chambrier
Y. Yoshimura	
Zamani, A.G.	J. Salleh, Temporary
Zhang Z.	Lu A., Temporary
A.G. Zoccali	

R.H. Munzberg, Secretary
S. Bhatia, Assistant
P. Cirillo, Assistant
D. de Vos, Assistant

Republic of Korea—Report by Staff
Staff representative: Neiss, APD

Supplemental Reserve Facility—Establishment
Staff representatives: Boorman, PDR; D. Williams, TRE; Gianviti, LEG

Republic of Estonia—1997 Article IV Consultation; and Stand-By Arrangement
Staff representatives: I. Kapur, EU2; Schadler, PDR

Also Present
African Department: E.A. Calamitsis, Director. Asia and Pacific Department: H. Neiss, Director; A. Singh, Deputy Director; F.C. Adams, T.S. Calen, D.J. Goldsbrough, K.M. Meesook. European I Department: M.C. Deppler, Director. European II Department: J. Odling-Smee, Director; O. Havrylyshyn, D.G. Jones, I. Kapur, F. Le Gall, J.R.Márquez-Ruarte, N. Thacker, A.M. Westin, B.B. Zazoico. External Relations Department: S.J. Anjaria, Director; M.E. Hansen, C. Hellemaa, K.L. White. Fiscal Affairs Department: K.-Y. Chu. Legal Department: F.P. Gianviti, General Counsel; W.E. Holder, Deputy General Counsel; H. Elizalde, J.L. Hagan. Monetary Exchange and Affairs Department: R.K. Abrams, P.T. Downes, A. Lönnberg. Policy Development and Review Department: J.T. Boorman, Director; J. Ferran, Deputy Director; T. Leddy, Deputy Director; A.G.G. Bennett, S.M. Schadler, T. van der Willigen. Research Department: E.R. Borensztein, R. Sahay, M.A. Savastano. Secretary's Department: P. Gotur, A. Mountford. Statistics Department: C.S. Carson, Director. Treasurer's Department: D. Williams, Treasurer; D. Gupta, Deputy Treasurer; B.E. Keuppens, M.G. Kuhn, B.C. Yuen. Western Hemisphere Department: C.M. Loser, Director; A.S. Linde. Office of the Managing Director: M. Russo, Special Advisor; M. Cross, Special Assistant; F.J. Gaitan. Office of the Deputy Managing Director: B. Christensen, J.A. Clément, O.J. Evans. Advisors to Executive Directors: M.A. Ahmed, M. Askari-Rankouhi, T. Brizuela, J.A. Costa, M.H. Elhage, S.S. Farid, P.M. Fremann, G.M. Iradian, J. Jonáš, J.M. Jones, M.F. Melhem, H. Mori, S. N'guiamba, H. Ogushi,Y. Patel, O. Sein, T. Turner-Huggins. Assistants to Executive Directors: A.S. Alosaimi, N.R.F. Blancher, M.A. Brooke, J. Chelsky, D. Chen, M.A. Cilento, H.W. Cocker, A.L. Coronel, D.A.A. Daco, D. Fujii, J.K. Honeyfield, H. Javaheri, M. Kell, K. Kpetigo, Lai K., A. Lucenti, A. Lushin, M.Z. Maatan, D. Merino, I. Moon, L. Palei, A.R. Palmason, Qi J., E.T. Rădulescu, S. Rouai, O. Schmalzriedt, T.T. Schneider, R.P. Watal.

1. REPUBLIC OF KOREA—REPORT BY STAFF

In restricted session, the staff reported on recent developments in the Republic of Korea.

2. SUPPLEMENTAL RESERVE FACILITY—ESTABLISHMENT

The Executive Directors continued from Executive Board Meeting 97/121 (12/15/97) their consideration of the Supplemental Reserve Facility (EBS/97/225, 12/5/97; Sup. 1, 12/12/97; and Sup. 1, Rev. 1, 12/16/97). They also had before them a background paper on charges on the Supplemental Reserve Facility (EBS/97/234, 12/12/97).

The Chairman noted that Directors had had the opportunity at Executive Board Meeting 97/121 to address general issues relating to the Supplemental Reserve Facility (SRF) and to express their concerns on various aspects of the facility. He suggested that, at the current meeting, Directors should focus their interventions on the key elements of the structure of the facility—particularly the charges and the length of the terms—in order to facilitate the early conclusion of a suitable consensus. Thereafter, Directors could turn their attention to the specific details of the language of the decision establishing the facility. To those ends, he invited the Director of the Policy Development and Review Department to indicate any emerging consensus on the various aspects of the facility.

The Director of the Policy Development and Review Department made the following statement:

> At a Board meeting on December 15, 1997, most Directors favored the establishment of a Supplemental Reserve Facility broadly along the lines proposed by the staff.[1] The attached, revised draft decision incorporates the views of Directors on various aspects of the facility, including its aims and objectives. The revised draft decision also incorporates new proposals on the issues of maturity and charges, which the staff, having considered the views expressed by Directors, believes may command broad support in the Board. The following paragraphs provide additional explanation of the new proposals in these two areas.
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> With regard to maturity, as with other Fund resources, repurchases would fall due after a specific period following each purchase. The staff paper had proposed that repurchase expectations would arise in four equal quarterly installments 2¼ years, 2½ years, 2¾ years, and 3 years, respectively, after each purchase. Each of these repurchase expectations could, at the request of the member and with the approval of the Board, be established as a repurchase obligation for up to one year later than the original date of the expectation. In other words, should a member find itself unable to meet a repurchase expectation, it would make representations to the Board to that effect (including a description of actions it was taking to strengthen its balance of payments), and the Board would determine whether it wished to retain or

[1]"Supplemental Reserve Facility," EBS/97/225, December 5, 1997.

extend the repurchase expectation or (if it is not met) convert it into an obligation. Thus, repurchase obligations would arise, at the latest, in four equal quarterly installments 3¼ years, 3½ years, 3¾ years, and 4 years, respectively, after each purchase.

The new proposal would shorten this repurchase schedule significantly, while retaining the flexibility inherent in the combination of expectations and obligations. Repurchase expectations would arise in two equal semiannual installments 1 year and 1½ years, respectively, after each purchase, and repurchase obligations would arise, at the latest, in two equal semiannual installments 2 years and 2½ years, respectively, after each purchase. As in the original proposal, a member finding itself unable to meet a repurchase expectation would make representations to the Board to that effect, and the Board would determine whether it wished to retain or extend the repurchase expectation taking into account the actions being taken by the member to strengthen its balance of payments and an assessment by staff of the sufficiency of these measures.[2] Any expectation that is not met can be made an obligation, at the discretion of the Board.

Regarding charges, the staff paper had proposed that purchases under the facility be subject to a surcharge (uniform for all members) above the adjusted basic rate of charge, at a level within the range of 200–400 basis points. The majority of Directors preferred the upper end of this range, although at least six argued for a surcharge at the lower end. Many Directors also expressed interest in a surcharge that progresses, rising either according to amount purchased or according to the time resources have been outstanding, or both.

While progression according to the amount outstanding would be possible, as long as it was based on amounts in percent of a member's quota (and not in absolute terms), the staff believes that much of what the Board wishes to achieve can be accomplished by progression according to time outstanding. Limiting the progression of charges to this schema would have the advantage of clarity and simplicity. The new proposal would set the initial surcharge at 300 basis points, and would have the surcharge rising by 50 basis points every six months as long as any resources under a given purchase remain outstanding (see annexed Figure 1).

The new proposal is summarized in the annexed Table 1, which sets out the surcharges and repurchases associated with a particular purchase of SDR 1 billion made at time "t" (dates are indicated in months, and the surcharge in basis points).

Thus the surcharge would reach 400 basis points at the time the first repurchase expectation arose, and would go as high as 500 basis points in the

[2]The staff has also added to the draft decision a paragraph that would provide for the interruption of purchases under any ongoing arrangement if a member fails to meet a repurchase expectation arising under the facility.

final six months if the Board decided to extend the period of repurchase up to the maximum permitted under the facility. If a member made all purchases according to the original expectations the average maturity would be 1¼ years and the average rate of surcharge would be 340 basis points; if expectations were converted to obligations to be met six months (one year) after the original date of expectations, the average maturity would be 1¾ (2¼) years and the average rate of surcharge would be 364 (389) basis points (see annexed Table 2).

Messrs. Guzmán, Kafka, and Zoccali submitted the following statement:

We can agree with the establishment of the Supplemental Reserve Facility.

We think that drawings on the facility should be under the conditions suggested in the revised draft decision; i.e., due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected on pressure in the capital account and the member's reserves as long as there is a reasonable expectation that appropriate adjustment policies and financing will result, within a short period of time, in an early correction of such difficulties. We regret, however, that this facility is not available for crisis prevention.

The facility should be linked to the existence of a Stand-By or Extended Arrangement as described in points 2 and 3 of the revised draft decision.

Financing under this decision should be available as stated in point 4 of the revised draft decision.

We can accept that purchases under this facility take place in two or more installments, but we are not convinced that this tranching will provide sufficient front-loaded assistance when a member is facing a liquidity crisis.

Keeping in mind that the timing of the return of market confidence is uncertain, the Fund should extend each repurchase obligation by six months beyond the periods proposed in point 6(a) of the revised draft decision.

Holdings acquired under this decision should be charged 200 basis points per annum above the rate of charge under Rule I-6(4)(a) and increased by 50 basis points after six months, and every six months thereafter, provided that the surcharge should not exceed 400 basis points per annum. In our opinion, these increments should apply to each tranche rather than to the outstanding balances. The use of additional income from the surcharge levied on such purchases should be decided separately; i.e., we would support deletion of all brackets in the second part of point 8 of the revised draft decision.

We propose that the word "normally" be included between the words "is" and "likely" in 1(c).

We can accept Mr. Esdar's proposal under 1(d) that all options should be considered to minimize moral hazard and to ensure appropriate burden sharing.

Mr. Kiekens made the following statement:

I continue to have strong reservations about the wisdom of hastily adopting the new Supplemental Reserve Facility (SRF), for the reasons I gave during last Monday's Board meeting.

A major drawback is that under the SRF, the Fund is only prepared to provide financial assistance to countries already facing an open financial crisis. As the staff puts it in paragraph 16 of the paper, "it is not intended that this facility would be used ... where a crisis of confidence has not actually developed." This is at odds with the first principle of the Fund's guidelines on conditionality, encouraging members "to adopt corrective measures, which could be supported by use of the Fund's general resources, in accordance with the Fund's policies, at an early stage of their balance of payments difficulties, or as a precaution against the emergence of such difficulties." The new facility provides the wrong incentives for countries facing the threat of a crisis. It is difficult to understand that, as the staff has it in paragraph 16, "the purpose of the facility is not to finance significant outflows but rather to stop further outflows," and that it is necessary to wait until the country has lost market confidence before supplying large financial support in the expectation that this will ensure an early return of confidence.

I admit that early corrective measures will reduce the need for large Fund support. But one cannot rule out that, in exceptional circumstances, countries facing a very high bunching of maturing debt may need high precautionary access in support of their adjustment policies.

However, since the Fund's decisions on Stand-By Arrangements, the Extended Fund Facility, and access limits remain unchanged, and given the wording of section 2 of today's proposed decision, it is my understanding that countries remain entitled, in exceptional circumstances, to request Fund support under those facilities beyond normal access limits in order to forestall a crisis. I observe that under such circumstance it might be inconsistent with the rules of the SRF to provide access at a normal rate of charge and for a standard repurchase period. But the Board also continues to have discretion to increase charges and shorten repurchase periods as a condition for waiving the 200 percent access limit. I am confident that the Board will not disagree with these conclusions.

I would like to make the following remarks concerning the text of the draft decision.

The eligibility requirement that the loss of market confident be "sudden" excludes countries with a gradual loss of market access, as shown by steadily increasing risk premiums and decreasing borrowing. This process, if not reversed, may result in a financial crisis, for instance at the time a country has to service a bunching of maturities.

For certain, we must prevent bailout guarantees. But some Board members may be under the impression that in such a course of events, there is no salvation for the country concerned beyond the Fund's access limits, no matter how exceptional and deserving the case may be. Here again, I plead that we may preserve desirable flexibility allowing the Fund to decide on a case-by-case basis. I think our present policies under Stand-By Arrangements remain valid, coupled with more active use of the Board's discretionary waiver policies under Article V, section 4.

Section 1(b) is not specific to the SRF, but is valid for all drawings under the Fund's credit tranche policies, and is thus superfluous.

Section 1(c) gives a message diametrically opposite to what I advocated last Monday in seeking rules that would signal that access under the Fund's lender of last resort facility is not a foregone conclusion. Section 1(c) confirms that big countries are likely to be bailed out, adding to the perception that big countries are too important to be allowed to fail.

Section 1(d) confirms the general principle that access to the Fund's resources depends on a country's balance of payments needs, and is thus also dependent on what financing is provided by other creditors. Drafted in this way, section 1(d) merely confirms general policies and makes the policy under the new facility no different from existing policies.

If one wants to make parallel financing by other creditors a condition for eligibility under the SRF, section 1(d) should be drafted so as to explicitly limit, as I suggested last Monday, the Fund's financial support to only a part of a country's external debt falling due, and to require that in addition to the Fund's support, the country obtains firm commitments, as opposed to mere expectations that the country's creditors will not withdraw.

Section 1(e) only paraphrases Article VI, section 1 of the Fund's Articles of Agreement. If one wants to make the Fund's policies under Article VI more explicit, it would be more consistent with the meaning of Article VI to confirm that the Fund is obliged, under that Article, to require the country to impose exchange restrictions in order to prevent Fund resources from being effectively used to finance large capital outflows—or, in more up to date terminology—to require that the beneficiary country use instruments of orderly resolution of its liquidity crisis, so as to force its creditors to temporarily maintain their credit to the country in parallel with the Fund's financing.

I think that it is this condition Mr. Esdar wants to see confirmed in the text of the decision, rather than touting the desirability of solidarity to creditors who are running away from the country.

Section 6(b) introduces the expectation of early repurchases one year before the repurchases become due. The same section also allows for postponing this expectation to a date closer to the due date, or canceling it, but the proposed text does not specify what considerations can justify such postponements or cancellations. According to Article V, section 7(b) of the Articles of Agreement, the due date of a repurchase obligation can only be advanced "because of an improvement in [the country's] balance of payments or reserve position." The same Article requires that such a finding must be made "in accordance with policies on repurchases that the Fund shall adopt." Article 6(b) of the proposed decision is superfluous. What is desirable is an active application of existing rules requiring members to make repurchases as soon as their balance of payments position improves. This might even be earlier than one year before the due date of the repurchase. If the Board is willing to take seriously its responsibilities in making the determination that a country no longer has a balance of payments need, the necessity for imposing strict shortened repurchase obligations irrespective of the country's external position diminishes. The proposed decision relies heavily on early repurchase expectations, which implies that the country no longer has a balance of payments need, but nonetheless permits the country to continue making drawings under the Stand-By Arrangement that is being supplemented by the SRF.

Section 6(c) of the proposed decision declares a member ineligible to use the Fund resources for failure to fulfill an expectation of early repurchase. This violates Article V, Section 7(b) of the Articles of Agreement, which requires that "the Fund represents to the member that it should repurchase because of an improvement in its balance of payments and reserve position." Such representations must be made "in accordance with policies on repurchase that the Fund shall adopt."

Section 10, in rather ambiguous language, provides that "the Fund will be prepared to grant a waiver of the limitation of 200 percent of quota." Article V, section 4 of the Articles of Agreement guarantees, for the Board, the competence of setting discretionary safeguards as a condition for waiving the access limit. Those discretionary safeguards must be decided on a case-by-case basis, considering the situation of the member requesting the waiver. The Board cannot abdicate its responsibility in this regard. I therefore suggest that Section 10 be deleted.

The Director of the Policy Development and Review Department considered that there were basically three issues on which Directors would need to concentrate. The first involved the changes that were made at the behest of Mr. Esdar and a number of other Directors affecting subparagraphs 1(b) to 1(e) in the draft decision. The second issue dealt with the maturity profile in the architecture of the facility, whereby there would be an expectation of repurchase set first, which could be extended by the Board up to a point of a fixed obligation to be specified in the decision. Those obligations in the draft decision were set at two and two-and-a-half years for the final semiannual repurchases that would be due under each purchase. From the discussion at the previous Board meeting, it was clear that such a basic architecture was generally agreed; at the same time, Messrs. Guzmán-Calafell, Kafka, and Zoccali had issued a preliminary statement, in which they suggested a lengthening of the maturity structure by six months. The third issue related to charges. There appeared to be general agreement that charges should be structured progressively. The preliminary staff statement issued and discussed informally the previous day contained one possible suggestion for such a structure.

There were several questions that remained, the Director continued. First, the initial rate needed to be established. The staff had suggested 300 basis points, which might capture the center of gravity among Directors' stated positions. Some Directors favored a somewhat higher rate, while Messrs. Guzmán-Calafell, Kafka, and Zoccali and a number of other Directors preferred a lower rate; in the joint preliminary statement of those three Directors, they specifically suggested 200 percent. Second, regarding charges, there was a question about the rate of progression. Again, the staff had suggested 50 basis point increases, which had also been the example used by Mr. O'Donnell. However, there were two subissues: should the progression occur at six-monthly intervals from the start of the arrangement, or should there be a period of one year perhaps—the period of the arrangement itself—before the progression started, and then have the progression proceed at six-monthly intervals? A related point was made in the joint preliminary statement by Messrs. Guzmán-Calafell, Kafka, and Zoccali, in which they suggested that there be a cap on the rate at 400 basis points. Under the proposed structure—either in the staff statement itself, which would have six-monthly intervals, or under the alternative, which would have a first interval of one year and then six-monthly intervals—the maximum surcharge could go above 400 basis points. Lastly, there seemed to be agreement that charges should be levied on outstanding balances; however, some confusion might remain. The latest staff proposal would not make the rate of charge a function of the outstanding balances; rather, at any given moment when charges were assessed by the Fund, they would be assessed on whatever the level of outstanding balances would be at that time. That basically meant that the six-monthly intervals for the progression of charges would begin at the point the arrangement was approved, rather than at the point for each individual purchase when the purchase was drawn. There was relatively broad support for assessing the charges on outstanding balances, but again in the joint preliminary statement of Messrs. Guzmán-Calafell, Kafka, and Zoccali, they suggested a structure which was similar to that which appeared in the preliminary staff statement; that is, that the progression would begin with each purchase.

The Treasurer added that there was broad agreement also to include a paragraph in the decision establishing the SRF to address overdue obligations.

The Chairman said that he agreed that the issue of overdue obligations would need to be addressed in the decision.

Mr. Taylor pointed out that several Directors had considered it important to address the issue of whether the new facility would be confined to larger countries. On that issue, he considered that the Chairman's original language was more appropriate.

The Chairman stated that an effort would be made to utilize the most appropriate language for the decision.

Mr. Mirakhor expressed concern that, as currently designed, the proposed SRF would exclude some ESAF-eligible emerging market economies that might face a crisis induced by a sudden loss of market confidence. He asked the staff how such situations could be addressed.

Mr. Shaalan clarified that he could support Mr. O'Donnell's suggested progression in the surcharge, but he would prefer a cap at 400 basis points. He also expressed support for the proposal by Messrs. Guzmán-Calafell, Kafka, and Zoccali to begin the surcharge at 200 and proceed to 400. However, he said that he would remain flexible on that point.

Mr. Yao said that he agreed with Mr. Taylor on the importance of addressing the issue of whether the facility should be confined only to larger countries. Also, he said that he agreed with Mr. O'Donnell's proposal on the progression of surcharges, provided that the first increase occurred one year after the first drawing, which was in line with the position of Messrs. Guzmán-Calafell, Kafka, and Zoccali.

Mr. Zamani considered that the facility should not be terminated after two years, as suggested by Mr. Esdar. Also, members currently under Stand-By or Extended Arrangements should have access to the new facility.

Mr. Zhang said that he agreed with Mr. Taylor regarding the eligibility to the facility. Also, he stated that he agreed with the views expressed in the preliminary statement by Messrs. Guzmán-Calafell, Kafka, and Zoccali. On the duration of the facility, he would support the staff proposal, if a consensus of the Board was reached. Also, the progression of surcharges should begin after one year, beginning at 200 basis points.

Mr. Cippà noted that, at the previous discussion, there had been some support for the inclusion of some reference to the conditions relating to potential arrears under the SRF.

The Chairman said that the staff would propose some draft language that would address Mr. Cippà's concern.

The Director of the Policy Development and Review Department pointed out that the footnote on page 11 of the staff report treated the question of ESAF-eligible countries with respect to the proposed SRF. The facility would, in principle, be available to all members of the Fund; however, it was suggested that, normally, most ESAF-eligible countries would not be expected to be able to have access to the facility, since they would not be exposed to confidence crises that resulted from severe balance of payments pressure from potentially large capital outflows. In the few cases that might qualify, the particular situation would need to be reviewed carefully. It was important to ensure that resources made available to ESAF-eligible countries were appropriate to their specific circumstances and that ESAF resources continued to be considered as concessional in nature.

The Chairman said that he agreed with the views expressed by the Director of the Policy Development and Review Department.

Mr. Mirakhor asked that the decision reflect the Director of the Policy Development and Review Department's statement that ESAF-eligible countries could, in exceptional circumstances, have access to the SRF.

The Chairman noted that the Fund practice was to have concise decisions; the minutes of Board meetings provided a commentary and background to any decision. In the interest of brevity, it would be best to limit any additions to the proposed decision on the SRF.

Mr. Mirakhor considered that the SRF was designed to address exceptional problems facing all countries—including ESAF-eligible countries and irrespective of the size of the potential capital outflows they faced. It was important to recall that an ESAF-eligible country may encounter problems with capital outflows of an amount that might be considered as manageable in more advanced economies.

Mr. Wijnholds said that he agreed with the Director of the Policy Development and Review Department that the SRF would, in principle, be open to all countries, but that it was not expected that ESAF-eligible countries would normally request access to resources under the SRF. The countries that would normally have access to resources under the SRF were those that had access to international financial markets. It was important to recall that the use of SRF resources would be subject to a substantial surcharge that might make those funds prohibitively expensive for ESAF-eligible countries. Nevertheless, there might be other categories of countries with access to markets that, while not posing an immediate threat to the stability of the international monetary system, might be eligible for SRF resources.

Mr. Yao said that he agreed with Mr. Wijnholds. Within his constituency, Mauritius was a small country without access to international financial markets, but was not currently under an ESAF-supported program.

The Chairman asked the Director of the Policy Development and Review whether it would be possible to broaden the language of the proposed decision to capture other potential users of the SRF referred to by Messrs. Wijnholds and Yao.

The Director of the Policy Development and Review Department said that he agreed that there could be other categories of countries whose circumstances emerged in a way that would warrant consideration under the facility. At the same time, an ESAF-eligible country enjoying large market access and paying market rates of return might also begin to raise questions about the use of scarce concessional resources from the Fund.

Mr. Sivaraman stated that he agreed with the Director of the Policy Development and Review Department; slightly redrafting paragraph 1(b) in the draft decision would likely address the concerns of several Directors.

The Chairman said that paragraph 1(b) could be slightly redrafted; the minutes of the meeting would record the explanation provided by the Director of the Policy Development and Review Department.

Mr. Esdar questioned the appropriateness of including ESAF-eligible countries in the context of the SRF; he would return to the matter during the course of the discussion.

The Chairman suggested that the Board review the draft decision paragraph-by-paragraph. On paragraph 1, the current draft decision incorporated the concerns expressed by Mr. Esdar and other Directors at the previous Board meeting.

Mr. Esdar said that he was broadly satisfied with the current paragraph 1. He had made an additional suggestion for paragraph 1(d) to include the words: "All options to minimize moral hazard and to ensure an appropriate burden sharing should be considered."

Mr. Kafka recalled that the joint preliminary statement that he had submitted along with Messrs. Guzmán and Zoccali supported Mr. Esdar's suggestion.

Mr. Kiekens considered that, with respect to paragraph 1(a), a major drawback of the proposed facility was that the Fund was only prepared to provide financial assistance to countries already facing an open financial crisis. As stated in paragraph 16 of the staff paper, it was not intended that the SRF would be used in the event that a crisis of confidence had not actually developed. This was at odds with the first principle of the Fund's guidelines on conditionality, encouraging members to adopt corrective measures that could be supported by the use of the Fund's general resources, in accordance with the Fund's policies, at an early stage of their balance of payments difficulties, or as a precaution against the emergence of such difficulties. The new facility provided the wrong incentives for countries facing the threat of a crisis. It was difficult to understand that, as the staff had stated in paragraph 16 of the staff report, "the purpose of the facility [was] not to finance significant outflows but rather to stop further outflows," and that it was necessary to wait until the country had lost market confidence before supplying large financial support in the expectation that that would ensure an early return of confidence. It was true that early corrective measures would reduce the need for substantial Fund financial support, but one could not rule out that, in exceptional circumstances, countries facing a large bunching of maturing debt might need high precautionary access in support of their adjustment policies.

Mr. Kafka pointed out that his joint preliminary statement supported Mr. Kiekens' concern that the facility would not to be available for crisis prevention.

Mr. Shaalan said that he agreed with Mr. Kiekens. He suggested removing the words "sudden and disruptive" from paragraph 1(b).

Mr. Kiekens noted that, in his preliminary statement, he had commented on the use of the word "sudden." While the word "sudden" should be deleted, an explicit reference should be made to the availability of the SRF to prevent a crisis.

Mr. Kafka considered that it would not be sufficient to remove the words "sudden and disruptive," because the word "loss" referred to something that had already happened.

Mr. Cippà said that he understood Mr. Kiekens' concern; however, it was unlikely that a country would be willing to pay the surcharge associated with the SRF before a potential crisis erupted.

Ms. Lissakers believed that, in some circumstances, countries would be willing to use SRF funds before a crisis erupted, as had been made evident during previous Board discussions on a currency stabilization fund. She said that she agreed with Mr. Kiekens that there might be cases where substantial resources on a precautionary basis would serve a country well. If the country had the financial capacity and was dealing with a short-term currency stabilization situation, then it would make sense—from the Fund's point of view—to charge a substantial premium on the use of the facility and to insist on short repurchases. At the same time, she understood Mr. Esdar's point on limiting the use of the SRF to those cases that posed a systemic threat.

The Chairman remarked that, at times, the attractiveness of the Fund's financing and the quality of the Fund's policy guidance and technical assistance were insufficient to encourage countries to approach the Fund at an early stage to seek assistance to prevent a crisis. As a result, it was difficult to see how the SRF could serve to prevent crises.

Mr. Esdar considered that there would not have been a need for such exceptional financing if the Asian countries currently in crisis had come to the Fund sooner for assistance. Moreover, it was important for the Fund not to undermine its message that appropriate policies prevent crises—without the need of Fund financial assistance. If the Fund were to create a "prevention facility," then its resources would quickly evaporate because many countries—perhaps including some advanced economies—would likely request access to the resources.

Mr. O'Donnell said that he was sympathetic to the idea expressed by Ms. Lissakers about dealing with expectations of sudden and disruptive losses of confidence. However, it would be extremely difficult to implement on a practical level, because the establishment of a facility for that purpose would likely send the message to financial markets that the Fund expected a substantial loss of confidence. The SRF could be viewed as a "hospital" and the crisis-affected country as a "patient": once the patient had entered the hospital, it was already in need of major surgery. The other mechanisms of the Fund could be viewed as preventative—much like the role played by a general practitioner.

Mr. Esdar considered that the decision establishing the SRF should not try to specify those situations in which the facility could be used to prevent emerging crises, because the use of the facility in such cases might actually spur the crisis it would be trying to avoid. Such cases should be addressed individually and in a practical manner.

The Chairman believed that, in conjunction with the establishment of the SRF, the Fund and the international community would need to reiterate the importance of appropriate crisis-prevention efforts. For example, prudential standards needed to be strengthened to ensure better credit allocation. Also, the international community needed to advance work on issues related to moral hazard concerns—especially a common definition of moral hazard—and to the appropriate institutional arrangements needed to deal with any future crisis. In the period ahead, the Board would be discussing various issues emerging from the Asian crisis. As a result, and in response to the concerns expressed by Mr. Kiekens and other Directors, the establishment of the SRF would not solve all the problems that the Fund was confronting in the Asian crisis, but it was part of a broader strategy that included bolstering crisis-prevention efforts and creating ways to deal with private-to-private creditors' and debtors' problems.

Mr. Vernikov said that he welcomed the Chairman's explanation; however, he strongly endorsed the thrust of Mr. Kiekens' statement. The Fund should have the capacity to help members prevent crises; in that context, there might be cases for which access to Fund resources significantly above quota access limits was required. Were Directors to agree on the use of the SRF for crisis-prevention, then the language in paragraph 1(b) would need to be revised significantly. If the SRF could not be used for crisis prevention, then an alternative—perhaps some kind of currency stabilization fund—might be needed.

Mr. Mirakhor considered that Mr. Kiekens had made a compelling argument. While he understood Mr. Esdar's point about sending countries the message that implementing appropriate adjustment programs would help them avoid resorting to exceptional financing, it was also important to recall that the establishment of the SRF should send the message to financial markets that the Fund would support countries that adopted appropriate policies. Also, there might be cases of countries following sound macroeconomic policies that experience external pressures. It might be useful to include some language—perhaps in a preamble—that captured the importance of crisis-prevention efforts and the fact that the Fund would support members that, despite following appropriate policies, were subject to financial market pressures.

The Chairman agreed that it might be worthwhile repeating the Fund's basic purpose to stand by its members and provide appropriate support as soon as requested.

Ms. Lissakers noted that, in creating the facility, the Fund was signaling that it was equipped to deal with such crises, but Mr. Esdar's point that the facility should not be viewed as a kind of open-ended invitation for countries to tie up the scarce resources prematurely was valid. The two sides could be bridged by using the words "an actual or emerging loss of market confidence" in paragraph 1(b) instead of "sudden and disruptive." Also, the word "strong" could be substituted for "appropriate adjustment," and "appropriate" or some equivalent word on financing could be used rather than "adequate financing," because adequate financing suggested that the Fund was prepared to cover all outflows.

The Chairman noted that the use of the word "appropriate" would mean that not all capital outflows would be covered. An official interpretation of the word "appropriate" could be inserted somewhere in the decision.

Ms. Lissakers said that she could go along with the use of the word "adequate," on the understanding that that would not imply the coverage of all capital outflows.

Ms. Srejber remarked that she shared Mr. Esdar's concerns. Countries should be encouraged to take early corrective measures, and the Fund's normal facilities with access limits were instrumental to that end. In order to support crisis-prevention efforts at an early stage, it was important to recall the Fund's catalytic role. As Mr. Esdar had noted, adequate corrective measures at an early stage of an emerging crisis should make it unnecessary for countries to request very high access to Fund resources. In any event, very high access to the use of Fund resources should be very exceptional, which would require the activation of the exceptional circumstances clause.

The suggestion made by Ms. Lissakers to use the words "actual or emerging loss of market confidence" instead of "sudden and disruptive," was acceptable, Ms. Srejber continued. The suggested change of "appropriate" adjustment policies to "strong" was also acceptable. However, the term "adequate financing," was less than ideal; perhaps "appropriate" or another term was preferable.

The Chairman asked Ms. Lissakers if she could agree to include a reference to the Fund's catalytic role in the decision.

Ms. Lissakers responded that she would prefer not to mention the Fund's catalytic role; the views that she had expressed at previous Board meetings on that matter had not changed.

Mr. Esdar commented that he could accept the words "actual or emerging." However, the concept of "disruptive" should be reflected one way or another, because a loss of market confidence in many countries' policies happened with some frequency in financial markets. He suggested using the words "actual or emerging, disruptive loss of market confidence."

Ms. Lissakers said that it was desirable to incorporate the concept of a "disruptive" loss of market confidence.

The Chairman suggested that the Board adopt in the third line of paragraph 1(a) the words "due to a large short-term financing need resulting from an actual or emerging, disruptive loss of market confidence."

Mr. Sivaraman said that he could accept the Chairman's formulation. Returning to Mr. Kiekens' point on the possible use of the SRF to prevent crises, he would prefer that the facility be used only in truly exceptional situations. The Fund had other procedures and arrangements to deal with crisis prevention, including consultations and discussions with the authorities and Stand-By and Extended Arrangements. He said that he agreed with Messrs. Esdar and O'Donnell that broadening the scope of the SRF would not send the appropriate signals to international financial markets about the specific purpose of the facility.

In order to address Mr. Sivaraman's point, the Chairman suggested adding to the first line of paragraph 1 the words "The Fund will be prepared to provide exceptional financial assistance...."

Mr. O'Donnell suggested that, instead of adding the word "exceptional" to the beginning of the paragraph, the word "exceptional" should be added before the words "balance of payments difficulties" in the second line of paragraph 1(a).

Echoing Mr. Sivaraman's concern, Mr. O'Donnell pointed out that adding the words "or emerging" to the concept of sudden and disruptive market loss was a significant change to the nature of the facility that opened the door to considerably greater use. The more that door was opened, the higher the entry price should be, in order to limit the number of people going through that door.

Mr. Giustiniani said that he supported the concerns expressed by Messrs. Sivaraman and O'Donnell.

Mr. Guzmán-Calafell recalled that, as noted in his joint preliminary statement, he supported the use of the SRF for crisis prevention. Some Directors had expressed the concern that such a use of the facility would be counterproductive. However, it was not unusual for countries to seek lines of credit either from commercial banks or from other governments as a line of defense in case difficulties in the balance of payments emerged. Therefore, the use of the facility in that context would not be of any danger.

Mr. Taylor said that he agreed with Messrs. O'Donnell and Sivaraman that the SRF should not be used as a crisis-prevention instrument. He also said that he could agree with all of Ms. Lissakers' suggestions, except on the use of the word "emerging," which was an open-ended and loose word. The word "imminent" might be closer to the original intent for the facility.

Mr. Esdar considered that, if the word "imminent" meant that a crisis had already started, then it would be preferable.

Ms. Lissakers believed that the word "emerging" signified that a crisis had already begun.

Mr. O'Donnell considered that the word "imminent" meant that something had not yet started. For example, an "imminent fall" would mean that someone was perched on the edge of a cliff.

The Chairman said that the General Counsel had remarked that the facility was intended to respond to a member already experiencing an exceptional balance of payments problem, which meant that the word "imminent" would not be appropriate.

Mr. Taylor and Ms. Lissakers considered that it was unnecessary to add either the word "emerging" or "imminent" to the sentence.

The Chairman suggested that Directors accept the original language for paragraph 1(a), that is, retaining the words "... to a member that is experiencing exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive..."

Mr. Kiekens recalled that his basic stance was that the facility was superfluous, and that trying to draft language to account for all potential eventualities was fruitless—which was borne out by the discussion so far. A more effective strategy for the Fund would be to strengthen preventative efforts and to utilize its existing financing instruments. Nevertheless, he observed that the drafting of the facility was flawed in a number of ways. For example, the draft language was too narrow and precluded large precautionary access to the Fund's resources in support of a country's adjustment policies before an actual crisis erupted. Moreover, the draft decision stated that the balance of payments difficulties must be reflected in pressures on the capital account and on the member's reserves. While it was generally understood that such pressures would be reflected in a decrease in a member's reserves, there were cases where pressures mounted because reserves increased. For instance, banks often borrow foreign currencies in the markets because they were unwilling to widen their open positions in the markets; that led to increased foreign reserves in the central bank. However, over time, the situation became increasingly fragile, as the banking system weakened and the country's external reserves increased. The narrowly drafted language in the decision would preclude the necessary use of substantial Fund financial assistance in order to prevent a crisis. Finally, in order to safeguard the Fund's scarce resources, it was important to incorporate the appropriate incentives to encourage early repurchases through, inter alia, higher interest rates and possibly shorter maturities. If such incentives were not included in the facility, he stated that he could not agree with the proposed decision.

The Chairman said that Directors had understood that Mr. Kiekens had many concerns about the establishment of the proposed facility. Many of Mr. Kiekens' concerns focused on actions to prevent such serious crises and, in that context, the conditionality and surveillance policies of the Fund. However, the Fund was currently faced with the challenge of devising actions to deal with the crisis at hand. He asked the Director of the Policy Development and Review Department to address Mr. Kiekens' concerns.

The Director of the Policy Development and Review Department pointed out that it was not intended for the proposed SRF to substitute for the current facilities available within the Fund, including precautionary mechanisms under which a country could request assistance for potentially emerging problems to support appropriate corrective actions. Moreover, the SRF was not intended to be a stand alone facility, but one that would be used in the context of a Stand-By or Extended Arrangement. Indeed, in the event that a precautionary arrangement or an arrangement under one of the regular facilities was not able to stem the development of a sudden and disruptive loss of market confidence, it would be possible, under the emergency financing mechanism procedures, to provide quick additional support from the SRF.

The conditionality of the facility derived, to a large extent, from its purpose: to stem capital outflows, the Director continued. Accordingly, the conditionality and the recommended policies would be aimed at that particular goal, and not at allowing continued financing of outflows. However, as was currently evident in some of the Asian cases, if the recommended policies and the conditionality were not able to reverse the situation quickly, then there might be some limited financing of outflows under the facility; in that case, the aim would be to stop such financing and reverse those flows.

The General Counsel noted that the staff had given a great deal of thought to the issue raised by Mr. Kiekens, namely a distinction between the actual and major balance of payments problem addressed in the facility and a potential balance of payments problem. There was complete symmetry between the provisions of paragraph 1(a) and paragraph 2. Under 1(a), the exceptional assistance was available when there was an actual major problem. Under paragraph 2, countries in those cases that qualified under the SRF would not have access to the normal resources of the Fund. However, in other cases, everything else remained available. In other words, when there was a potential problem, a country would still have access to the credit tranches including the possible application of the exceptional circumstances clause.

Mr. Kiekens said that he took note of the General Counsel's response, which corresponded to the fourth paragraph in his preliminary statement. He said that he would go along with the Board's consensus on the matter; he would be willing to limit significantly the scope of the facility because the General Counsel had assured the Board that all that was not under the facility remained possible under existing facilities. He asked Directors to confirm the point that, in exceptional cases, countries would be provided with high access to the Fund's resources in order to prevent a crisis.

The Chairman asked Directors whether they were satisfied with the General Counsel's response to Mr. Kiekens' concerns.

Mr. Zoccali responded that he broadly agreed with the General Counsel's interpretation. However, he wondered why, in the current Asian crisis, contagion had not been deterred and that, except for the Philippines, no country had been induced to come to the Fund to support preventative efforts. In fact, the existing Fund facilities were supposed to provoke precisely that sort of virtuous circle. He considered that, for cases where liquidity supplementation was required, the prospect of adequate availability in a timely nature of sufficient resources to quell a liquidity crisis was the overriding incentive. During the previous discussion on the SRF on December 15, 1997, Mr. O'Donnell had raised the issue of the "yellow flags," and he had raised the issue of prequalification. Perhaps countries that were implementing policies deemed worthwhile from the macroeconomic and structural point of view should have some sort of differentiation in terms of automaticity of access to exceptional financing. In turn, they would be paying the commitment fee under a precautionary Stand-By or Extended arrangement, but they would be getting, in return, some assurance of automaticity to the SRF under penalty conditions if a liquidity crisis should erupt. That prospect could constitute a positive incentive to come to the Fund at an earlier stage. Therefore, such a proposal should not be excluded outright.

The Chairman recalled that he had been attracted to the notion of the use of "yellow cards" or other incentives to encourage countries to approach the Fund at an early stage for assistance with potential problems. Unfortunately, the practice had been for countries to wait until just before an actual disruptive loss of confidence. Indeed, the authorities in the crisis-stricken countries in Asia had made public denials of any prospect of Fund assistance until the last possible moment. Therefore, while it was desirable to stress the importance of engaging the Fund at an early date to help resolve problems, it would be difficult to change immediately the behavior of authorities. To that end, it was important, at the time of the establishment of the SRF, to underline the need to buttress the Fund's surveillance capabilities, to strengthen early warning mechanisms, and to improve the perception of the Fund and its support for programs in the membership.

Directors should be aware that, at the current stage of the discussion, the Board had yet to agree on a single paragraph of the draft decision, the Chairman continued. He suggested that Directors should focus their remarks on the specific provisions of the decision, rather than on general considerations.

Mr. Kafka said that he agreed with the Chairman's final statement. He reminded Directors that each decision would need to be interpreted by the Board and by the staff. Therefore, it was not important to discuss the differences between the words "sudden and disruptive" and "actual and emerging," since they were broadly similar.

Mr. Mirakhor wondered whether the General Counsel's response to Mr. Kiekens' concern implied that the SRF would essentially be a window on an existing facility, which would mean that higher charges, except in a refundable form, would not be possible.

The Chairman and the General Counsel noted that the SRF would not be a window within an existing facility, but a separate facility. Holdings under the SRF would be floating, vis-à-vis, for example, the reserve tranche and holdings under other facilities.

Ms. Lissakers considered that, contrary to Mr. Kiekens' assertion, the creation of the SRF would not foreclose the option of providing exceptional access under the Fund's regular facilities. In fact, that was one of the reasons she favored a facility, because she recognized that there would be circumstances where exceptional access should be granted, but that did not necessarily require higher charges or shorter maturities.

The Chairman noted that Ms. Lissakers' position was compatible with the interpretation given by the General Counsel.

Mr. Guzmán-Calafell pointed out that Mr. Kiekens had noted in his preliminary statement that the creation of the SRF should not eliminate the option of using the exceptional circumstances clause. He repeated Mr. Kiekens' question of whether it would be possible to use higher charges in combination with the exceptional circumstances clause.

Mr. Kiekens recalled that he had discussed the matter in his preliminary statement. He considered that there were many possibilities to consider, including the use of higher charges in conjunction with the exceptional circumstances clause.

Mr. Guzmán-Calafell considered that, even though such a situation would be rare, the use of higher charges might go against the spirit in which the Board was discussing the creation of the SRF. The staff had explained that the rationale for higher charges and for shorter repurchase periods in the facility was that it would be accompanied by a short-term financial need and that such cases would be accompanied by an expectation of a rapid turnaround in confidence. Moreover, the staff had pointed out that there were two kinds of financing needs a country could have—an underlying one and a short-term one. It was important to note that, if the Fund were granting access under traditional facilities and using the exceptional circumstances clause, it would be supporting an underlying balance of payments need, and therefore it would not make sense to use either higher charges or shorter repurchase periods.

The General Counsel stated that he had a different view of the Fund's powers under Article V, Section 4 than Mr. Kiekens had expressed in his preliminary statement. He reiterated that the Fund would not have the power to impose nonrefundable charges under Article V, Section 4.

Mr. Kiekens remarked that, on behalf of his constituency, he would be pleased to see the General Counsel's point of view confirmed by the Board; however, his personal opinion remained different. He said that he had good reason to be on the other side, because otherwise, the Board currently agreed that countries could request high access to the traditional facilities such as a Stand-By or Extended Arrangement—provided that they were not suffering an actual crisis—and that they would pay the normal interest rates, and that there was no possibility to use Article V, Section 4 to ask them to pay what was, in his opinion, reasonable, i.e., a higher interest rate. However, he remained unconvinced by the General Counsel's arguments.

The General Counsel said that he agreed with Mr. Kiekens that, if a country outside the scope of the SRF's provisions were to come to the Fund and request the use of the Fund's resources beyond 200 percent of its quota—or even 300 percent under exceptional circumstances—it would be subject to the credit tranche or Extended Fund Facility charges and would be paying the normal rate of charge. Moreover, under Article V, Section 4, the Fund could add an exceptional, higher rate of charge, but it would be refundable; the proceeds would not be part of the Fund's income but only a precautionary balance.

The Chairman asked that Directors conclude discussion on paragraph 1(a). He suggested that Directors adopt the section, adding to the second line the word "exceptional" to read: "...to a member experiencing exceptional balance of payments difficulties..." Also, on line 5, replace "appropriate adjustment policies" with "strong adjustment policies." Finally, in line 6, the words "adequate financing" would be retained. He suggested that Directors turn their attention to paragraph 1(b).

Mr. Sivaraman considered that the first line of paragraph 1(b) should say that the "...purpose of the facility will be to support the implementation of adjustment policies..." Adding the notion of the implementation of policies would strengthen the section.

The Chairman believed that Mr. Sivaraman's suggestion was acceptable.

Mr. Zoccali said that the word "and" in the last line of paragraph 1(b) should be replaced by the word "or," because it was not clear that the real costs in all circumstances would be limited through exchange rate depreciation; that would preclude the possibility that if a country did not exhibit an overshooting of the exchange rate, it would not be able to access the facility.

The Chairman suggested using the words "and/or."

The General Counsel pointed out that the real purpose of the facility appeared in the first clause—to support the implementation of adjustment policies—and that the rest of the section outlined some of the worst possible consequences of a potential crisis. Since the paragraph did not create a condition that such consequences should be the target of the facility, the precise wording was not of crucial importance.

The Chairman, seconded by Mr. Zoccali, suggested that paragraph 1(b), as amended by Mr. Sivaraman, be adopted.

Mr. Kiekens recalled that the Chairman had suggested that the text of the proposed decision should be as succinct as possible. Since paragraph 1(b) merely confirmed the general purpose of all of the Fund's facilities, it did not add anything substantive. Moreover, the scope of the facility should be as narrow as possible, since that would allow those countries that fall outside of the facility to rely on the Fund's normal practices in which they were better treated. As a result, paragraph 1(b) was unnecessary and should be deleted.

Ms. Lissakers said that she had some unease with the reference to "unnecessary insolvencies" at the end of paragraph 1(b). She said that she agreed with Mr. Kiekens that paragraph 1(b) did not add much substance to the decision; therefore, it could be dropped.

The Chairman stated that he agreed that paragraph 1(b) should be deleted.

The General Counsel stated that he would also favor a shorter text. Paragraph 1(b) had been inserted in response to views expressed by a few Directors on the matter at the December 15, 1997 meeting.

The Chairman pointed out that, after reflecting on their colleagues' interventions, Directors modified their positions from time to time; in the current case, Mr. Kiekens' logic had convinced the Board. He suggested that paragraph 1(b) be deleted and that Directors moved to consider paragraph 1(b).

Mr. Kiekens recalled that, in his preliminary statement, he had made the point that paragraph 1(b) gave a message diametrically opposite to what he had advocated during the previous meeting in seeking rules that would signal that access under the Fund's lender of last resort facility was not a foregone conclusion. The section seemed to confirm that large countries were likely to be bailed out, adding to the perception that large countries were too important to be allowed to fail.

The Chairman asked the General Counsel whether it was important for a decision to specify the circumstances surrounding its utilization. Since the notion of the risk of contagion had been captured in paragraph 1(a), it was not clear what paragraph 1(b) was adding to the substance of the decision.

The General Counsel responded that the proposed paragraph 1(b) had been included to accommodate the views of some Directors. However inelegant the section might be, there was a famous precedent in the history of the Fund. It was not the first time that a question of a possible discriminatory treatment among members had arisen. The previous example was that of the creation of the Extended Fund Facility. The idea at the time had been to create the facility exclusively for developing countries—a clear case of discrimination. The language used was "...the facility, in its formulation and administration, is likely to be beneficial for developing countries in particular." While it was not a condition, the language made some Directors' particular concern clear. A similar construction was used in the proposed decision on the SRF.

The Chairman noted that, if Directors sought a parallel with the Extended Fund Facility decision, then the proposed language was appropriate; perhaps the language could be more elegant.

Mr. Shaalan considered that paragraph 1(b) described a particular kind of contagion—one that could pose a threat to the international monetary system; that meant that a less critical type of contagion would not be covered by the SRF.

The General Counsel reiterated that paragraph 1(b) merely stated the expectation of the kind of problems that the facility would address. It did not state the conditions for access to the facility, which appeared in paragraph 2.

Mr. Shaalan asked what was the operational meaning of paragraph 1(b).

The General Counsel responded that paragraph 1(b) had no operational meaning.

Mr. Shaalan suggested that paragraph 1(b) be deleted.

The Chairman considered that the section should not be deleted.

Ms. Lissakers suggested that it could be recognized that the facility was open to all members, but it was likely to be used in cases that could pose a threat to the international monetary system.

The Chairman noted that the minutes of the Board meeting could reflect the principle that the facility was open to all members.

Mr. Esdar suggested that the Chairman's concluding remarks reiterate the same idea.

The Chairman said that he agreed with Mr. Esdar's suggestion.

Mrs. van Geest, speaking on behalf of Mr. Wijnholds, noted that the text of the proposed decision should be closer to the text of the summing up of the Board discussion on the Emergency Financing Mechanism. For example, it could read: "the facility is to be used in cases where the member was faced with a truly exceptional situation threatening its financial stability and a rapid Fund response in support of strong policies was needed to forestall or to contain significant damage to the country itself, or to the international monetary system, it being understood that the potential for spillover effects would be an important element of the Board's final judgment."

The General Counsel pointed out that all members would need to meet the same conditions—a point that had not been clear in Mr. Wijnholds' previous statement. Two alternative criteria for access to the facility would need to be considered—either the effect on the international monetary system or a large problem in the country concerned. Consequently, if the Board took into account the effect on the international monetary system to determine access to the facility (and, therefore, exclusion from the credit tranches), access would not be determined by the need of the country. In that event, the problem of nonuniform treatment would return, that is, different facilities for countries facing problems of the same nature and magnitude.

The section quoted by Mrs. van Geest on the Emergency Financing Mechanism concerned the acceleration of the Fund's procedures, and not the level of access, which was the issue in the current discussion, the General Counsel continued.

Mr. Esdar said that he would be disturbed if, in the context of the current discussion, paragraph 1(b) did not have any operational relevance. However, given that similar language appeared in the decision on the Extended Fund Facility, the section should remain in the decision.

Mr. Sivaraman suggested that Directors' concerns could be met by combining paragraph 1(b) and Box 2 on page 15 of the staff report that described the summary features of the SRF. That would confirm the principle that the facility was open to all members, but that access to resources under the facility would be decided on a case-by-case basis.

The General Counsel pointed out that, as clarified in the staff paper, the systemic impact was not a relevant consideration in assessing the level of access of the member to resources under the SRF.

The Chairman asked whether, with the benefit of the clarification given by the General Counsel, Mr. Esdar and Mrs. van Geest could agree to maintain paragraph 1(b) as originally proposed.

Mr. Taylor considered that either the current wording served in practice to contain the facility to large countries, in which case it was unacceptable and inconsistent with paragraph 1(a), or it did not, in which case it was redundant and should be deleted.

The Chairman stated that the Board need not repeat the discussion on the occasion of the creation of the Extended Fund Facility in 1974, during which it had been necessary to reconcile the universal purpose of all the facilities of the Fund with the likelihood of its utilization—something which deserved to be mentioned in the specific language of each facility and which was reflected in the proposed decision on the SRF.

Mr. Esdar considered that paragraph 1(b) was not redundant and should be retained.

Mr. Shaalan suggested that the language of paragraph 1(b), along with language on the principle that the facility would be opened to all members, be included in the Chairman's concluding remarks of the discussion.

The Chairman considered that it would be more appropriate for the minutes of the Board meeting to reflect the fact that all facilities of the Fund were open to all members. Also, as the Board had noted at the time of the establishment of the Extended Fund Facility, the decision establishing the SRF would state the likelihood that some countries would be more appropriate candidates to benefit from access to resources under the facility. He noted that Directors agreed to his proposal. He suggested that Directors turn their attention to paragraph 1(d), which addressed the issues of burden sharing and moral hazard.

The Director of the Policy Development and Review Department recalled that the term moral hazard did not have a common, standard definition. It might be useful to associate the term with the point about seeking to maintain exposure of all creditors. He suggested revising the beginning of paragraph 1(d) to read: "When approving a request for the use of Fund resources under this decision, the Fund will take into account the financing provided by other creditors. In order to minimize moral hazard, a member using resources under this decision will be encouraged to seek to maintain the exposure of all creditors, both official and private, until the pressure on the balance of payments ceases." Such a revision would give content to the concept of moral hazard. Also, in order to capture the other part of Mr. Esdar's suggestion, a sentence could be inserted at the end of the paragraph to read: "All options should be considered to ensure appropriate burden sharing."

Mr. O'Donnell said that he agreed with the suggestions made by the Director of the Policy Development and Review Department.

The Chairman suggested that Directors approve paragraph 1(d), as modified by the Director of the Policy Development and Review Department. He suggested that Directors consider the draft of paragraph 1(e).

Mr. Kafka considered that the initial three words, i.e., "In appropriate cases," did not add anything substantive to the sentence and could be deleted.

The Chairman suggested that Directors accept paragraph 1(e), as amended by Mr. Kafka. He invited Directors to consider paragraph 2.

Mr. Kafka considered that the second sentence of paragraph 2 dealing with access to the credit tranches or under the Extended Fund Facility beyond the annual or cumulative limit could be deleted, because it did not add anything substantive to the paragraph.

Mr. Esdar asked whether the section referred to by Mr. Kafka was not covered by existing procedures.

The General Counsel said that he did not know of any decision that would prevent the use of the Fund's resources beyond the existing policies when that member was using the facility. If the Board deleted the section referred to by Mr. Kafka, then the Board would signal that it was prepared to have both exceptional circumstances and, on top of that, the SRF.

The Chairman asked whether the first sentence of paragraph 2 prescribed such an action.

The General Counsel responded that the first sentence only described the conditions that had to be met in order to qualify for the facility. It did not say what happened to access under other policies once the member qualified under the facility—that question would remain open if the second sentence were deleted. If the Board so desired, that point could remain open; it would mean that one would have the credit tranches, then exceptional circumstances, and then the facility.

The Director of the Policy Development and Review Department considered that the first sentence of paragraph 2 described the circumstances under which a member would come into the facility. The second sentence stated that, if the member's situation was so characterized by those circumstances that would invite them into the facility, then the member should not be appealing to exceptional circumstances under Stand-By and Extended Arrangements. However, it should be clear from the sentence and from views expressed at the previous and current meetings that exceptional circumstances might still exist for countries that had problems that warranted use of those facilities, but not the circumstances outlined in paragraph 2.

The Chairman suggested deleting the sentence from the decision, but having a clarification in the minutes of the Board meeting.

The General Counsel stated that, in that case, the text of the decision would be nonnormative. There could be a normative provision in the concluding remarks of the Board meeting, but that could be rather confusing.

The Chairman said that he would prefer avoiding any confusion.

Mr. Giustiniani suggested retaining the original text of paragraph 2.

The Chairman suggested that Directors accept paragraph 2, without amendments. He noted that no Director had questioned paragraph 3; he suggested that Directors accept paragraph 3, as originally drafted. He invited Directors to comment on paragraph 4.

Mr. Vernikov recalled that, at the previous discussion on the SRF, it had been confirmed that a member could have recourse to the facility while a program was under way. Indeed, the current situation with Korea was an example of such a situation. As a result, the second part of the second sentence, which read "...which will normally coincide with the approval of the corresponding arrangement,"should be deleted, since the term "normally" was vague.

Mr. Zoccali said that he agreed with Mr. Vernikov; the sentence in question should end after the word "decision."

The Chairman considered that the use of the word "normally" would open the door somewhat to the use of the facility.

The General Counsel pointed out that the word "normally" appeared in the paragraph to indicate that, in fact, there might be exceptions. It would be expected that the member facing that kind of problem at the time the Stand-By or Extended Arrangement was being requested would also make the request for financing under the facility, rather than start the arrangement and then come with a request under the facility. The design of conditionality, the phasing of disbursements, and other elements were made in light of an overall program. However, a member was not prevented from requesting financing under the facility after an arrangement was under way.

Ms. Srejber considered that the Board had agreed that access to resources under the facility would be subject to stronger conditionality, which would imply the possibility of modifying an existing arrangement. She asked whether that agreement would be affected by the amendment proposed by Mr. Vernikov.

The Chairman responded that a kind of vacuum might be created; in that event, the practice of the Fund would be the one described in the section in question. It might be preferable to retain the section.

The Director of the Policy Development and Review Department recalled that paragraph 2 stated that the facility would be available to members under a Stand-By or Extended Arrangement. However, it did not specify that access to resources under the SRF would need to be granted at the beginning of an arrangement. It appeared to be clear from Directors' comments that, were a crisis as outlined in the draft decision to develop, then a member could request access to resources under the SRF. As a result, the section was not crucial; it was intended to assure what normally—but not always—would be the case.

Mrs. van Geest noted an example of a country that had a Stand-By Arrangement, but then was hit by a severe crisis. If the section in question were deleted, she asked whether the country would be able to draw on resources without any changes to the existing arrangement. She considered that it might be necessary to keep open the possibility of strengthening an existing arrangement, if the circumstances required.

The Chairman considered that it was not necessary to mention a strengthening of an arrangement, because at the time of the approval of an arrangement, the Board would ensure that it was appropriately strong. He suggested that it would be useful to retain the section to help clarify the intentions of the facility.

Ms. Srejber said that she agreed with the Chairman. She said that her authorities would prefer an explicit reference in the decision to strong conditionality—either in a new arrangement or a strengthened, already existing arrangement.

The Chairman asked Mr. Vernikov to withdraw his suggestion.

Mr. Vernikov said that he remained unconvinced, but he would drop his suggestion in the interest of moving the discussion forward.

The Chairman considered that Directors agreed with paragraph 4, as originally drafted. He suggested that Directors accept paragraph 5, which was uncontentious. He invited Directors to comment on paragraph 6.

Mr. Kafka recalled that, in his joint preliminary statement, he had suggested extending the period of repurchase from between two to two-and-a-half years to between two-and-a-half and three years, which would help ensure that the repurchases actually took place.

Mr. Giustiniani said that he could not support Mr. Kafka's suggestion. His interpretation of the aim of the facility was to have something quite different from a Stand-By Arrangement, something that was short term, and consequently also short term in repurchase requirements. Indeed, he recalled that in his first intervention on the matter, he had proposed an expectation to repurchase after six months and an obligation after one year. In the light of the Board discussion, he said that he could support an expectation to repurchase after nine months, and an obligation after another nine months. Such a structure would reflect better the aims of the facility to address short-term financial needs with the expectation of a quick reversal. It was also important to consider the fragile liquidity position of the Fund and the need to maintain the revolving character of the Fund's resources. He concluded that two stages of nine months each represented an appropriate compromise.

Ms. Srejber said that she fully associate herself with Mr. Giustiniani's comments.

Ms. Lissakers said that she shared Mr. Giustiniani's sentiments. She recalled that many Directors had supported a one-year expectation of repayment after purchase, so Mr. Giustiniani's proposal was a compromise between that and the longer terms others had proposed. It seemed that Directors were losing sight of one of the founding principles of the facility, which was that it was to be short term in nature, and that the expectation of early repayment should be explicit in the facility and in the use of the facility. Otherwise, it would be more appropriate to pursue the option of opening a window onto an existing facility, with higher charges for all exceptional access. Extending out into the longer end of the maturity structure blurred the line between the SRF and the existing facilities. She concluded that Mr. Giustiniani's suggestion was sensible.

The Director of the Policy Development and Review Department clarified that paragraph 6(a) established the outer limit of the obligation; section (b) established the expectations; and, (c) described the result of not meeting the expectation.

Mr. Giustiniani considered that the time frame of the obligation and the details on the expectations were related and should be discussed together.

Mr. Esdar said that he also had sympathy for Mr. Giustiniani's proposal. However, there were two elements that would affect any early repurchase: the repurchase period and maturity and the rate of charge. Those issues might need to be considered simultaneously to determine what the combined incentive would be.

The Chairman said that he agreed with Mr. Esdar that the two elements of the time frame and the cost were related. It was also important to have the appropriate incentives built into the facility. He asked the Director of the Policy Development and Review Department to repeat the suggestions outlined at the beginning of the Board meeting in order to allow Directors to agree on a broad balance between various positions. Directors could then consider over the lunch break the various positions and possible outlines for agreement.

The Director of the Policy Development and Review Department said that he agreed that the two related issues of the maturity and the structure of progressive charges might need to be considered together. Emerging from the informal luncheon the previous day, there was general agreement—but views on both sides—of starting at 300 basis points above the rate of charge. There was a general sense that, under the maturity structure that had been established in the staff statement, the progressive steps should be 50 basis points. There was general agreement—except challenged in the statement of Messrs. Zoccali, Kafka, Guzmán-Calafell—about applying the charges to outstanding balances. He suggested that Directors might wish to consider whether each of the steps should be at six-month intervals or whether there should be a one-year interval to begin, and then six-monthly steps thereafter; that matter might affect Directors' views with respect to the size of the steps. Also, Directors might wish to consider a starting point of the charges at 300 basis points above the (adjusted) normal rate of charge on outstanding balances, and whether the interval should be 50 basis points. He noted that, were the Board to accept a structure of a one year repurchase expectation with increases of 50 basis points each six months, then the charges on the outstanding balances could reach a rate of 550 basis points above the (adjusted) normal rate of charge on the most delayed final purchase, assuming a starting point of 300 basis points and the maximum allowable extension of two-and-a-half years granted by the Board.

The Chairman considered that it was important to reach a rate that created an appropriately strong incentive.

Mr. O'Donnell noted that the length of time a member could have access to resources under the facility was also an important issue to consider. Within that issue, a decision would need to be made with respect to the length of time of expectations and obligations of repurchases. The Director of the Policy Development and Review Department had suggested a maximum time frame of two-and-a-half years, but the joint statement by Mr. Zoccali and other Directors seemed to suggest a different option.

The Chairman asked the Director of the Policy Development and Review Department when an expectation and an obligation would begin.

The Director of the Policy Development and Review Department responded that he had understood that the joint preliminary statement by Mr. Zoccali and other Directors had suggested that the obligation to repurchase be extended out to two-and-a-half to three years; it was not clear whether the expectation to repurchase had also been extended out by six months from the staff proposal. In the event, the staff had proposed that there would be an expectation to repurchase one year and one-and-a-half years after a purchase; that expectation could be extended to the ultimate obligation point. He suggested that the staff could distribute a graph that would display the proposed time frame.

The Chairman asked that the staff make the graph available to Directors at the beginning of the afternoon session.

Mr. Mirakhor recalled that, during a 1996 Board meeting on charges and large-scale use of Fund resources, Directors had proposed many interesting ideas. For example, the surcharge should be structured in such a way that it would not deter large-scale use since there were clearly occasions when the Fund should encourage adequate financing. In that context, he warned that the Board might price the SRF too high for the use of members who may be in actual need of it. In the worst possible case scenario, it may be that the Fund would price itself out of the lender-of-last-resort function and perhaps even encourage the possibility of the emergence of regional facilities. It was important to recall that the Fund was a cooperative institution, and that when the solutions were proposed for a country in trouble, the decisions approved by the Board would be supported by the entire membership—a function that the commercial market could not provide. Consequently, he urged Directors to consider the possibility of not overpricing the facility. He concluded that the proposal of Mr. Kafka and other Directors in their joint preliminary statement was acceptable in providing the possibility of pricing the product at least to the point where the moral hazard risk was minimized, while at the same time not minimizing the cooperative solutions that the Fund devised and supported.

The Chairman considered that it was important to provide more substance and effective meaning to the concept of a cooperative institution. He noted that he had spent eleven years trying to serve that purpose. However, he believed that Mr. Mirakhor's suggestion was not the best way to achieve that goal, because, in the current situation, the Fund was confronted with countries that had, implicitly or explicitly, rejected the below market cost of the Fund's ordinary facilities. While the SRF would remain below market cost, it would be more expensive than other facilities, which would strengthen the incentive for members to request earlier access to resources under the Fund's ordinary facilities. He concluded that the suggestion made by the Director of the Policy Development and Review Department served that purpose well.

Mr. Mirakhor said that it was important to consider which solution was more effective. Starting the rate of charge at 200 basis points above the (adjusted) normal rate of charge and capping it at 400 would make the facility distinctly more expensive than normal facilities. The Fund was not a profit-making institution, but attempted to help members, through the use of its normal facilities, toward adjustment and stabilization. The fact that some members had not earlier requested access to resources under normal facilities should not rule out the possibility of people making mistakes and being allowed to correct them. The fact that they would request access to resources under the SRF was a signal that they were prepared to take corrective measures. Otherwise, the facility might be interpreted as a kind of severe punishment, even if the charges began at 200 basis points and proceeded to 400. Also, there was still a risk that whatever was decided on the SRF might become a reference point or a benchmark for the market to price their instruments. The Fund should try to make it easier, not more difficult, for members to correct their past mistakes.

Ms. Lissakers considered that the more likely scenario would be one that had already been seen, where a member that was likely to use the facility turned down an offer of private market financing that could accompany Fund financing, which were not mutually exclusive. It would be undesirable to create an open-ended facility, for which the access limits were lifted without any definition, and to price it in such a way as to create an incentive for a member country to make as maximum use of the facility as to forego opportunities that may arise in the context of a Fund-supported program to access private market financing. That would put an enormous demand on the Fund's resources. She stated that she would not agree to a facility on those terms. She would agree to provide temporary replacement for market financing, on the understanding that there was a built-in incentive for a country to return to financial markets quickly; in that context, the pricing and maturity profile of the facility was important.

Ms. Srejber said that she agreed with Ms. Lissakers. Also, with respect to the outline presented by the Director of the Policy Development and Review Department, she considered that the length of the maturity was too long. She recalled that she had suggested that the rate of charge should begin well above 400 basis points above the (adjusted) normal rate of charge and that the maturity should be under one year, with progressively higher rates if an expectation to repurchase were extended. Korea's recent rejection of private market financing that was 400 basis points above LIBOR on the grounds that it was too expensive made clear that the interest rate on the SRF should be high to create the necessary incentives. Otherwise, the Fund's resources might become concentrated on a very few countries, which was not beneficial for the other countries that might need access to the Fund's normal resources.

Mr. Giustiniani said that he agreed with Ms. Lissakers. In one respect, one of his concerns was similar to Mr. Mirakhor's view, in that the facility addressed the needs of countries that might have the possibility of tapping financial markets. The Fund was providing them with liquidity support at a rate that might be concessional. In that case, the Fund would need to safeguard its resources that might be used by other countries; if substantial resources remained outstanding for a long period of time to a few countries with access to financial markets, then the Fund could not provide financial assistance to other countries without such access. As a result, it would be preferable to shorten the maturity of the facility.

Mr. Taylor pointed out that the staff proposal was built around the notion of expectation and then obligation, which was a sensible feature to emphasize for the particular facility. But Mr. Kiekens challenged that aspect in his preliminary statement, concluding that it violated Article V, Section 7(b). He asked the General Counsel to respond to Mr. Kiekens' concern.

The General Counsel responded that there was a generally accepted distinction between obligations and expectations. When an expectation arose, the member would not be considered in arrears to the Fund when it failed to repurchase. Under the Fund's policies, however, although the Fund could not impose a sanction because there was no breach of obligation, the Fund could take precautionary measures. For instance, there were a number of decisions in the Fund that provided that a member that failed to fulfill an expectation to repurchase might be subject to a suspension of use of Fund resources. That was not an ineligibility, which was a sanction. Suspension was a policy measure taken by the Fund under policies on the use of its resources. Therefore, the provisions of the Articles that dealt with arrears as a breach of obligation did not apply to expectations. The member could not be declared ineligible, nor did the Fund have to discuss postponing repurchase obligations, because there was no repurchase obligation at that point. The provision of the Articles on the postponement of repurchase obligations did not apply to repurchase expectations.

Ms. Lissakers said that the General Counsel's explanation of expectations differed from that of the Director of the Policy Development and Review Department, who had stated that if a country failed to meet the expectation, the Board could at that moment change the obligation date.

The General Counsel responded that he was addressing the issue of whether the Board would have to take a decision postponing a repurchase obligation; an extension of the period for meeting an expectation was not a postponement of a repurchase obligation. What the Director of the Policy Development and Review Department had mentioned was that the Fund could convert an expectation into an obligation by a decision of the Executive Board and set the date when the conversion would take place.

Ms. Lissakers noted that failing to meet the expectation, per se, would have no major implication for a country that was deemed to have the capability to repay. While the Fund could suspend the country's access to Fund resources, presumably the country did not need to have access to additional resources if the Fund had already made a judgment that the country had the capacity to repay.

The General Counsel responded that, under the current staff proposal, the suspension of the member's access to Fund resources would be automatic; there would be no need to have a special decision. However, that could be changed, and it could be provided that suspension would require a decision.

Ms. Lissakers commented that she had understood that the suspension of access under the circumstances currently under discussion would have no practical meaning for the country concerned.

The Director of the Policy Development and Review Department pointed out that the Board would have the discretion at that point in time, however, to convert that expectation to repurchase into an obligation; if the member failed to meet the obligation, then that would trigger ineligibility and the other sanctions referred to by the General Counsel.

The Chairman noted that paragraph 6 also made clear that members not meeting expectations might expose themselves to difficulties. Also, the paragraph stated clearly that the Board could decide to transform an expectation immediately into an obligation.

After adjourning at 1:20 p.m., the meeting reconvened at 2:30 p.m.

The Chairman invited the Director of the Policy Development and Review Department to explain the graph distributed to Directors (see annexed Figure 2).

The Director of the Policy Development and Review Department made the following statement:

> We have presented in the distributed document two portrayals of extreme situations under the scenario that I had outlined this morning. The modification that has been made to the original staff proposal incorporates the proposition that the initial rate of charge of 300 basis points above the (adjusted) normal rate of charge would last for one year, and then would go up in steps of 50 basis points. The top chart portrays what the situation would be if the expectations of repurchase that are established at the outset are in fact satisfied. A member would make a purchase, let us say, of X at the approval of the arrangement. At the end of one year, there is an expectation to repurchase one-half of that amount, and after another six months the other half of that amount. That is what is portrayed by the Xs at one year and 18 months. That means that the whole amount of that purchase would be outstanding for one year at 300 basis points above the rate of charge, and half of that original purchase outstanding for an additional six months at 350 basis points above the rate of charge.
>
> There are many other possibilities, of course, depending upon how this is tranched. The expectation is that the resource availability would probably be clustered toward the beginning; that is, heavily front loaded. To highlight an extreme, again: if there were a purchase at the very end of the arrangement period—close to the point of one year—that purchase would also be repurchased in semiannual installments one year later and one-and-a-half years later, at the points marked by the Os. So each of the separate purchases would have maturities of a year to a year-and-a-half, but if a repurchase were made at the end of the arrangement year—again, that is an unlikely event—resources could be outstanding for a maximum of two-and-a-half years.
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> The bottom graph portrays the situation when, in fact, the latest possible date at which the obligations must be satisfied; that is, two years and two-and-a-half years after the original purchase. In that case, the member would make a purchase on approval; at the end of one year, which is shown in the top chart, there is an

expectation to repurchase, and the member should repurchase. If the member does not and the Board agrees to extend that, the maximum extension possible is an additional year. So that repurchase would have to be made after two years, and the full amount of that purchase would then carry charges of 300 basis points for one year, 350 for a half a year, and 400 for a half a year. The other second half of that amount, which has to be repurchased six months later, is then outstanding for that period at 450 basis points.

Similarly—and again this is the extreme—if a purchase were made at the very end of the arrangement year, it should have been repurchased, as the Os show in the top chart, but each of those could be extended at the discretion of the Board by one year, maximum, so that they would be repurchased at three years and three-and-a-half years. At one year of the arrangement period, the purchase takes place. The repurchases should be a year and a year-and-a-half after that, but each of them can be extended for a maximum of one year. So the obligations that are shown here are the extreme obligations.

The Board can, within its discretion, take any number of decisions when a situation arises that the country cannot meet its expectations. If we go back to the original example, a purchase is made on approval of the arrangement. One year later, the first repurchase is coming due. The country comes to the Board, makes a representation as to its situation, and basically appeals for an extension of that expectation. The Board then can agree to extend that expectation for any period up to one year; it could extend it for three months, six months, or whatever it wishes. When that expectation comes due, it could do the same thing or at that moment, if it so wished, it could convert it to an obligation. So there is the legal possibility that the ultimate obligation could be shortened from what is expressed in the decision.

In response to a question by Ms. Lissakers, the Director of the Policy Development and Review Department said that the ultimate obligation date could not be extended.

Mr. Guzmán-Calafell asked the staff to consider a situation in which a disbursement were made in the first year of access under the facility. There would be an expectation to repurchase in the second year, during which the surcharge would be 400 basis points. The member then encountered difficulties in returning to the markets and requested an extension from the Board, to which the Board agreed. In approving the request, the Board was acknowledging that the member had a financing need, perhaps did not have access to capital markets, and was experiencing serious economic difficulties. At that point, perhaps it did not make sense to increase the surcharge further, since it would not be a matter of the member not choosing to make a repurchase, but rather not able to make a repurchase.

The Director of the Policy Development and Review Department said that he had understood the proposal for progressive charges to be taken out to the limit for as long as resources remained outstanding. It had been noted that it was important to encourage on a continuous basis the authorities to adopt the necessary reform measures and to return to private capital markets as soon as possible.

The Chairman pointed out that Mr. Guzmán-Calafell's example dealt with the final tranche available under the facility. However, before that point, there would have been several program reviews that would provide early opportunities to avoid such an undesirable situation. The Fund would provide the appropriate policy recommendations and technical assistance to help avert an unfortunate situation.

Mr. Guzmán-Calafell considered that, despite the best efforts described by the Chairman, Directors should consider the possibility of having a cap on the surcharge.

The Chairman pointed out that the proposed surcharge was capped at 550 basis points. The best way of helping a country avoid a difficult situation was to act very early in the process of an emerging crisis to create the conditions that would encourage a reflow of reserves; that would also assist the country to make repurchases as soon as possible and avoid an escalation of the surcharge.

Mr. Sivaraman said that the proposed outline appeared to be acceptable. However, there seemed to be an incentive for the borrower to make all the purchases at the time of approval. If the country postponed purchases, then automatically the surcharge would increase by 50 basis points.

The Chairman pointed out that resources would not be made available in a single disbursement.

Mr. O'Donnell said that he would prefer an increase in the surcharge six months after the initial approval. Otherwise, there would be no incentive to make a repurchase during the full first year. It was important for the surcharge to continue to increase over time to encourage countries to return to the market. Some countries might believe that the higher risk premium demanded by markets for loans was temporary, when in fact it might be permanent. An increasing surcharge on the use of resources under the SRF would reduce the subsidy element and, over time, encourage a country to return to the market by helping it to realize the definitive increase of the cost of its financing.

The Director of the Policy Development and Review Department clarified that the higher surcharges would apply only to remaining outstanding purchases. For example, if the member had purchased $2 billion in the course of an arrangement, $500 million would have been repurchased at each of the X points on the graph, and there would be only $1 billion outstanding. So the $1 billion would be subject to a surcharge of 500 basis points, and in the end only a $500 million would be subject to the 550 basis points surcharge. In other words, the highest rate of charge would never apply to the entire purchase made by the member. Also, any purchase made during the arrangement period in the first year that added to the outstanding balance the member had vis-à-vis the Fund or to the Fund's holdings of the member's currency would become subject to the higher charge immediately after the one-year threshold. For example, a purchase late in the year would become subject to a 350 percent surcharge once the one-year threshold was crossed.

Mr. Guzmán-Calafell, responding to Mr. O'Donnell's point that the aim of the facility was to encourage a member to return to financial markets, reiterated that, at a certain point, the Board might determine that a member could have access to the Fund's resources precisely because of a lack of access to financial markets. In that case, it did not seem justified to continue to increase the surcharge over time.

Mr. Esdar said that he shared Mr. O'Donnell's concern that maintaining a stable surcharge of 300 basis points during the entire first year of access under the facility did not provide the optimum incentive. However, he considered that, since the access under the SRF would be in the context of a strong Stand-By Arrangement, it was likely that only a part of the resources would be drawn if the authorities implemented the agreed program. In that case, it was unlikely that the 500-550 basis point surcharge would ever be activated; if all the resources were drawn, then that might indicate a more serious flaw in the program design or implementation. Also, he said that he agreed with Mr. Giustiniani that it was important to maintain the revolving character of the Fund's limited resources, so it was crucial to provide the appropriate incentives for repurchases as soon as possible.

Mr. Giustiniani considered that the Board was progressing in the right direction. In order to take into account the concerns echoed by Messrs. Esdar and O'Donnell, he suggested that there should be an expectation to repurchase after 9 months and an obligation after 18; a 300 basis point surcharge could apply for the first 9 months, increasing by 50 basis points each quarter until it reached 500 basis points after the 18 month period.

The Chairman pointed out that a broad majority was required for Mr. Giustiniani's proposal to be adopted; the proposal was possibly outside the center of gravity of the Board's views. He recognized that all Directors would need to revise their starting positions to achieve a consensus, and he thanked Directors for having shown flexibility and the ability to consider carefully various opinions. The direction and general outline of an agreement were emerging.

Mr. Cippà asked what Board majority would be required to change an expectation to repurchase into an obligation and whether there was a possibility to change an obligation.

The General Counsel responded that, in order to extend an expectation for a period of time or in order to convert that expectation into an obligation, the Board would need only a majority of the votes cast. With respect to the postponement of a repurchase obligation, it was legally possible for the Board to postpone the discharge of a repurchase obligation as long as it was within the maturity of the purchase; that could be done by a majority of the votes cast. However, to postpone the repurchase obligation beyond the maturity of the purchase, a 70 percent majority would be needed. It was important to recall that there was a very firm policy in place—although not a rule of the Articles—that the Fund did not reschedule repurchase obligations, in order to maintain the Fund's preferred creditor status.

The Chairman said that, during his 11 years at the Fund and perhaps since the Second Amendment, there had never been a rescheduling of a member's obligation to repurchase from the Fund. He asked the General Counsel whether there were any precedents of the Fund utilizing a rescheduling facility.

Ms. Lissakers considered that, under certain circumstances, rescheduling might be a more transparent procedure than refinancing, which the Fund did often.

The General Counsel responded that there was an assumption among Paris Club members that the Fund was not prepared to reschedule such obligations. If the Fund were to change that policy, then a number of assumptions in Paris Club negotiations would have to be revised.

Ms. Lissakers said that, in reference to the distributed graph, the Os can be moved to the Xs and the Xs can be moved to the Os; she asked whether the Os could not be moved beyond two-and-a-half years. However, if X were to become an obligation, then O would coincide with X; she asked whether, in that case, the Board would need to review the disbursements of tranches. Also, if at the end of one year, an expectation were converted into an immediate obligation, she asked when the payments would be due.

The General Counsel responded that the Board could decide at what time the expectation would become an obligation. That decision could also include, for example, segmentation; that part of the obligation would be extended as an expectation and maybe some other part of the repurchase would be converted to an obligation. There could be different possibilities.

Ms. Lissakers asked whether it would be possible for the Board to require that half of the outstanding balance be repaid immediately and the rest at the original obligation date.

The Chairman answered in the affirmative.

The Director of the Policy Development and Review Department said that he agreed with the Chairman's affirmative response to Ms. Lissakers' question. He pointed out that, in the graph distributed to Directors, the Xs and Os were not expectations and obligations. The X was a purchase which took place on approval; the O was a purchase which took place toward the end of the arrangement period. If a purchase took place on approval of the arrangement—say, SDR 1 billion—the Xs would represent the points at which expectations for each SDR 500 million would come due. The Os represented a purchase which took place at the very end of the arrangement period, and the expectations for repurchase associated with that purchase would take place a year and a year-and-a-half after that purchase.

Mr. Fernandez noted that the Os also represented the obligation for the purchase which had occurred on the date of approval. In fact, the Os were two things at the same time: the obligation of a purchase that occurred on the approval date and the expectation of a purchase which occurred on the first X date.

The Director of the Policy Development and Review Department responded in the affirmative.

Ms. Lissakers stated that she would need further clarification. Referring to the top chart in the document distributed to the Board, she asked whether, if there were a purchase at the end of the first year of the facility, the latest possible repurchase would be at the end of two-and-a-half years.

The Chairman answered in the affirmative.

The Director of the Policy Development and Review Department said that he would respond to Ms. Lissakers question with the aid of a numerical example. He asked Directors to assume a purchase on approval of the arrangement of SDR 4 billion. At one year—where the X appeared on the top graph—SDR 2 billion would be expected to be repurchased. At the next X, at 18 months, SDR 2 billion would be expected to be repurchased.

Ms. Lissakers asked what was the latest possible repayment on the first purchase.

The Director of the Policy Development and Review Department responded that the latest repurchase appeared on the bottom graph. Each of those Xs could be moved out a maximum of one year, at which point they would become an obligation, but they could also be moved forward by anything less than that—by one month or three months or five months—by the Board, creating another expectation of repurchase. If the member made a second purchase right at the end of the arrangement year of SDR 3 billion, then the first O on the top graph was SDR 1.5 billion of an expectation of repurchase, and the second O was another expectation of the other SDR 1.5 billion. In other words, the top graph showed that, if there were a purchase on approval, then the member would begin repurchasing by expectation one year after that arrangement was approved. If the arrangement lasted for a year, and if in the unlikely event there was a purchase right at the end of the arrangement period, then the member could have those resources outstanding for a period of two-and-a-half years from the beginning of the arrangement, but still only one-and-a-half years from the purchase.

Ms. Lissakers asked what the bottom graph represented.

The Director of the Policy Development and Review Department responded that the bottom chart assumed that, at each point when there was an expectation, the Board approved the maximum scope for delay to the member; it moved each one of those expectations forward by one year. So the expectations at one year and 18 months—the Xs in the top graph—were moved out to two years and two-and-a-half years. The expectations that were at two years and two-and-a-half years—the Os in the top graph—were moved out to three years and three-and-a-half years.

Ms. Lissakers asked the staff to consider an arrangement that was to last from January 1, 1998 to December 31, 1998 and the member made a purchase on December 31, 1998. She asked what would be the latest possible date by which that money had to be repaid if the Board used all its scope for extending the expectation dates.

The Chairman responded that that date would be June 30, 2001.

Ms. Lissakers asked whether the maximum maturity for any purchase was two-and-a-half years.

The Director of the Policy Development and Review Department responded in the affirmative.

Mr. Cippà asked the staff to consider a situation in which there was only one purchase at the beginning of the arrangement, and that, upon the expiration date two-and-a-half years later, the repayment did not occur. He asked what would be the rate of charge applied to the arrears.

The General Counsel responded that the rate on overdue charges would be the maximum rate under the facility—currently 550 basis points above the (adjusted) normal rate of charge.

The Chairman considered that there existed the basis for an agreement on issues related to the time frame and surcharge of the facility. He suggested that Directors reflect further on the matters, and that the Board return to the precise details later in the meeting. In the meantime, he invited Directors to consider paragraph 6(b).

Ms. Lissakers suggested that paragraph 6(b) could state explicitly that the Fund could accelerate the obligation to repurchase if a repurchase expectation were not met.

The General Counsel pointed out that the phrase "...the Fund may require..." implied that there could be a conversion into an obligation.

The Chairman considered that Directors tentatively agreed to paragraphs 6(b), (c), and 7. He invited Directors to consider paragraph 8.

The Director of the Policy Development and Review Department pointed out that, pursuant to the Board's tentative agreement, the words "...the first six months..." would have to be changed to "...the first year."

The General Counsel added that there would have to be several more corrections. He also clarified that the calculation was based on average daily balances of holdings, and that a section on the applicability of the provision on overdue charges would need to be added.

The Chairman suggested that the staff distribute to Directors draft language on a revised paragraph 8, reflecting, in particular, the highest possible surcharge in the event of arrears under the facility.

Mr. Kafka warned against a surcharge as high as 550 basis points above the (adjusted) rate of charge, which might discourage the use of the facility. If a country were forced to request access to resources under the facility, such a high surcharge might promote a default, rather than prevent it.

Mr. Mirakhor said that he agreed with Mr. Kafka and he asked Directors to reconsider the imposition of high rates of charge. Some Directors had referred to the facility as providing a subsidy; however, rather than a subsidy, the facility would provide the assurance that a member in difficulty would ask the Fund to support a well-articulated and comprehensive stabilization and reform program. Many Directors preferred that countries seek financing in financial markets, but markets could not provide support for adjustment and reform programs like the Fund could. If countries were forced into situations of possible default, they would not approach financial markets, but end up requesting assistance from the Fund—at a much higher price to the Fund and the international community. Therefore, much care needed to be taken in addressing the question of high rates of charge; it would be unfortunate if the growing calls for higher rates of charge were to spill over to other Fund facilities. While it was important to have an incentive structure to encourage members to approach the Fund for assistance at an early stage, as well as to make clear to the institution, the member, and the markets the costs involved in such assistance, it was inconceivable to penalize countries that come to the Fund in support of adjustment and reform programs.

The Chairman said that he took note of Mr. Mirakhor's concerns. Careful reflection was needed in agreeing to the details of the facility, but that exercise did not question the spirit of cooperation and solidarity that was at the heart of the Fund as an international institution. While Mr. Mirakhor had expressed the legitimate concern that the call for a higher surcharge in the context of the SRF might spill over to other facilities, and that that might increase the risk of defaults, other Directors had pointed out that adopting a lenient rate of charge for the SRF might lead to cases of imprudent financing. Therefore, it was important to find an equilibrium between the various positions, while safeguarding the Fund's limited resources. It was certainly important to demonstrate the solidarity of the institution, but it was also important to recognize that certain countries had allowed their economic plight to decline quite seriously by not immediately adopting the necessary reforms. At the same time, it was important to avoid a situation in which a member with large outstanding Fund credit would reach a point where falling into arrears was inevitable. The concerns expressed by Messrs. Kafka and Mirakhor were quite serious, but other Directors had pointed to the need to establish the appropriate incentives to encourage a member to adopt the necessary policies that would avert the progression up to the highest surcharge.

Mr. Guzmán-Calafell said that he associated himself with the comments made by Messrs. Kafka and Mirakhor. While he understood the various positions of Directors, he urged Directors to reconsider the imposition of graduated charges.

Mr. Cippà considered that, if the rate of charge on the use of resources under the SRF were too low, then the rate of charges on the use of other facilities might be negatively affected because the Fund might not have enough reserves to cover the possible substantial purchases under the SRF.

Mr. Vernikov said that he supported the views expressed by Messrs. Kafka and Mirakhor.

Mr. Shaalan recognized that there were many considerations that entered into selecting the range of surcharges; however, he supported the views expressed by Messrs. Kafka and Mirakhor.

Ms. Lissakers reiterated that she was prepared to support the establishment of the SRF only if there were an escalating rate of charge structure. The only other acceptable alternative that would attempt to meet some of the goals set out for the SRF would be to open a window through existing facilities, where all exceptional access would be subject to higher charges. However, since there would not be the short maturity structure protection that was part of the proposed SRF, the charges would have to be much higher than currently proposed for the SRF to provide enough incentive for exceptional access funds to be returned early to the Fund.

An effort had been made by those Directors who had favored changing the rate structure for exceptional access to take the more complicated, and more difficult to provide, facility channel precisely to protect the option of continuing to provide exceptional access under normal Fund terms when circumstances warranted, Ms. Lissakers continued. Such an option would be foreclosed if the Board chose the alternative route that Mr. Kiekens had proposed. It had many merits, including the fact that it did not require an 85 percent majority and that it would be more broad in its coverage. However, it was unlikely that the majority of the Fund membership would be prepared to continue to provide the magnitude of resources currently under consideration, on Stand-By and EFF terms, which were designed for very different purposes.

Ms. Srejber said that she agreed with Mr. Cippà that the Fund's risk would increase, so the Fund's reserves would need to be increased accordingly; also, if the charges on the type of access currently under consideration were not high enough, then all charges across the board would have to be increased. She added that she fully associated herself with the views of Ms. Lissakers.

Mr. Zoccali considered that the issues currently under discussion were quite difficult to resolve. However, the important point to resolve was how the Fund would react to twenty-first century-type disturbances, in which stock adjustments were taking place and where contagion was also a reality. So, in fact, this was somewhat unexplored territory and, since it was a matter of judgment and since he had gone through similar experiences in his country in the 1980s and 1990s, he agreed with Mr. Kafka's comments.

The Chairman said that he agreed that, to a large extent, the international community was currently in uncharted territory; he considered that it was important—as had been suggested—to review the experience under the SRF no later than end-1998 in order to learn from the experience. It was important to recognize that the establishment of the SRF was only one element of the international community's broad response to such new types of financial crises. The Fund would focus on, inter alia, strengthening surveillance and helping to develop complementary avenues of additional surveillance, on improving prudential measures, and on efforts to promote orderly debt workouts. The precise strategy would be crafted, reviewed, and adapted as more was learned about the nature and ramifications of such crises. He repeated that the Fund's response would need to be more broad than just establishing the SRF; it was important to discourage the view that, whenever there was a problem, a new facility should be created to address it.

Mr. Zoccali said that he shared the Chairman's views. However, it was important to recognize the danger—as expressed in paragraph 1(e)—that the afflicted countries might adopt measures that the Fund might be assumed to recommend in extreme circumstances under Article VI, Section 1. Since there was not a comprehensive strategy to deal with the issue, the danger should not be downplayed.

Mr. Zhang said that he was also concerned about the high surcharge under discussion—especially in cases where members would make a purchase at the end of the one-year availability period. In order to reduce the penalty rate for purchases at the end of the period, perhaps the increments could increase by 25 basis points, instead of the proposed 50 basis points.

The Chairman thanked Mr. Zhang for his suggestion; however, he would hesitate to undo a consensus that seemed to be emerging among Directors.

Mr. Esdar said that he would not reiterate his views on whether higher or lower charges were preferable. He reminded Directors that, during the previous and current Board meetings, there were different views expressed, including a group of countries who favored 200 percent as a starting position; there were others—a larger group of countries—who considered it preferable to start with at least a 400 percent surcharge. The Board was currently confronted with a proposal, and it did not make sense for Directors to reread their statements from the previous Board meeting. It would be a more efficient use of the Board's time to move the discussion forward.

Mr. Kiekens made the following statement:

> On this topic I tried generally to have a balanced position since I represent both creditor countries and emerging markets. I think that the proposal which is on the table, with a 300 percent starting point and after 6

months a half percent more, is acceptable. But, if the Fund gives very large access, we take a high risk, and the high risk is indeed default. I do not think that the risk of default is higher because we put half a percent or 1 percent interest more. The risk is that the program is not implemented as it should, or that the program is ill designed; we have to be tough on the policies we implement.

Apart from that, a higher interest I accept as a reasonable balance, but the spirit with which a country comes to such a deal with the Fund must be in good faith, which is that it should repurchase as soon as possible, depending on its market access in a reasonable way. Higher charges are not necessarily the only rule. One can have countries who pay more than market interest rates to the Fund and who will continue not to repurchase, because they know very well that if they push for large amounts in the markets that their interest rates will go up very high, very soon.

I represent a country with reasonable spreads in the markets—2–3 percent—which was for many years a net repayer because they were aware that if they want higher access on the markets they would pay much higher interest rates. So, do not believe that a somewhat higher spread will necessarily kick in the money or have the money back soon. What is really important is that the program works.

We have a rule-based solution where we say after one year you have an expectation, and so forth; I was not here in the Board. But my point is that there must be cases where a country should repurchase even before one year because it has access to the markets. If that is the situation, we should do it. We have the instrument for doing that, which is the assessment of balance of payments need. I think this is an instrument that we should use more actively, because this gives us the possibility, if we judge so, to have a case-by-case approach which is more close to the reality than to rely only on high interest rates.

Now, how does this lead me to where we are? My conclusion is conditionality, try to have good-faith relations, use more actively the balance of payments need instrument. I ask those countries which are emerging market countries to accept these higher interest rates. I think it is fair, and I support them.

The Chairman noted that the experience of Mr. Kiekens' diversified constituency was interesting. He noted that Mr. Kiekens was not completely opposed to the current proposal, but that he would put less emphasis than many Directors on the very high rate of charge at the end of the availability period. He would also put more emphasis than currently proposed and than was currently the practice of the Fund on the good faith obligation of a member to accept early repurchases when the balance of payments so allowed.

Mr. Kiekens responded that the Chairman's characterization of his current position was correct.

The Chairman asked Mr. Kiekens whether he would propose extending in an explicit way to the SRF the obligation of early repurchase in view of the balance of payments (which was in any event in the associated Stand-By or Extended Arrangement) and the obligation for the Fund to make recommendations to the country to repurchase early; if those elements were included, he asked whether he would consider that the escalation in charges could be less severe, and that perhaps a somewhat high cap—perhaps at 450 or 500 basis points—could be included.

Mr. Kiekens responded that the Chairman's description would be broadly acceptable. He said that he did not have expertise in the area of balance of payments need representations, and he asked the Director of the Policy Development and Review Department to address the matter. However, under the current Fund policies—which had not been implemented regularly—the issue was treated in a straightforward fashion: a member either had a balance of payments need or did not; if it did, then it could draw on resources and did not have to repurchase. It might be useful to consider a more nuanced policy, in which, for example, a member had SDR 10 billion outstanding, and the Fund determined that the member had a balance of payments position strong enough to repurchase SDR 2 billion. Perhaps in that situation, the Fund would suggest that the member return to capital markets for the SDR 2 billion, but would recognize that the member could not raise the entire SDR 10 billion for the time being.

The Chairman asked the Director of the Policy Development and Review Department whether Mr. Kiekens' proposal could be made operational in the context of the SRF. He then invited Directors to comment on whether they would prefer Mr. Kiekens' proposal over the initial staff proposal.

The Director of the Policy Development and Review Department recalled that, at the current stage of the discussion, there were several different kinds of expectations of repurchase under consideration. There was the common policy and, indeed, the dictum of the institution that if a member's balance of payments improved, then it ought to repurchase resources that had been made available to it from the Fund. In addition, there was the expectation built into the SRF, which was a more formalistic expectation; it was quite specific—an expectation of repurchase was created at the time the member purchased the resources. The first of these expectations had been a longstanding policy, and members, on occasion, had been asked to satisfy the expectation when their reserve position improved. It was possible to make representations to the member about the strengthening of its balance of payments position and its reserve position that would warrant expectations. He noted that the Board was due to review the policy on early repurchase expectations in early 1998.

The matter was not simple to address, the Director continued. The same situation had arisen in the context of the recent Mexican crisis, for example. Moreover, the matter was complicated by the fact that the disposition of a country's reserves was under its control and authority. It could be changed by the way the member chose to deal with its reserve liabilities other than to the Fund so that gross reserves could be modified by discretionary action by the authorities. Nevertheless, it was still possible to look at the strengthening taking place in a member's balance of payments, and for the staff to make a judgment and bring that judgment to the Board for its consideration. He concluded that it might be possible to incorporate explicitly Mr. Kiekens' suggestion into the structure of the SRF, even though it was already part of all of the policies of the Fund: as a country's situation improved faster than expected, it should be expected to repurchase the resources that had been made available to it. Such an approach would be different from the formalistic expectation created under the proposed facility, which should be maintained.

The Chairman said that the incorporation of Mr. Kiekens' suggestion might make the incentive to exit from the SRF even stronger.

The Director of the Policy Development and Review Department answered that such an incentive might be stronger.

Mr. Mirakhor noted that, at the present point of the discussion, Directors had accepted the idea of a surcharge for the use of resources under the SRF, despite the fact that several Directors had expressed views to the contrary. The current challenge was to bridge the two apparently extreme positions to create the best incentive structure for those who will use the facility. He considered that there were various ways to establish an incentive structure for members to repurchase as quickly as possible. For example, the surcharge could begin at 200 basis points, but then move 100 points to 300 at the end of the first year, and then from there on it could increase by 50 basis points. Under the currently proposed structure, there might be an incentive for a member not to repurchase at the end of the first year because, for a very marginal additional cost, the repurchase could be postponed until later.

Ms. Srejber asked whether it was possible to make an early repurchase mandatory.

The General Counsel answered that the expectation could be converted into an obligation.

Mr. Guzmán-Calafell asked whether the Fund had had to make an early repurchase expectation mandatory in the past.

The General Counsel responded that he had been referring to the expectation under the current proposed decision. The other expectation—under Article V, Section 7(b)—was the expectation that arose when there was an improvement in the member's balance of payments and reserve situation. That was an expectation that would require first the adoption of policies by the Fund to be converted into an obligation, but such policies were not in place.

Ms. Srejber asked whether it was not the case under all facilities, including the proposed SRF, that if the country's reserves and balance of payments situation improved faster than expected, an expectation of early repurchase would be created. If that were the case, she wondered whether Mr. Kiekens' proposal contained any new aspect.

The Chairman responded that the new aspect was that it would apply not only to the underlying facility but also to the SRF.

The General Counsel answered that it would be an automatic extension, because any facility that was created by the Fund, being subject to the Articles, would give rise also to the expectation in case of an improvement in the member's balance of payments and reserve positions. The underlying arrangement would make it clear that, in case of improvement, all purchases would be subject to the early repurchase expectation.

Mr. Kiekens considered that, in a formal way, Ms. Srejber was correct: the expectations were there and the Fund could make a representation for early repurchases. The important point was that the Board would need to come to a consensus to use that instrument. That instrument had not yet been used, and the Fund needed to adjust its policy over time, given the change in financial markets. For instance, it was clear that it was not entirely appropriate to rely primarily or solely on the criterion of gross reserves—a debate that the Board had had recently concerning the operational budget. It was also important to adjust Fund policies to include a consideration of what the de facto access of the country was on the market. As a result, the Fund currently had no active policy on early repurchases, although it was possible for the staff to suggest informally that a country undertake to advance its repurchases.

The Chairman pointed out that Mr. Kiekens was correct to say that the staff and management were actively involved in ensuring that resources were returned to the Fund as soon as possible. There had been several recent examples of members being encouraged to repurchase earlier than anticipated—a process that had been undertaken in a pragmatic and efficient way. Perhaps some language could be included in the proposed decision on the SRF to strengthen the informal process.

Mr. Kiekens proposed that, if there were a consensus on the more active use of the balance of payments need instrument, then the surcharge could be capped at 500 basis points.

Mr. Giustiniani proposed a surcharge starting point of 300 basis points for the first year, to be followed by quarterly increases of 50 basis points and capped at 500 basis points.

The Chairman thanked Mr. Giustiniani for his proposal and asked Directors and the staff to comment on the proposal.

The Director of the Policy Development and Review Department pointed out that Mr. Giustiniani's proposal would make the progression of charges steeper than had been proposed earlier.

Mr. Sivaraman noted that, in reference to the graph distributed earlier by the staff, the top graph addressing the surcharge during the expectation period could start at 250 or 300 basis points and be capped at 400 basis points. Thereafter, during the obligation period, the surcharge could begin at 400 basis points and rise to 475 or 500 basis points. Such a compromise might satisfy both sides of the current debate.

Ms. Srejber said that both Mr. Giustiniani and Mr. Sivaraman had made interesting proposals. She said that she agreed with Mr. Kiekens that the early repurchase policy should be more active. She said that she would consider modifying her previous position if the Board were to make such an early repurchase mandatory. In that event, part of Mr. Sivaraman's proposal could be included, such that as soon as an expectation had been converted into an obligation, the surcharge would increase rapidly.

Mr. Guzmán-Calafell noted that he had previously asked whether there had ever been a case in which an early expectation of repurchase had not been met. Also, he said that he understood the concerns expressed by many Directors. However, he recalled the number of lines of defense against possible abuses in the use of the facility. First, there was a shorter period of repurchase. Second, there were higher rates of charge. Third, there was an early repurchase policy. Mr. Kiekens had mentioned earlier that it had not been used; however, in the case of Mexico it had been used in April 1994, when Mexico had made an early repurchase to the Fund. Fourth, there was also trust in the member countries. The Fund had to trust in their good intentions, as had been mentioned previously by Mr. Mirakhor. In that respect, without an early repurchase expectation being generated by the evolution of balance of payments developments in the case of Mexico, Mexico had repaid 30 percent of the amount that had been repurchased in the 1995 Stand-By Arrangement. He considered that good intentions should be a common expectation among the Fund's member countries.

Mr. O'Donnell pointed out that—as the top graph in the document circulated by the staff showed clearly—as long as expectations were met, the surcharge on the resources drawn on approval would be 300-350 basis points. The starting point needed to be high enough to compensate the Fund for the considerable risk, and the progression of the surcharge was needed to encourage a country to return to private capital markets for financing. That said, some flexibility surrounding a cap on the surcharge could be considered.

Ms. Lissakers said that she agreed with Mr. O'Donnell. She recalled that the sums involved in the use of the SRF would be substantial; such a large use of the Fund's resources was clearly unsustainable. She considered interesting Mr. Giustiniani's proposal of a rate structure with the quarterly increments of 50 basis points, and, if strongly desired, a cap at 500 basis points; however, the starting point in the graduated structure was an integral part of the facility, and it was not sufficient to incorporate language or principles that already existed in the Articles of Agreement about early repurchases into the decision as a substitute for the rate structure.

Mr. Kafka considered that Directors had heard some interesting suggestions by Mr. Kiekens, Mr. Sivaraman, and now by Ms. Lissakers. He stated that an agreement on a reasonable cap would be appreciated by many Directors.

The Chairman noted that he had understood that Ms. Lissakers could accept a cap at 500 basis points with respect to the obligation period and 400 basis points with respect to the expectation period, provided that Mr. Giustiniani's proposal of increases every quarter of 50 basis points— instead of the previously proposed 50 basis points every two quarters—was adopted.

Mr. Cippà asked whether, if a distinction were to be made between expectations and obligations, the surcharge would no longer apply on outstanding credit.

The Chairman responded that the surcharge would continue to apply to outstanding credit.

The Director of the Policy Development and Review Department pointed out that Mr. Cippà had raised a valid point.

Ms. Lissakers said that she could not accept Mr. Sivaraman's proposal, which would allow the increase in the surcharge to be postponed along with the extension of the expectation period. She considered that the increase of the surcharge should not be moveable.

The Director of the Policy Development and Review Department pointed out that, under the proposed structure that would begin at 300 basis points for the first year and then increase in steps, if a country were to meet the repurchase expectations (i.e., that a purchase made at the time of the approval of an arrangement was met within the year-and-a-half period), the effective rate of charge on the entire purchase would be about 325 basis points. In light of that, if that was generally acceptable, he proposed that it might be possible to start at 325, and leave it for a year-and-a-half. Thereafter, it would be possible to go up by 75 basis points to 400 for the next year, and then go up to 475 for the rest of the period. The three steps, with the first one at 325, would accomplish the same thing as the first gradation under the current proposal, and it would last for the entire expectation period. Then, as one entered into what would be the period of extension for that first purchase, the rate could increase up to 400 basis points. Then, if one entered into the last year, which was the final period of any possible extension of any purchase under the arrangement, there would be another increase of 75 basis points to 475. There was a certain logic in having the steps associated with the first year-and-a-half, which was the minimum amount of time that the purchases would be available, even if the expectations were met. Then that could be extended for a year at a higher charge, and the last purchase under the arrangement that could possibly be made, if that was extended as well, would be at even at a higher charge. Such a proposal would reduce the rate structure to three steps, accomplish the same in terms of effective charge on the early purchases if the expectations were met, and still include a gradation.

Mr. Fernandez suggested that it would not be complicated to adopt the Chairman's proposal of a maximum of 400 basis points for the expectation period and a 500 basis point maximum for the obligation period; the starting point would be at 300 basis points, since that would be a reasonable compromise between the various positions.

Mr. Yao pointed out that, under Mr. O'Donnell's proposal, if a country followed the rules and repurchased during the expectation period, then the surcharge would be 350 basis points. However, if that same country made a drawing at the end of the one-year eligibility period, then it would be paying a higher surcharge than another country that used the SRF and had the same outstanding balance.

Mr. Wijnholds considered it unlikely that a country facing a severe crisis would wait a full year before making a drawing under the SRF. Accordingly, it was unlikely that the 3-and-a-half year maximum period would be reached.

Mr. Zhang suggested that the structure of the surcharge could be applied in relation to the actual time of the drawing, with a moveable one-year time period.

Mr. Esdar recalled that that option had been discussed earlier and it was decided that such a structure would create a perverse incentive to draw all tranches early, and then reschedule the first tranche with the last tranche, because of the lower cost.

Mr. Cippà said that he had some sympathy for the proposal made by the Director of the Policy Development and Review Department. However, a basic concern remained that, in order to cover the high risk of this facility, the surcharge had to be quite high. He said that he would be prepared to approve a starting point of 325 basis points , and then give credit to the good faith of the country and leave the surcharge unchanged until the expectation was not met, at which point it could be increased sharply.

The Chairman pointed out that Mr. Cippà's proposal differed from that outlined by the Director of the Policy Development and Review Department.

The Director of the Policy Development and Review Department recalled that, at the previous day's informal luncheon, it had been decided that, on account of what had been perceived as a perverse incentive, the surcharge would be levied on outstanding balances, irrespective of when the purchase took place. Also, in order to accomplish the scheme of associating different rates of charge with expectations on the one hand and obligations on the other, it would mean a return to the original proposal, in which the time periods for the assessment of charges were levied relative to each individual purchase rather than relative to the outstanding balances at any one moment in time.

Ms. Lissakers considered that the Board was losing sight of the link between the amount of resources made available and the length of time of access to those resources. She recalled that many Directors had started the discussions on the SRF with the expectation of a six-month facility with the possibility of one six-month rollover; currently, the Board was considering maturities of two and-a-half years, which was a substantial extension. She stated that she would be prepared to support such a maturity, provided that the rate structure substituted for the short maturity and the swap principle. However, she was concerned that even that element was in the process of disappearing from the proposal. She said that she was not prepared to tie the rate structure and the gradation to the expectation point, because the expectation point was moveable. There had to be a date certain by which the rate increased, and the increase in the rate had to be meaningful. She was concerned that the Board seemed to be moving away from principles that had garnered some earlier support, as well as away from the underlying principles of this exceptional facility with exceptional magnitude of financing. The facility was supposed to be short term and high cost; currently, there seemed to be suggestions to stretch the dates and shrink the charges.

Mr. Esdar stated that, as he heard more arguments, he would be prepared to support the staff's previous proposal, with a cap on the surcharge at 500 basis points.

Mr. Fernandez said that he agreed with Mr. Esdar.

The Chairman noted that, in the spirit of compromise and to explore all possibilities, he had wished to hear Directors' suggestions; what he had observed was that the current center of gravity was not far from the proposal made by the Director of the Policy Development and Review Department, possibly with the addition of a cap in the surcharge at 500 basis points, which showed the good willingness of several Directors. He suggested that Directors accept that proposal; otherwise a better proposal might require considerable more time and effort.

Mr. Mirakhor asked whether the 500 basis point cap referred to the obligation period and the 400 basis point surcharge on the expectation period.

The Chairman and Mr. Fernandez answered in the affirmative.

Mr. Mirakhor asked whether the starting point would be a 250 basis point surcharge.

Mr. Fernandez responded in the negative.

Mr. Mirakhor asked again whether, in the top portion of the graphs distributed by the staff, there would be a cap in the surcharge during the expectation period of 400 basis points.

Mr. Fernandez clarified that that was not his understanding of the emerging consensus. He had understood that the only difference from the proposal outlined originally by the Director of the Policy Development and Review Department was that there would be a cap in the surcharge of 500 basis points.

The Chairman asked Directors whether the proposal outlined by the Director of the Policy Development and Review Department, modified by the addition of a cap in the surcharge at 500 basis points, was acceptable. In particular, he asked Mr. Taylor whether he agreed to the modified proposal, since a country in his constituency would be the first user of the SRF.

Mr. Kiekens said that he agreed with the proposal.

Mr. Taylor noted that the Korean authorities would have preferred a starting point for the surcharge below the proposed 300 basis points. However, the matter had been discussed at length by Directors, and the staff proposal seemed acceptable. The modification of the surcharge from 550 basis points to 500 should help to support a Board consensus.

Mr. Kafka asked when the decision would be reviewed.

The Chairman and the Director of the Policy Development and Review Department responded that the draft decision provided for a review before end-1998.

Mr. Kafka concluded that he could accept the proposal.

Messrs. Al-Tuwaijri and Zhang said that they could go along with the proposal.

The Chairman concluded that Directors agreed to the proposal. He suggested that, since a revised paragraph 8 was currently being circulated, Directors should consider paragraph 9.

After some brief discussion, the Chairman stated that Directors agreed to paragraph 9. He invited Directors to consider paragraph 10.

Mr. Kiekens said that he could accept paragraph 10 if the General Counsel would confirm that the Board would still have to waive the access limit of 200 percent stated in the Articles of Agreement. Clearly, if this facility were adopted, then there would be an understanding that in normal cases, the Board would waive the limit, but that did not preclude a case where the Board had another opinion that it could require additional safeguards under Article V, Section 4. If that was the General Counsel's interpretation, then he would agree.

The General Counsel noted that this was a standard provision of the Fund's decisions establishing facilities. There was a similar clause, for example, assuring members of the Fund's willingness to grant the waiver in the decision creating the Extended Fund Facility, the Systemic Transformation Facility, and the Contingency and Compensatory Financing Facility. The clause did not legally limit the power of the Fund to require additional safeguards. However, there was an understanding that the conditionality would be such that, again, normally such safeguards would be met through the Fund's conditionality.

The Chairman asked Mr. Kiekens whether the General Counsel's explanation was satisfactory.

Mr. Kiekens responded that he was more or less satisfied with the explanation.

The Chairman noted that Mr. Kiekens was sufficiently satisfied with the General Counsel's explanation. He noted that paragraph 11 contained the provision to review the experience under the facility before end-1998; he concluded that Directors agreed to accept the paragraph. He then invited Directors to review the amended proposed decision. He noted that Directors had agreed on paragraph 1(a) and had agreed to delete (b).

Mr. Shaalan asked what had been agreed on paragraph 1(b).

The Secretary responded that Directors had agreed to maintain paragraph 1(b) as proposed, but to include in the Chairman's concluding remarks a confirmation that all Fund facilities were available to all members.

Mr. Shaalan asked whether the inclusion of such a statement in the concluding remarks would ensure that the rights of members were not negatively affected.

The General Counsel stated that paragraph 1(b) did not deal with the rights of members and did not breach the principle of uniformity of treatment of all members. The paragraph outlined the point that, in the future, the facility would be used mostly in cases that affected the international monetary system; however, it was not a condition of eligibility or a qualification for access to the facility.

The Chairman reiterated that the facility would be open to all members, and that that point would be included in the concluding remarks. He noted that Directors had agreed to paragraphs 2, 3, 4.

Mr. Vernikov considered that the meaning of the words "the arrangement" in paragraph 5 was unclear. If that referred to the corresponding Stand-By or Extended Arrangement, then there might be a problem in cases where countries already had an existing arrangement.

The General Counsel pointed out that Ms. Srejber had raised a similar point. It was clear that a country that already had an arrangement before the current decision was taken would need to convert the arrangement, and at that time the phasing and the amounts available under the facility would be identified. Of course, that would be done in all future arrangements. So the current provision was necessary, even for existing arrangements, when they were converted.

Mr. Vernikov said that he accepted the General Counsel's explanation. He suggested that the wording be clarified.

The Chairman proposed that the word "corresponding" be added to the first line of paragraph 5 before the word "arrangement." He noted that Directors agreed to the amendment. He asked the Director of the Policy Development and Review Department whether the currently drafted paragraph 6(a), (b), and (c) reflected the Board's consensus.

The Director of the Policy Development and Review Department answered in the affirmative.

The Chairman noted that Directors had agreed to paragraph 7. He pointed out that, with respect to paragraph 8, Directors had agreed to cap the surcharge at 500 basis points above the (adjusted) normal rate of charge.

Mr. Giustiniani pointed out that, as currently drafted, paragraph 8 stated that the initial surcharge of 300 basis points would apply "...from the date of the first purchase." However, he asked Directors to consider a situation in which, for example, access to financing were approved on January 1, but a first purchase did not occur until December 31. In that case, the member would pay a surcharge of 300 basis points into the second year of access to resources under the facility. As a result, he suggested replacing the words "...the first purchase" with the word "approval."

The Director of the Policy Development and Review Department noted that that point had been a matter of discussion among the staff. He said that he concurred with Mr. Giustiniani that the structure of the facility had been agreed such that the rate of charge would go up on all outstanding balances at the end of one year. That was the structure of the proposal in the chart that had been distributed to Directors.

The Chairman asked Mr. O'Donnell whether he agreed with the Director of the Policy Development and Review Department.

Mr. O'Donnell said that he agreed that the word "approval" should replace the word "purchase."

The Chairman stated that the beginning of the first line of paragraph 8 should read: "During the first year from the date of the approval under this decision..."

The General Counsel said that the date of approval or the date of the first purchase was only the beginning of a period. At the end of that period, whatever had been purchased, whether at the beginning or the end, would be subject to the higher rate. The reference to the first purchase did not mean that only holdings of the first purchase would be subject to the higher rate; rather, it was only a starting point for calculation. Also, the first purchase would normally be made two or three days after the approval.

Mr. Giustiniani repeated that the period for the purposes of determining the surcharge should begin upon approval of access to resources under the SRF, not on the date of the first purchase. For example, if approval was granted on January 1, 1998, then the increase in the surcharge should begin January 1, 1999—irrespective of when purchases were made during the one year period.

The General Counsel suggested replacing the words "...the first purchase..." with the words "...the approval of financing..."

The Chairman observed that the General Counsel's suggestion would meet the concerns of Messrs. Giustiniani and O'Donnell.

Mr. Taylor asked whether the proposed amendment would have any different effect on Korea's anticipated recourse to the SRF.

The General Counsel responded that the proposed amendment would not make a difference for Korea's access to resources under the SRF, unless, as Mr. Giustiniani had pointed out, purchases were made at the end of the one year purchase period. Korea's access to Fund resources would be switched from the credit tranches to the SRF, and Korea would be making its first purchase coincidentally on the same day or within 24 hours of approval of financing.

Ms. Lissakers noted that the timetable regarding the increase in the surcharge would begin at the time of the approval of access to financing under the SRF, irrespective of whether the first tranche were drawn at a later date.

The Chairman confirmed Ms. Lissakers' observation.

Ms. Lissakers asked whether the reference in paragraph 8 to the rate of charge on the average daily balances of holdings was a reference to the one year purchase period.

The Treasurer pointed out that that reference would need to be deleted, otherwise the calculation would be zero while the charges accrued.

The Chairman noted that the words "...the average daily balances of..." should be deleted. He pointed out that the square brackets in the second part of paragraph 8 that dealt with the additional income generated by the surcharge should be dropped.

Ms. Lissakers recalled that Directors had agreed to defer until later all decisions on what would be done with the income—and not just the surcharge—from the SRF. Since a considerable amount of money would be generated, some time would be needed for reflection on the options for the disposal of such income.

Mr. Esdar said that he agreed with Ms. Lissakers.

The Treasurer pointed out that Ms. Lissakers was, in fact, correct that Directors had agreed to defer all consideration of the matter. However, at the previous Board meeting, two views had been expressed: some Directors had favored deferring the distribution of only the income from the surcharge, while some others had preferred that all the income from the new facility should be deferred. Those different views had been reflected in the square brackets; it remained a matter for the Board to decide.

Ms. Lissakers proposed deleting the words "by the surcharge levied on purchases."

Mr. Esdar said that he agreed with Ms. Lissakers.

The Chairman noted that he had understood the opposite, but he was willing to follow the Board's wishes.

Mr. O'Donnell said that he agreed with Ms. Lissakers. He asked for an explanation of the meaning of the phrase "additional income."

The Chairman responded that the phrase referred to the income generated by the SRF.

The Treasurer recalled that the midyear review of the Fund's income would need to be completed. In that, the staff had forecasted that the income in excess of the target amount—which was about SDR 100 million—would amount to SDR 220 million; a decision would need to be taken regarding the disposal of that income.

Mr. Vernikov questioned whether a reference in the decision establishing the SRF to the income generated by the facility was necessary.

The Chairman considered that such a reference was needed; otherwise there might be undesirable consequences.

Mr. O'Donnell stated that he did not quite understand the Treasurer's explanation; nevertheless, he suggested that, as he had understood the Board's wishes, the disposal of such income should be the subject of careful consideration. In the meantime, all the income could be placed in a "pot," pending a thorough discussion based on the staff's paper (EBS/97/234).

The Treasurer pointed out that the staff paper on charges on the SRF was neutral with respect to which part of the income from the facility should be distributed. It could be either just the proceeds of the surcharge or the total income.

The Chairman invited Directors to comment on the matter.

Mr. Al-Tuwaijri noted that, at the previous Board meeting, Directors had been presented with options in the staff paper. At that time, he had supported the option of using only the income generated from the surcharge, placing that in a special account or a "pot," and then deciding the matter of disposal at a later date. If the SRF were not to have been created and there had been a case of high access for a country—like in the case of Mexico—all the income generated would have been used to reduce charges retroactively and to pay for some of the burden sharing. Part of the income generated by the SRF should be used in a similar way, and the rest of the income should be put in a special "pot" for a later discussion. He concluded that all square brackets in the proposed paragraph should be removed.

Mr. Fernandez considered that the Board would enter into a long discussion if an attempt were made to settle the matter during the current meeting. Indeed, at the previous meeting, Directors had expressed a variety of views. It would be most prudent to follow Ms. Lissakers' suggestion to delete the words "by the surcharge levied on purchases," as well as the word "additional" as suggested by Mr. O'Donnell, in order not to preempt any future decision. The Board could return to consider carefully the matter at a later date.

The Chairman pointed out that Messrs. O'Donnell and Esdar shared Mr. Fernandez's views.

Mr. Cippà noted that, as he had stated during the previous Board meeting, if even a part of the income generated by the SRF were to be considered as part of normal Fund income, then a consequence might be that there would be a retroactive refund of the rate of charges, which was not the Board's intention. Moreover, at the previous consideration of the

Fund's net income, the likely substantial income from the SRF was not considered. As a result, he said that he supported Mr. Fernandez.

Ms. Srejber said that she agreed with Mr. Fernandez.

Mr. Zoccali said that he agreed with Mr. Al-Tuwaijri that, if the SRF did not exist, the other sources of net income would, in fact, accrue to the General Resources Account. In addition, there were not insignificant expenses that would be incurred by the Fund immediately.

The Chairman considered that, by taking the most neutral language, the Board would reserve its right to consider carefully all options and decide at a later date. He suggested that Directors agree, without prejudging in any way a future decision on the matter, to delete the word "additional" and the words "by the surcharge levied on purchases." He invited Directors to consider the proposed additional paragraph recently distributed by the staff that dealt with the treatment of overdue financial obligations. He noted that the rate of charge on such overdue obligations would be 500 basis points above the (adjusted) normal rate of charge. He proposed that the additional paragraph be numbered paragraph 9.

Mr. Esdar pointed out that the decision mentioned in paragraph 9 was mislabelled "6TR"; it should read "GTR." Also, the decision had been amended, and he suggested adding the words "as amended."

The General Counsel said that the decision should have read "GTR." Also, whenever a reference was made to a decision, it was implied that that included any amendments. He suggested that the paragraph remain as drafted.

The Chairman noted that Directors agreed to paragraph 9, with the slight typographical modifications. He noted that Directors agreed to the renumbered paragraph 10.

Ms. Lissakers stated that, upon rereading the previously labeled paragraph 1(d) (currently paragraph 1(b)) dealing with the prevention of moral hazard, she wondered about the implications of including the words "maintain the exposure of all creditors, both official and private." She asked whether that implied that the Fund would ask all creditors to freeze their exposure so that development banks, for example, could not accept net repurchases, and so that other official creditors would suddenly be frozen under those terms. While she supported the intent of Mr. Esdar's suggestion, she wondered whether the phrase was perhaps too sweeping in its scope.

The Chairman said that he agreed with Ms. Lissakers. He recalled that international discussions on debt issues in the 1980s had been complicated by suggestions to oblige all multilateral institutions to maintain their exposure. He suggested that less sweeping language be included to preserve the possibility for alternative options.

Ms. Lissakers suggested including the words "to preserve access to all other sources of creditors" or "to all other creditors." She understood the desire to include all actors who already had an exposure, but the word "all" should not stand alone without an appropriate modifier. The phrase "maintain the exposure" might have the implication of freezing exposure.

The Chairman noted that Mr. Wijnholds had had much experience of the debt discussions of the 1980s. He asked Mr. Wijnholds for his contribution to the matter under discussion.

Mr. Wijnholds suggested the words "to seek to maintain participation of all creditors."

Ms. Lissakers considered that Mr. Wijnholds' suggestion improved the paragraph.

The Chairman asked Ms. Lissakers whether she agreed to keep the word "all."

Ms. Lissakers stated that the word "all" continued to cause some problems, particularly regarding official creditors.

The Chairman proposed deleting the word "all," which would also introduce qualified flexibility.

Mr. Esdar said that he could go along with deleting the word "all"; however, he suggested including the words "creditors, both official and, in particular, private."

The Chairman noted that, with the proposed amendments, the sentence would read: "...will be encouraged to seek to maintain participation of creditors, both official and, in particular, private."

Ms. Lissakers said that Mr. Esdar's suggestion might remove emphasis from official creditors.

Mr. Esdar responded that that was his intention.

The Chairman asked Mr. Esdar to reconsider his proposal, since his intention would be served by using the words "both official and private." He noted that Mr. Esdar agreed to the suggestion, in which case the particular part of the previously labeled paragraph 1(d) would read: "...to seek to maintain participation of creditors, both official and private..." He observed that Directors agreed to the remaining paragraphs, without modifications. He thanked Directors for their constructive contributions in reaching a difficult and complex decision.

Mr. Esdar made the following statement:

> Not all points which we made were addressed in this compromise, but we are prepared to support the proposed decision. However, on behalf of my authorities, I have been asked to put the following statement in the record.
>
> First, we consider it essential that the new Supplemental Reserve Facility, as a matter of principle, will only be utilized in cases where there is a risk of serious threat to the international financial system; thereby the exceptional character of this facility would be underlined.
>
> Second, it is imperative, in our view, that the new facility is considered a substitute for Fund financial assistance made hitherto available under existing

facilities. It is important that it is not understood as a signal for generally higher Fund assistance.

Third, most important, however, we believe that the Fund must develop mechanisms which will make it possible to have all the private market participants contribute adequately to the solution of financial market crises. In this context, we deem it necessary that the Fund actively explore inter alia the two following options: limitation of Fund financing to the payment of interest due to foreign currencies and, where necessary, the provision of a standstill or any other temporary capital outflow restrictions. I think my authorities will guide their decisions under this facility to these three basic principles. Again, I would make the point that we support the new facility.

The Chairman said that he had no difficulties with Mr. Esdar's comments, as they were part of the concerns shared by all Directors. However, he noted that, in order to establish the sounder international framework needed in the current globalized environment, national authorities should not expect the Fund to be responsible for resolving all aspects of problems, including things that were beyond its reach and that were under their own, more direct responsibilities. For example, the Fund needed the active support and participation of countries through the preparation of the appropriate national legislation and amendments to prudential policies, as well as cooperating with the Fund to help establish orderly debt workouts and other ideas.

Mr. Esdar noted that his authorities were aware that such matters were a global responsibility.

Mr. O'Donnell noted that the Chairman had made a suggestion that, in announcing the establishment of the facility, mention would be made in the press release that the Fund would come back to a more general study of the issue of moral hazard.

The Chairman said that he agreed with Mr. O'Donnell's suggestion.

Mr. Wijnholds said that he assumed that there would be a press release on the decision. The press release should highlight much of the language in previously labeled paragraph 1(d) dealing with the participation of creditors, the matter of moral hazard, and burden sharing.

The Chairman noted that, as usual, presentations to the media would be based very closely on the text of the decision, and the matters mentioned by Messrs. O'Donnell and Wijnholds would figure prominently.

Mr. Kiekens, in concluding the discussion, noted that, in his book on decision making and voting in the Fund, Sir Joseph Gold wrote that one of the reasons why it was possible in very difficult matters to come to decisions in the Board was that all members had the possibility to be on record with their view. He noted that he was on record with the views he had defended passionately. He considered that they remained correct, and thanked those Directors who supported him on the most important issues. He agreed that the decision was adopted, and he was fully on board to work on the important agenda that the Board would need to address.

Mr. Kafka said that he was impressed with the way the Board had been able to reach a decision relatively quickly and efficiently. At the beginning of the meeting, he had doubted whether such a decision could have been concluded at the current meeting.

The Chairman thanked Mr. Kafka, the Dean of the Board, for his generous comments on the efficiency of the Board in reaching a consensus.

Ms. Lissakers pointed out that the unexpected efficiency with which the Board was able to come to a very complex and a very important decision demonstrated the best traditions of consensus building in the Board, given that it was recognized that the issue required near unanimity. She credited the leadership of the Dean of the Board and many other members. All Directors had come to the exercise with somewhat different preferences and expectations, but managed to bridge the differences quickly.

The Chairman made the following concluding remarks:

> The Executive Board has adopted a new facility designed to deal with the circumstances of members experiencing exceptional balance of payments problems due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves. While resources under Fund facilities are available to all members, the facility is likely to be utilized in cases where the magnitude of the outflows may create a risk of contagion that could pose a potential threat to the international monetary system.
>
> There was very broad support for establishing repurchase periods that were shorter than those for resources in the credit tranches. Directors agreed that it would be appropriate to reserve some flexibility and agreed, accordingly, that repurchases should be subject to expectations, which the Board could extend, and thereafter to obligations.
>
> The repurchase expectation established under the proposed decision is distinct from, and in addition to, the repurchase expectation of Article V, Section 7(b) of the Fund's Articles. Under that provision, a member is expected normally, as its balance of payments and reserve position improves, to repurchase the Fund's holdings of its currency that result from the purchase and are subject to charges. This repurchase expectation, which is reflected in the provisions of all Fund arrangements for the use of the Fund's general resources, applies to all outstanding purchases subject to charges irrespective of the policy under which they are made and would thus apply to purchases under the facility. When calculations show that a member is subject to a repurchase expectation under Article V, Section 7(b), representations are made to the member for a prompt fulfillment of that expectation. The Board will return to the issue of the Fund's early repurchase policies at an early occasion.
>
> The decision establishing the new facility states that, in order to minimize moral hazard, a member using resources under the decision will be encouraged to seek to maintain participation of creditors, both official and private, until the pressure on the balance of payments ceases. It also states that

all options should be considered to ensure appropriate burden sharing. The Board will return to issues relating to moral hazard in the near future.

As for the income to the Fund that might be expected to result from members' use of this facility, Directors preferred to delay taking a decision on the different options until early 1998. Pending the decision by the Board on the use of such income, the Board decided that for financial year 1998 such income would not be taken into account when determining the amount of net income in excess of the net income target for purposes of paragraph 3 of Decision No. 11482-(97/42), April 21, 1997.

The Chairman said that he would prefer to have a discussion on the disposal of the income generated by the SRF as soon as possible.

Mr. Esdar considered that several Directors had concluded that the Board would need to return as soon as possible to the issue of private sector involvement and reducing moral hazard. He suggested that such a reference be included in the concluding remarks.

The Chairman said that he agreed with Mr. Esdar that several Directors had made that point, and that that should be reflected in the concluding remarks. The discussion on the matter should take place before the April 1998 Interim Committee meeting, and the conclusions transmitted to Ministers.

The Executive Board took the following decision:

1. (a) The Fund will be prepared to provide financial assistance in accordance with the terms of this Decision to a member that is experiencing exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves, if there is a reasonable expectation that the implementation of strong adjustment policies and adequate financing will result, within a short period of time, in an early correction of such difficulties.

(b) This facility is likely to be utilized in cases where the magnitude of the outflows may create a risk of contagion that could pose a potential threat to the international monetary system.

(c) When approving a request for the use of its resources under this Decision, the Fund will take into account the financing provided by other creditors. In order to minimize moral hazard, a member using resources under this Decision will be encouraged to seek to maintain participation of creditors, both official and private, until the pressure on the balance of payments ceases. All options should be considered to ensure appropriate burden sharing.

(d) The Fund may make the use of its resources under this Decision conditional upon the adoption by the member of measures under Article VI, Section 1 of the Fund's Articles of Agreement.

2. Financing under this Decision will be available to members under a Stand-By or Extended Arrangement in addition to resources in the credit tranches or under the Extended Fund Facility, in cases where (i) a member faces the type of balance of payments difficulties described in paragraph 1 above and (ii) the projected access in the credit tranches or under the Extended Fund Facility, taking into account outstanding purchases, would otherwise exceed either the annual or cumulative limit. In those cases, unless the member's medium-term financing needs require access in the credit tranches or under the Extended Fund Facility beyond the annual or cumulative limit, financing in the credit tranches or under the Extended Fund Facility will not be provided beyond the annual or cumulative limit, and financing beyond either limit will be provided only under this Decision.

3. Financing under this Decision will be determined by the Fund, taking into account the financing needs of the member, its capacity to repay, including in particular the strength of its program, its outstanding use of Fund credit, and its record in using Fund resources in the past and in cooperating with the Fund in surveillance, as well as the Fund's liquidity.

4. Financing under this Decision will be committed for a period of up to one year, even if the corresponding arrangement is for a longer period, and will generally be available in two or more purchases. The first purchase will be available at the time of approval of financing under this Decision, which will normally coincide with the approval of the corresponding arrangement. The subsequent purchases will be available subject to the conditions of the corresponding arrangement.

5. The corresponding arrangement will identify the total amount and phasing of the financing provided under this Decision.

6. (a) A member making purchases under this Decision shall repurchase the outstanding amounts of its currency resulting from such purchases within two to two and a half years from the date of each purchase in two equal semiannual installments; the first installment shall become due two years and the second installment two and a half years from the date of each purchase.

(b) The member will be expected to repurchase those amounts one year before they become due, provided that the Fund may, upon request by the member, decide to extend each such repurchase expectation by up to one year. If a member fails to make a repurchase as expected, the Fund may require the member to make the repurchase in question within a specified period not to exceed the repurchase schedule under (a) above.

(c) The Fund shall not approve, and the Managing Director shall not recommend for approval, a request for the use of the general resources of the Fund by a member that is failing to meet a repurchase expectation under (b) above. Provision shall be made in each stand-by and Extended Arrangement for the suspension of further purchases under the arrangement whenever a member fails to meet a repurchase expectation under (b) above.

7. Purchases under this Decision and holdings resulting from such purchases shall be excluded for the purposes of the definition of "reserve tranche purchase" pursuant to Article XXX(c).

8. During the first year from the date of approval of financing under this Decision, the rate of charge under Article V, Section 8(b) on holdings acquired as a result of purchases under this Decision shall be 300 basis points per annum above the rate of charge referred to in Rule I-6(4) as adjusted for purposes of burden sharing. Such rate shall be increased by 50 basis points at the end of that period and every six months thereafter, until the surcharge reaches 500 basis points, subject to the provisions of paragraph 9.

Pending a Decision on the use to be given to the income generated under this Decision, such income shall not be taken into account when determining the amount of net income in excess of the net income target for purposes of paragraph 3 of Decision No. 11482-(97/42), April 21, 1997.

9. The provisions of Decision No. 8165-(85/189) G/TR, December 30, 1985, except Section IV, shall apply to overdue financial obligations arising under this Decision, subject to the following provision:

The rate of charge on overdue repurchases shall be determined by the Fund but shall not be less than the maximum rate of charge specified in paragraph 8.

10. Except for the purposes of determining the level of conditionality applied to purchases in the credit tranches, the Fund's holdings of a member's currency resulting from purchases under this Decision shall be considered separate from the Fund's holdings of the same currency resulting from purchases made under any other policy on the use of the Fund's general resources.

11. In order to carry out the purposes of this Decision, the Fund will be prepared to grant a waiver of the limitation of 200 percent of quota in Article V, Section 3(b)(iii), whenever necessary to permit purchases under this Decision or to permit other purchases that would raise the Fund's holdings of the purchasing member's currency above that limitation because of purchases outstanding under this Decision.

12. This Decision and its operation will be reviewed no later than December 31, 1998.

Decision No. 11627-(97/123) SRF, adopted
December 17, 1997

3. REPUBLIC OF ESTONIA—1997 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1997 Article IV consultation with the Republic of Estonia and its request for a 15-month Stand-By Arrangement in an amount equivalent to SDR 16.1 million (EBS/97/212, 11/24/97; and Sup. 1, 12/15/97). They also had before them the authorities' letter of intent (EBS/97/202, 11/7/97), together with a background paper on selected issues in the Republic of Estonia and a statistical appendix (SM/97/277, 12/1/97).

Mr. Andersen made the following statement:

> Estonia's economic performance in recent years has been remarkable, and Estonia is generally considered one of the most successful reformers among the countries in transition, an impression that is underscored by Estonia's strong track record under four successive Stand-By Arrangements, the latest of which expired in August. The significant macroeconomic achievements, supported by sound and credible macroeconomic policies and comprehensive structural reforms, have brought Estonia to the doorstep of negotiations with the European Union (EU) and, with the decision last Saturday of the European Council to begin negotiations with Estonia in the spring of 1998 on the conditions for its entry into the European Union, the door is now opened to new opportunities but also important challenges in the period ahead.
>
> While recent developments have shown continued strong performance in many regards, with growth this year expected to be at least 7 percent, presumably closer to 10 percent, a stronger than expected improvement of the budget balance moving the general government into a small overall surplus, and with inflation decelerating somewhat more rapidly than anticipated, though still at an uncomfortably high level in the lower teens, the spectacular acceleration of economic growth fueled by strong, sometimes almost euphoric expectations in the private sector have brought about significant risks manifested in a sharp widening of the current account deficit. Furthermore, the continuous inflow of foreign capital, an increasing share with short-term maturities, but with foreign direct investments still taking up a significant part, has ignited a tremendous growth in bank lending, increasing the risks undertaken. On the size of the current account deficit, the Bank of Estonia recently announced some changes in the balance of payments statistics, leaving out trade transactions between nonresidents carried out through the customs warehouses. The revised current account deficit for the first three quarters of 1997 was slightly below 10 percent of GDP or approximately unchanged compared to the level for 1996. These revisions have led to a significant downward revision of the deficit compared to earlier estimates. My authorities agree that the current account deficit, as well as the strong credit growth, is clearly excessive and unsustainable, necessitating a strong policy response in order to guard against the risks of disruptive changes in investor sentiments.
>
> It is against this background, together with the challenges associated with Estonia's preparation for membership of the European Union, that my

authorities have formulated a strong and comprehensive economic program covering the period up to the end of 1998. My authorities consider it essential that their achievements so far and the prospects for continued high sustainable growth will not be jeopardized by excessive financial risks. As mentioned by the staff, a three-pronged approach is being followed, involving tighter fiscal policies, monetary and prudential measures designed to limit the credit expansion, improve its quality, and strengthen the soundness of the financial sector and, finally, accelerated structural reforms to improve productivity and increase private savings. Essentially, the program represents a continuation of the economic strategy anchored in Estonia's currency board arrangement, but with a strengthening of the underlying policies in view of recent developments. My authorities are strongly committed to pursue these policies with the appropriate discipline in a transparent manner. They believe the policies envisaged for the program period will be adequate to achieve the program objectives, but are prepared to take additional measures should the need arise. In support of this economic program, my authorities are requesting a new precautionary Stand-By Arrangement.

The staff has produced an excellent and well-focused assessment of recent developments in the Estonian economy and the important challenges it faces. My authorities are in broad agreement with the staff's analysis as well as their policy recommendations. Consequently, I will limit my remarks to some areas of special importance within the three-pronged approach.

Estonia's currency board arrangement has continued to be the cornerstone of monetary policy. This arrangement has played a key role in the macroeconomic stabilization efforts as well as in putting discipline into the financial system. Moreover, with strong growth in exports and Estonia's continued market share gains in its main trading partners reflecting rapid increases in productivity, it is difficult to find any hard evidence that competitiveness is being threatened. While the competitiveness situation needs to be watched carefully in the present situation with strong domestic demand and some pressure on wages and prices, my authorities have repeatedly shown their strong preference for and ability to adjust policies if needed rather than to consider modifications in the fixed exchange rate regime. Thus, as rightly emphasized by the staff, my authorities strongly believe that there are no reasons to bring into question either the currency board arrangement or the present level of the exchange rate peg to the deutsche mark. With the advent of the Economic and Monetary Union, they intend to replace the kroon's link to the deutsche mark with a link to the euro according to the conversion rate at which the value of the deutsche mark will be fixed to the euro.

Given the currency board arrangement, fiscal policy will continue playing the key role in ensuring macroeconomic stabilization. Building on a better than anticipated fiscal outcome for this year, my authorities have adopted an even more ambitious target for 1998 with a fiscal stance designed to generate a fiscal surplus slightly below 2 percent of GDP. This will be achieved by improved revenue collection, a widening of the tax base, continued divestiture of state assets, and reduction of expenditures. My authorities fully recognize the need for higher public savings to lower the aggregate demand

and are committed to transfer excess revenues to a Stabilization Reserve Fund, which will be invested abroad by the Bank of Estonia acting as an agent of the government in close cooperation with the Treasury. This will not only contribute to reinforcing the contractionary effect of the fiscal adjustment, but the Stabilization Reserve Fund will also serve as a useful buffer for meeting potential future contingencies if warranted. The authorities had accumulated EEK 500 million in the Reserve Fund in the past month and a further EEK 200 million will be placed before the end of the year. A budget for 1998 consistent with the economic program has been submitted to parliament. Following a successful second reading of the budget in parliament last Wednesday, it is still possible that the budget can be passed on December 17 but, for procedural reasons, final approval may not take place before the Board meeting, as mentioned by the Prime Minister in his letter to the Managing Director of December 11. While numerous proposals have been put forward during the budget negotiations, it is noteworthy that, following the second reading, the amended draft budget preserves the aggregate revenue, expenditure, and surplus targets as described in the economic program, but with some reallocation of expenditures toward higher salaries for teachers as the most significant amendment. As emphasized in the letter, my authorities are confident that the 1998 budget that will eventually be approved by parliament will be fully consistent with the fiscal undertakings in the economic program. The outcome reflects the strong commitment of the government to the program, and shows that the need for more ambitious fiscal polices at the present juncture has gotten generally widespread recognition.

Within the framework of the currency board arrangement, the Bank of Estonia is taking decisive action with regard to a strengthening of the financial sector by way of measures aiming at restraining commercial bank credit and installing financial prudence. The central bank has viewed with concern the extremely rapid growth of private sector credit and has taken a number of measures in steps trying to strengthen the prudential basis for the expansion of the balance sheets of banks. A number of such measures were announced already in April, including an extension of reserve requirements to the net foreign borrowing of domestic banks from credit institutions abroad, and an increase in the capital adequacy requirement for credit institutions from 8 to 10 percent which came into force in October. However, as credit growth has continued to expand, the Bank of Estonia is supplementing these measures by several additional actions and, as referred to in the staff supplement, these measures are starting to show the desired effects on credit expansion. My authorities have set strengthening of the credibility of Estonia's financial system as one of their key priorities in economic policy, realizing that the characteristics of an open transition economy sometimes make it necessary to apply requirements exceeding the standards recommended by the Basle Committee or the EU. Over the coming months, Estonia is set to implement "best practices" in their reinforcement of bank prudential standards, including preparation of the introduction of consolidated supervision. The importance of the latter has been demonstrated by the fact that banks are the owners of many nonbank financial institutions that are operating actively in the securities, leasing, and insurance markets.

The sustainability of the authorities' policy approach has been tested during the sharp volatility in stock prices. Following increases of about 400 percent in the Tallinn stock exchange (TALSE) from June 1996 up to the end of August 1997, when the index peaked at 493, some correction had already taken place when the first big drop in the TALSE index happened on October 23. Four weeks later the index had dropped to 189, but later rebounded to 262 as of today. A number of factors may be underlying the dramatic drop on the stock market in October-November. First and foremost, the shares were already considered to be overvalued due to excessive market optimism and, for a small and very open economy, it seems not that surprising that developments in Southeast Asia in general, and the drop in the Hong Kong stock market prices in late October in particular, were triggering a correction in an environment where contagion effects were felt globally. Moreover, the decline was aggravated by banks calling back loans or demanding collateral from individual investors who had borrowed in the banks using their stock portfolios as collateral. While the stock market developments were quite dramatic, my authorities do not expect a significant slowdown in the growth rate or a weakening of the credibility of the financial sector. Rather, developments are expected to lead to a welcome moderation of the excess optimism in the whole economy and force economic agents to more sound and prudent behavior. Moreover, the fact that the stock market turbulence was overcome quickly without any wider hazard and with the speculative pressure on the exchange rate being very short-lived, demonstrates general confidence in the policy approach, including an effective functioning of the currency board system. While there obviously is no room for complacency, my authorities feel vindicated in their emphasis on fiscal consolidation and a strengthened financial system in response to the macroeconomic risks. They are cognizant of the fact that an adjustment in the polices brought about by market forces during a crisis could have had much more widespread and potential damaging effects.

My authorities realize that structural reforms advanced more slowly than anticipated during most of 1997. The delays in certain areas regarding the implementation of reforms are by no means resulting from any lack of commitment of my authorities to further reforms, but have often been the result of the need to maintain an open political decision-making process within the parliament, and my authorities acknowledge the need for a deepening and broadening of structural reforms in several areas in order to reach Estonia's full growth potential. Furthermore, as noted by the staff, the pace of reforms has picked up more recently, especially concerning privatization of the remaining medium- and large-scale enterprises within the areas of infrastructure, energy, and telecommunication. The process of land reform has also been accelerated recently, and at least a doubling of private ownership to more than one-third is envisaged by the end of 1998.

My authorities are well aware that their very liberal trade and payments environment has given an important boost to the internationalization of the economy and has been one of the main underlying reasons for Estonia's economic successes. As accession to the European Union is coming nearer, there has been an internal political discussion in Estonia about the necessary harmonization of Estonia's policies to those in the EU. Moreover, in a setting

> where local farmers have to compete on their own with subsidized foreign production, it is perhaps not surprising that stronger political voices have been gaining ground in their request for support to the agricultural sector. While my authorities will carefully study the recommendations contained in a report submitted by a special commission, they are very determined to ensure that any measures taken in this area are consistent with the overall fiscal objectives, as well as with their strong commitment to open trade. More specifically, during the period of the new Stand-By Arrangement, my authorities will not introduce import tariffs except possibly on a highly limited number of agricultural products. If introduced, these tariffs are not expected to have any significant direct impact on the economy, as most of the agricultural products are imported from the other Baltic or European Union countries, with which Estonia has free trade agreements in force.
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> The staff points out that, even though Estonia compiles the core statistics necessary for surveillance on a timely basis, there are some deficiencies as well, particularly for fiscal and national accounts data. My authorities have given high priority to the resolution of the problems, including within the context of preparing for the subscription to the Fund's Special Data Dissemination Standard (SDDS). They agree that timely and comprehensive economic and financial statistics of good quality are critical to the ability to assess economic performance by themselves as well as for markets. The efforts to subscribe to the SDDS have been accelerated in recent months. The Fund has already evaluated the preliminary metadata of Estonia and their comments and suggestions are being considered by the officials. The authorities plan to subscribe to the SDDS as soon as possible in 1998.

The staff representative from the European II Department reported that the Estonian parliament had just passed the 1988 budget. To the staff's knowledge, the program's targeted fiscal surplus remained in place, though revenues and expenditures would be slightly higher than programmed, and there would be some reallocation among budgetary categories, offsetting each other to the amount of about EEK 100-200 million. Compared with total expenditures of EEK 27 billion, the reallocations were relatively small.

Mr. Andersen added that he wished to confirm the staff representative's comments on the budget.

Mr. Prader made the following statement:

> It is fitting that Mr. Andersen, who has worked so hard for the transition countries in his constituency, should represent Estonia today at his last meeting. We would like to congratulate the Estonian authorities as the first of the applicants selected to join the European Union. This reflects not only the overwhelming belief of the EU authorities in the right direction of Estonia's market-based reforms, but also their view that these reforms will bring Estonia up to the standards of its more advanced EU partners. Last Thursday's decision by Standard & Poors to give Estonia one of the best foreign currency ratings in Central and Eastern Europe shows that the markets hold a positive opinion as well.

However, the markets' views change quickly these days. What has seemed to suffice for the markets till now may not be enough much longer. We are glad the Estonian authorities realize this and have decided to invest in the extra security provided by a Fund precautionary arrangement in order to bolster their policy credibility. Given their overall strong economic performance over the last few years, we have no problem supporting this request, and are confident that this investment will pay off well.

Nonetheless, Estonia's macroeconomic indicators reveal the Achilles' heel of the economy. Strong domestic demand, fueled by faster credit growth than ever before, has produced a very large external current account deficit, exceeding 10 percent of GDP for the second year in a row. This is clearly unsustainable, and we are glad that the authorities recognize it. If this trend were to continue, the emergence of a crisis of external confidence would just be a matter of time, and a repetition of a larger scale of the recent exchange market turbulence. Estonia's low level of external debt could certainly buy some time, but without a strong, comprehensive adjustment, the country would remain under an economic sword of Damocles.

Against this background, we welcome the authorities' program which will cover the period up to the end of 1998, whose main goals are to cool down domestic demand and strengthen the financial system, while simultaneously accelerating structural reforms. However, it does not seem ambitious enough to meet the standards set by the authorities so far. From the projections for 1998 we cannot escape the impression that awareness of the comfortable external debt position, and the stronger confidence provided by a Fund program, has made the authorities less eager to sacrifice some real growth in order to send the markets a convincing message about their determination to adjust. And although the current account deficit is expected to fall to 5 percent of GDP by 2002, it is expected to be only slightly less than 10 percent of GDP in 1998. Non-government credit is expected to be significantly below the estimate for this year, but the 40 percent increase projected for 1998 seems far too high. Finally, the 1998 inflation target of 10 percent may not be consistent with the government's intention to continue pegging the kroon.

The staff report notes that the financing of the current account deficit has come increasingly to depend on debt-creating capital inflows, which make the economy highly susceptible to changes in sentiment in the international financial markets. Furthermore, the staff's appraisal points out that the success of the proposed policies requires that the turbulence in the international financial markets causes no liquidity difficulties for the Estonian banking system. I do not wish to make any self-fulfilling prophecies, but it is my feeling that the program does not address the root cause of the high current account deficit—excessive credit growth. The expected 1997 fiscal surplus of 0.5 percent of GDP is certainly commendable, but is dwarfed by the 14 percentage points of GDP of liquidity injected into the economy this year by the banking system.

We think that credit should be tightened further next year if the authorities are more quickly to reduce the current account deficit to a more sustainable level. Experiences from the other transition economies of Central Europe show that even smaller deficits over shorter periods of time were sufficient to force market adjustments.

The low level of savings is another reason why the current account deficit should be brought down faster. Though there is no doubt that the structural reforms already being implemented will significantly improve the efficiency of the economy, and possibly increase savings, for the short-term Estonia will either have to import more foreign savings or decrease domestic investment. We note that the staff finds some room for curbing public investment, but in view of the need to improve the public infrastructure, this is a second-best solution. It is also that often used when the savings-investment gap needs to be closed rather quickly.

As to the Currency Board arrangement, the authorities believe, and the staff agrees, that it continues to serve Estonia well. The staff report provides evidence that there is still some room for a real appreciation of the kroon. However, a recent Fund working paper on competitiveness in transition economies states that cost-competitiveness indicators are not reliable for predicting currency crises. These depend on a much broader range of variables driving short term capital movements. We therefore believe that for the continued credibility of the peg, the authorities need not only to strengthen their fiscal stance further, but also to send a signal to markets about their clear commitment to low inflation.

Finally, the Estonian Minister of Foreign Affairs, commenting on the Luxembourg summit decision, said inter alia that Estonia will have to impose tariffs and raise subsidies when it joins the EU. We assume that the sole purpose of this statement was to show how far the Estonian authorities have gone on their way to a liberal and open economy.

Mr. Merz made the following statement:

We support the proposed decision for a new precautionary Stand-By Arrangement for the Republic of Estonia. This support is facilitated by the sustained strong growth performance mainly based on a convincing economic reform agenda and by meeting of the main targets and performance criteria of the previous program. The country's progress is also recognized by the European Union leading to the decision last weekend to enter in the coming months into negotiations with Estonia about an accession.

Despite all this good news there remains one major point of concern which is also well elaborated by the staff and mentioned by Mr. Prader—"The strong increase of internal demand, fueled by an excessively rapid growth of bank credit and capital inflows, has resulted in a sharply widening current account deficit." I want to focus my following remarks on risks and options for economic policy faced with this situation.

Additional monetary and fiscal tightening measures are unavoidable if the externally financed credit expansion is not slowing down in the near future. In that event it should also be considered to switch to a more flexible exchange rate regime.

With regard to the currency board arrangement, the staff paper still supports this strategy which, however, contradicts in some way the "philosophy" of the recently issued paper on "exit strategies." There is no doubt that Estonia's situation is still comfortable in light of a sustainable level of external debt and deep reforms in the banking sector. But the lessons from South-East-Asia raise the question if the currency board arrangement is manageable in the medium term and if it has not put too much pressure on the current account and the real exchange rate. Let me underpin this by two observations:

First, despite a remarkable reduction of inflation the strong increase in the current account deficit indicates that the cumulated real appreciation of the currency hampers the competitiveness of the economy. If productivity gains will slow down or real wage increases stay at their level, speculative attacks cannot be excluded. In that event, the reaction potential of the authorities is limited. For example the ratio of foreign assets to "broad money" has dropped below the 100 percent margin for the first time since the introduction of the currency board arrangement in 1992. The amount of gross international reserves of 2 import months is also not very comfortable.

Second, recent developments in capital imports show a shift from foreign direct investment to portfolio investment. This may be supported by the currency board arrangement since the implicit exchange-rate guarantee favors portfolio-investment and the granting of loans.

Turning to fiscal policy, we welcome the significant progress in fiscal consolidation which should however be strengthened in light of the current account situation. It should also be noted that the result in 1997 has strongly benefited from a "one-time-transfer" from the "Estonian Shipping Company" to the state amounting to 0.6 percent of GDP. Moreover, in contrast to prevailing accounting rules privatization receipts reduce public deficits directly; since those receipts do not reduce demand as much as tax increases, the fiscal stance may in effect be more expansionary than the deficit figures suggest. Against this background, we support the authorities' intention to transfer revenue surpluses to the stabilization fund. We would further recommend contingency measures if budget laws should be not approved by parliament in a timely manner.

Given Estonia's good "track-record" in the past, we trust that the authorities will be able to manage the situation and go ahead with their reform agenda. We wish them much success in their efforts.

Mr. Coumbis made the following statement:

Estonia has had an excellent record during its transition period, and, more recently, it has met the broad objectives of the 1996/97 program, with remarkable economic performance in many respects. As a result, its credit rating was upgraded and it is included among the countries chosen by the EU to start negotiations next year for participation in the European Union.

There are some downside risks, however, in recent developments related to the substantial widening of the current account deficit and the fact that the rate of inflation remains above that in trading partners. It seems that the rapid rise of domestic credit and capital inflows have contributed to the substantial increase of domestic demand, which, if not checked in time, will lead to an unsustainable situation in the balance of payments. Moreover, the downside risks of an overextended banking system are clear, and are related to credit and foreign exchange risks. Furthermore, increases in real wages, fueled by the rapid increase in domestic demand, may surpass productivity gains, and, thus, affect competitiveness and further widen the current account deficit. These risks have to be taken into seriously, given recent developments in Asia and the fact that markets are edgy in this period. Recent turbulence in the Tallinn Stock Exchange is a reminder of the nervousness of the markets in this area.

The currency board arrangement, which has served Estonia very well and has contributed substantially to the country's achievements in the transition period, has provided only limited flexibility, nonetheless, in the use of monetary and credit policies to control effective demand. The authorities, therefore, have had to concentrate their efforts in the fiscal area. As a result, up until September, the general government surplus was larger than had been projected in the staff paper. For 1998, the measures proposed by the authorities, mainly in the area of current expenditure, will increase the surplus of the general government to 2 percent of GDP. Moreover, the decision of the authorities to place budgetary savings in the newly created Stabilization Reserve Fund is commendable.

In the area of credit policy, the authorities are trying to restrict the growth of credit, using a limited number of instruments at their disposal because of the currency board arrangement, to strengthen the banking system, to improve banking supervision, and to reinforce prudential standards and the surveillance of the financial system.

I am in broad agreement with the objectives of this program, particularly the policy measures aimed at achieving the macroeconomic objectives, and the structural measures in the areas of privatization, monopoly regulation, and promotion of competition. I also agree with the staff appraisal and can, therefore, support the proposed decision. I have some doubts, however, about the authorities' ability to implement the proposed measures in the area of prudential regulation and supervision of the banking sector, and particularly of the financial sector. It seems that the nonbank financial institutions—which are affiliated with large banks—have developed quickly.

However, as the staff indicates, they operate in a much less regulated fashion than commercial banks, as is especially the case with leasing companies. According to the staff, no supervisory agency is responsible for the activities of leasing companies. Moreover, the recent rapid growth of banking activity has tended, as the staff again indicates, to outstrip the authorities' ability to effectively monitor and supervise such activities. According to the staff, the banking supervision function is severely understaffed and the expertise of supervisors needs to be raised. I wonder if the staff or Mr. Andersen would comment in this area.

Mr. Pascual made the following statement:

Estonia has successfully faced a deep process of reform from a planned economy to a market-oriented one. To this end, its authorities—following the advice of the Fund—to establish a currency board arrangement to facilitate the stabilization of the economy after the major shock that entails a change like this. We can say that the currency board arrangement has worked pretty well. It has helped to reduce inflationary expectations and eased a certain convergence of interest rates between the anchor—deutsche mark—and the national currency. Despite the unpopular measures implemented, the authorities have shown a high degree of perseverance and commitment in directing the Estonian economy to an enviable position at the doors of the European Union. All in all, the authorities truly deserve to be commended.

Against this promising picture, there are, however, some causes of concern. I would mention, in particular, one of them: the need for a more stable growth supported by a more moderate internal demand.

I do not think that this disequilibria is a fault directly attributable to the authorities. On the contrary, I think it is the normal consequence of the existence and the working of the currency board arrangement with an underdeveloped financial system in a dynamic and changing framework of market competition. Nevertheless, I also think that this risk of excess demand is a better alternative than hyperinflation or the paralysis of the structural reforms. It is a less disturbing result and it is easier to deal with it through traditional demand policies.

I know from the staff report that both the staff and the authorities continue to be satisfied with the currency board arrangement. However, for the reasons mentioned above, and given the discipline and commitment shown by the authorities, and the downward trend in inflation, I wonder whether an orderly exit from the currency board arrangement must start to be considered. This strategy could give some more degree of discretion to the authorities to cope with disturbing capital inflows, the soundness of the financial sector, and the excess of internal demand. I would like to hear from the staff a further elaboration on this.

Apart from this, my recipes do not differ very much from those suggested by the staff.

On demand policies, I totally agree that the first and foremost target should be to restrain internal demand. This could alleviate pressures on prices and/or external accounts. In particular, I would point out the following:

In fiscal policy, I support the restrictive stance suggested by the staff, especially if it is implemented based on expenditure cuts. I would also welcome the attempt to subtract/avoid any unnecessary pressures on demand by allocating some of the privatization and also the unexpected revenues in an account with the characteristics of the Stabilization Reserve Fund. The Norwegian experience could be of help.

In addition to these measures, I would suggest specific increases in indirect taxes to discourage consumption and investment. This could help to alleviate demand pressures while increasing revenues.

On other fiscal related issues, I would also recommend the authorities to implement the pension reform. This measure would improve the medium-term sustainability of the system and would modify down the expectations of individuals, so as to change their permanent consumption function.

On monetary and financial policies, although I consider a tightening policy an extremely useful tool, I distrust public interventions, other than purely prudential regulations within this framework of the currency board arrangement. Thus, I would not defend present or additional reserve requirements only justified by the attempts to refrain credit growth. These measures, a sort of quantitative limits, only benefit the most inefficient institutions. Experience shows that. This is also the reason why the loan-deposit interest rate spread is so wide, which explains the negative deposit rates during the last three years.

On structural reforms, I would continue with orderly privatization and market liberalization. I am sure that expectations of soon joining the European Union will lead the authorities and will justify, to a certain extent, the required sacrifices by the population.

To sum up the Estonian case before us today is an interesting example on how to implement a transition process using effectively a currency board arrangement. But it also shows some of the risks that a currency board arrangement entails, even when soundly managed. Let us use it as a lesson for the future. In the meantime, I wish the authorities the best and fully support the proposed decision.

Mr. Salleh made the following statement:

As pointed out in Mr. Andersen's helpful statement, as well as in the staff paper, Estonia's economic performance in recent years has been nothing but remarkable. On the basis of the memorandum of economic policies, the authorities have clearly illustrated the benefits of Fund assistance. Indeed, the proposed Stand-By Arrangement will help Estonia to undertake much-needed second generation reforms, to consolidate the macroeconomic gains achieved thus far and to increase the momentum of growth durably over the medium term. The adoption of stronger policies is also in line with Estonia's intention to join the EU.

As the staff indicates, one of the key challenges facing Estonia appears to be the growing external current account deficit, which has been financed largely—and easily—by foreign capital flows. While my chair supports the authorities' proposed actions to deal with the current account deficit, we believe that, given domestic political factors in Estonia, the fiscal target aimed at reducing the growth of aggregate demand might have to be loosened.

In regard to monetary and financial sector policies, we agree with the authorities and staff that the currency board arrangement has served Estonia well over several years and that it should be maintained. The authorities' intention to deal with the unsustainable growth is commendable. We would also urge them to further improve prudential regulations, as well as strengthen banking supervision, in line with rapid developments in the financial sector.

On the structural front, the authorities are to be commended for the speed with which they have implemented reforms, particularly in comparison with other transition economies. Timely improvement in monopoly regulation, as well as protection of competition, and the much anticipated land reform should pave the way for more vigorous implementation of the privatization process. Regarding the trade regime, although the government currently has the power to impose tariffs whenever necessary, we strongly encourage it to maintain the existing tariff-free system. With these remarks, I support the proposed decision, and wish the authorities every success in their future endeavors.

Mr. Abdychev made the following statement:

I would like to begin by expressing our satisfaction that the progress in transforming and stabilizing the Estonian economy has been accompanied by increased economic activity. The private sector is growing rapidly and the share of the state enterprises in the economy has steadily declined. It is particularly commendable that the real income per capita has been increasing during 1996 and 1997. This is a bright example of positive results in economic transformation.

As we are in broad agreement with the authorities' views and the staff's recommendations, I will only make a few remarks:

We note that commendable progress has been made in fiscal stabilization. However, we concur with the staff that more fundamental reforms in fiscal area are needed to continue pursuing a firm budget stance. Such reforms would incorporate measures on both the revenue and expenditure sides, as well as strengthened and more transparent budget management procedures. The latter would include, first, a reduction of regional medical funds; second, giving more responsibility to the state treasury with regard to foreign loan disbursements and central government debt service payments; and, third, limiting the ability of local governments to borrow domestically and abroad. While we welcome the decision to transfer excess revenues to a Stabilization Reserve Fund held abroad, we urge the authorities to establish a close control by the Treasury over the activities of this fund.

The authorities have made solid progress in the area of structural reforms. They should now press ahead with efforts to create a well-functioning land market and to restructure and privatize enterprises in infrastructure sector. With regards to the adjustment of electricity tariffs, I agree that the proposed increase will be harmful for the population, but in order to succeed in privatizing the energy sector the authorities must seek full cost recovery.

With these remarks, we support the proposed decision and wish the authorities success in implementing their program. We are aware that this will not be an easy task in view of the political pressure due to the forthcoming elections.

Mrs. Paris made the following statement:

I wish to commend the staff for its comprehensive analysis of Estonia's economy. In spite of the country's impressive track record, the growing risks stemming from overheating have been well underlined by staff, whose recommendations are fully appropriate. I am gratified that the staff has been successful in convincing the authorities to embark on a program aimed at cooling down the economy, and I strongly encourage the latter to stick to the envisaged policy stance under the program.

Like the staff, I agree that the currency board arrangement has served Estonia well and could continue to do so, provided that an appropriate set of policies is in place. In this respect, Estonia's vulnerability to a disruption or reversal of short-term capital inflows, and the excessive growth of credit, indicate that there is a clear need for action to sustain the current exchange rate policy. The limited policy options available under a currency board arrangement create a preeminent role for fiscal policy to play. Despite their soundness, a tightening of fiscal accounts is therefore called for to restrain domestic demand. In this connection, while continued divestiture of state assets is a positive development, it would be misleading to consider privatization proceeds as contributing to fiscal tightening. Those proceeds should be treated as a financing item in the fiscal accounts, and not as a revenue item. In any event, the planned fiscal adjustment under the program is quite significant, and the authorities' creation of the Stabilization Reserve Fund attests to their serious commitment to the current economic policy regime. Nonetheless, I wonder if the staff would provide Directors with its views on a possible orderly exit from the currency board arrangement, as suggested by previous speakers.

A tightening of monetary conditions is essential. I thus strongly welcome the measures already undertaken by the central bank to restrain commercial credit, instill financial prudence, and enhance supervision. Although the first indication of a slowdown in credit growth is encouraging, the staff rightly stresses the risks inherent to the substantial exposure of the financial system to external developments. Close monitoring in certainly required.

The authorities renewed emphasis on structural reforms is welcome and to be encouraged, because it should contribute to increased productivity, possibly increased private savings, and further marked progress toward harmonization with EU regulations and practices. With these comments, I support the proposed decision.

Ms. Lu made the following statement:

I would like to first join other Directors in commending the staff for providing us with a comprehensive report on Estonia. I broadly agree with the staff's view on Estonia and share the comments of most Directors. I am also encouraged by the recent economic developments in Estonia, including the relatively rapid economic growth, the decreased inflation rate, and the stable exchange rate. I would also like to highlight the following points.

First, Estonia's currency board arrangement continues to lay the critical ground for its monetary policy. I support Mr. Anderson's view that this arrangement has played, and will continue to play,, a very important role in its macroeconomic stabilization. We think the risks exposed to the international financial market are not due to the exchange regime but to the liberalization of the capital market and if there is a sound financial system. In this context, we think that the currency board arrangement is the best choice for Estonia at this moment.

Second, given the currency board arrangement, fiscal policy will continue to be essential to Estonia's economic objectives. Because private savings rose tremendously, we think that the focus of Estonia's fiscal policy should be placed on an increase in public savings. At the same time, we also urge the authorities to make more efforts to cut expenditure while broadening the tax base and increasing the tax rate.

Third, we welcome the authorities' efforts in monetary policy, especially in restraining commercial bank credit, and instilling financial prudence. One of the lessons we can draw from the recent financial crisis is that a sound financial system is very important defense against volatile international financial exposures. In this sense, we welcome the policy measures listed in the staff paper. All these measures are important in strengthening the prudent supervision over the financial sector.

Fourth, we welcome the authorities' liberal trade and investment system. We are also aware of the problems encountered in Estonia, including the current account deficit, and the slow-paced structural reform. However, we are glad that the authorities are conscious of these problems and have taken steps to challenge them. We urge the authorities to speed up structural reform in order to improve productivity in Estonia, and we hope that the specific target to lower the current account deficit and inflation can be accomplished.

Finally, with the above remarks, I support the proposed decisions and wish the authorities every success in the future.

Mr. Lvin made the following statement:

I am sure my commendations would add little to the prestige of being the best reformer which Estonia has earned over the last five years. Indeed, the bulk of issues being discussed in the staff documents — like what to do with fiscal surpluses, how to curb commercial banks' lending to households, and what sort of damage an early accession to the European Union might inflict on the custom-free trade policies of the authorities — all these issues are still something rather unthinkable in most other post-planned economies.

I believe it will be the best recognition of the Estonian achievements if we apply the highest standards while assessing the authorities' policies. Indeed, one could summarize the whole story as follows: Five basic principles of flat tax, free trade, no monetary policy, no public ownership of the means of production, and no labor policy, when applied consistently, would lead to economic growth in a range of 5 to 10 percent. Once presented this way, the story may look very instructive and enlightening.

In view of such a remarkable conjunction, one may note that the staff appraisal seems to be based on somewhat outdated theoretical assumptions which do not fully correspond to the innovative practices established in Estonia. More often than not the staff encourages the authorities to introduce policy instruments which are very much in use in the industrial economies but can be shown to entail some negative effects.

The most important area where one may find such sort of inconsistency is the monetary policy. Indeed, there are many reasons to believe that the best monetary policy is no discretional policy at all; that there are no good and bad monetary policies but just bad and worse. And it is definitely the case in the environment of a currency board arrangement which itself is, first and foremost, an explicit commitment to exercise no discretion in monetary affairs. Still, it is believed by many that irresponsible behavior of commercial banks might put in jeopardy the very credibility of the currency board; it is concluded, therefore, that the banks should be closely supervised and directed by the authorities. Thus, the staff approvingly notes that the Bank of Estonia has decided to employ fully its residual power to restrain commercial bank credit.

I do, however, remain convinced that this sort of reasoning is rather a reversal of what is going on in reality. It is not the systemic folly on the part of commercial bankers which calls for increased central bank vigilance; it is the very existence of the central bank that makes the commercial bankers believe in the likely socialization of eventual losses. And the more active is the central bank, the more likely is that such a belief is widespread and overwhelming. Indeed, just by adopting and enforcing various prudential policies the central bank inevitably assumes responsibility for failures which may occur even if all regulations are strictly adhered to. To completely exclude risk-taking the central bank would have to nationalize the whole banking business. As long as this is not the case the best way to assure stability of the financial system is to keep the central bank as far as possible from the borrowing and lending business. It seems that one can produce no better evidence of this assertion than a simple comparison of, say, Thailand, Indonesia, Korea, on the one hand, and Hong Kong, Taiwan, and Singapore, on the other hand.

Therefore, I tend to think that at least one pillar of the authorities' policy package—I mean the monetary and banking policy—might be modified. It would be advisable if the Bank of Estonia, instead of intensifying various limitations on the commercial banks' activities, concentrates on sending, again and again, in the most forceful and credible terms, the simplest message: a possible failure of a deposit-taking institution will be none of our business.

If such a hands-off approach were adopted I would be even less concerned about the current account deficit. This deficit seems to be generated mainly by trade and capital flows between Estonia and Finland, and may be viewed as a sign of the deepening integration of these two economies.

Of course, excessive external borrowing by financial institutions able to produce a systemic maturities mismatch can create serious problems for the whole economy. Nevertheless, statistical data suggest a not too bleak picture. For instance, foreign liabilities of the commercial banks remain fully covered by their foreign assets, which I assume are rather liquid. Moreover, the foreign asset cover of the broad money remains extremely high, close to 90 percent. By the way, this fact demonstrates how misleading might it be to rely on the familiar reserves-to-imports ratio—which is rather low in Estonia—in this case. After all, import demand does not appear out of thin air; it is contingent on the availability of domestic funds, and their cover remains extremely comfortable.

It is interesting to note, in this respect, that the greatest part of short-term inflows is by far concentrated in the nonbank sector. According to the helpful clarification made by the staff, most of these nonbanks are industrial, nonfinancial companies. These inflows represent, therefore, mostly trade credit and do not represent any potential danger to the balance of payments. Indeed, it must be remembered that it is only a combination of deposit-taking and loan-making, specific to the banks only, which can translate an imprudent borrowing strategy into a system-wide crisis.

Turning to another pillar of the authorities' policy, namely, to the fiscal one, I can also express some doubt about the appropriateness of putting so much emphasis on demand management. Of course, fiscal surplus is incomparably better than fiscal deficit, but it still means a sort of drain on the resource pool of the general public. And, frankly, it would be openly disappointing for a decent taxpayer to learn that he has to surrender a part of his earned income not to support provision of some public goods or repay public debt but just to lower the aggregated demand. Also, accumulation of unused and not earmarked funds might easily trigger undesired expectations of a possible bailout among the overly risk-prone or less effective market participants.

After all, any demand policy is bound to be inherently unsound and detrimental, whether it aims at its stimulation or restraint. We are not equipped with a faculty to establish beforehand the optimal level of demand. Moreover, what is more important is not the demand volume itself but its distribution between different goods and projects. Trimming private incomes, therefore, is not equal to curbing bank credit and would affect spending patterns in a different way.

Perhaps, it would be politically and economically more advisable if eventual surpluses were allocated to a specially earmarked fund, for instance, toward future pension liabilities. Such an approach would increase the public awareness of this long-term problem and, at the same time, make it easier to address it in the future.

An extremely liberal trade policy is also a unique—and very much enviable—aspect of the Estonian reform. It is noted, however, that the idea of tariff support for agriculture seems to be gaining currency, at least in some quarters. In order to neutralize this idea, one may suggest expressing it in a different language, namely, that the population at large should be denied a unilateral foodstuff subsidy provided by the wealthiest governments. Perhaps, viewed from this angle, this idea would lose some attractiveness.

As far as the issue of competitiveness is concerned in this respect, I would recall that it was mentioned here, in the course of some previous discussion on Estonia, that the very concept of inflation and real appreciation of the kroon is not much applicable in the specific case of Estonia.

Such a view can be only reinforced by the note about methodology of the consumer price index in Estonia, namely about the continuous use of 1993 weights in the calculations. In view of that, I would suggest that all considerations about price-related indicators, like the real exchange rate, unit labor cost, relative competitiveness, and so on, be treated as very preliminary. Talking about prices, the staff call inflation "uncomfortably" high. But I see no inflation as we all have come to understand it; I see ongoing price adjustment closely related to the secular upward trend of wages. Incidentally, the wage chart on page 10 shows that wages were subject to sharp fluctuations, both upwards and downwards, during last three years. It suggests that wages remain flexible and can fully absorb a loss of competitiveness if it were to occur.

Finally, I wonder whether it is not the right time to abolish the state monopoly in the area of the metal trade? It would be inconsistent to privatize a state company responsible for such a trade, and still keep it vested with monopoly power.

With these observations I wish for the authorities to remain a beacon of transition and reform. I have no objection to the proposed decision.
Mr. Shields made the following statement:

I first wish to thank Mr. Lvin for his comments, which I found stimulating.

Several Directors raised the issue of an exit strategy from the currency board arrangement. There are obviously two possible exit strategies, first, the authorities' approach of exiting straight into EMU, and, second, another approach of exiting into some variant of a managed floating regime, then subsequently into EMU. While the authorities might intend to exit straight into EMU, there might in fact be an intervening period between a full exit from the currency board and a full entry into EMU—or a period in which the currency board will have to function in conjunction with the EU's chosen mechanism for countries not yet EMU members ("outs") and countries that are EMU members ("ins"). If this were to be the case, it is possible that there could be substantial currency speculation in the markets over the permanent conversion rate between the relevant currencies in EMU. This could present significant risks—especially given the concerns about Estonia's competitiveness—raising doubts about the kroon's chosen exchange rate under the currency board, and thereby making the kroon vulnerable to speculative attack. In the event, it would be preferable to adopt the other approach, namely, to exit the currency board by floating the kroon first, then considering EMU entry, second.

Given that Estonia has had several Stand-By Arrangements in succession and the prospect that it will join the EU and EMU in the medium term, I wonder why an Extended Arrangement for the country was not proposed.

The staff representative from the European II Department indicated that the authorities were determined to join EMU as soon as was possible given Estonia's economic situation and EMU members' willingness to accede to their entry. Moreover, they had stated so publicly. They believed that it would be possible within five years; but in the meantime, there would be an interim period between the start of EMU in 1999 and Estonia's entry into that monetary union. The staff had pointed out that both the domestic and external situations might change between the present and five years hence, and the authorities had, accordingly, agreed to keep the situation under review. Nonetheless, the staff supported the authorities' goal of entering EMU as soon as possible; their intention of retaining the kroon's peg to the deutsche mark, and thereafter to the euro; and their desire to maintain the currency board arrangement until an orderly exit into EMU. In any event, Estonia would, to some extent, enter EMU indirectly, given its existing currency peg to the deutsche mark, which the authorities did not anticipate changing until EMU entry.

The staff's support for the currency board arrangement was not unconditional, the staff representative qualified. Rather, the staff—and the authorities—believed that Estonia's policies had to continue to support the existing exchange arrangement and that the currency board should be kept under careful review. Given market turbulence over the past few months, the staff had considered the possibility of a less orderly exit than hoped for from the currency board, and had discussed with the authorities possible actions to support the existing exchange arrangement. Directors had seen some of those actions over the past few weeks, including the Bank of Estonia's rapid, open, and transparent move to improve banks' prudential situation and financial soundness, to demonstrate the authorities' support for the existing currency peg and board.

As indicated in its paper, the staff agreed with Directors that credit growth had been excessive, the staff representative stated. With rapid credit growth, there was a tendency for creditors to lend to higher risk borrowers, which was a concern to both the Bank of Estonia and the staff. Therefore, the authorities had taken measures to contain growth, as indicated in the staff paper. While the extraordinarily rapid credit growth was a cause for concern, the rate had fallen sharply over the previous two months, and the staff expected that it would fall even more sharply over coming months. However, to put the growth of credit into perspective, domestic credit outstanding as a ratio to GDP was about 20–25 percent in Estonia; 67–70 percent in the Czech Republic; and 60 percent in Chile. The ratio in Estonia was considerably lower than in most other transition economies.

Furthermore, Estonia had no capital controls and no administrative regulations on credit, and the only instruments available to the central bank were prudential requirements, which preempted it from directly influencing credit in the banking system, the staff representative added. That was not to say that the Bank of Estonia would protect commercial banks from poor lending decisions, or bail them out from the consequences of the latter. The Bank of Estonia's policy was clearly to allow insolvent banks to fail, while at the same time making every effort to establish a framework protecting the prudential viability of the banking system as a whole.

The rapid growth of nonbank financial intermediaries operating in a much less regulated framework than banks was one of the most worrisome aspects of rapid credit growth, the staff representative indicated. The Bank of Estonia was moving rapidly to bring those institutions under prudential supervision, partly through consolidated supervision of the banking groups, many of which owned the nonbank financial institutions. The Bank of Estonia was also proposing new laws and regulations that would make the operations of those intermediaries more transparent. While the process would take more time and resources than would be available within the next few months, the staff was convinced that the authorities were determined to supervise nonbank financial institutions.

Mr. Pascual wondered if it was appropriate to control credit growth in Estonia through reserve requirements. Under the currency board arrangement, it might be preferable to rely purely on prudential regulations rather than on admixed reserve requirements.

The staff representative from the European II Department indicated that the staff had discussed with the authorities a range of instruments to control credit growth, considering not just reserve requirements, but also liquidity ratios and limits on gross foreign liabilities of banks (to prevent the latter from borrowing abroad). In principle, the Bank of Estonia and the government clearly wished to avoid resorting to administrative and regulatory intervention, and to preserve as transparent a financial system as possible. The staff had sought to help Estonia preserve the latter, but with the option, if that approach failed, of resorting to a mixed approach (including perhaps some administrative controls). If they were needed, the latter options were available—though the Bank of Estonia did not believe that they were necessary yet.

Mr. Pascual asked whether excessive reserve requirements had caused the wide spread between deposit and loan rates, and whether that spread had affected the savings rate.

The staff representative from the European II Department responded that wide spreads between deposit and loan rates were due to many factors, not just reserve requirements. For example, the ease with which Estonian banks had been able to borrow in Germany, Sweden, and other Western European countries at low rates and to relend those funds at much higher rates had meant that the banks had not raised domestic deposit rates to generate increased domestic deposits. Moreover, the banking system had been dominated by only a few banks (essentially five, three of which were large); and there had been little differentiation among the banks, which had been able to borrow at similar rates in the interbank market. That situation, however, had been changing over the past two to three months as a result of the authorities' measures. Smaller and weaker banks could no longer borrow in the interbank market at the same low rates, resulting in a substantially increased interest rate spreads between the smaller and larger banks. There would be a continuing shake out among the banks, which might result in increased distortions in the short term, before the situation resolved itself. Mergers were likely, and continued differentiation of banks' operations, and a further decline in deposit-lending spreads. On its part, the Bank of Estonia believed that its overriding responsibility in the more competitive banking environment was to ensure that the banking system as a whole met the minimum capital adequacy requirements of the Bank for International Settlements or the EU.

Mr. Pascual queried whether the authorities were considering establishing limits on credit growth, particularly external borrowing by banks.

The staff representative from the European II Department pointed out that the staff paper and the authorities' letter of intent indicated the possibility of limits on gross foreign liabilities of banks. However, as those limits would represent a form of inward capital controls, the authorities hoped to avoid resorting to them, if possible. As many Directors had noted, Estonia had been successful over the previous several years because of its simple, open, and transparent system—including neither tariffs nor capital controls—designed to allow integration into Western Europe that was as rapid as possible. While those had been the authorities' principles, that did not mean that the latter were not prepared to adjust their principles pragmatically, if circumstances changed. Indeed, they had already indicated their willingness to adjust their no-tariff policy, in the interests of joining the EU. At some point, some of the authorities' principles would have to be adjusted, including regarding credit or capital controls. Nonetheless, to preserve the openness of the Estonian system as long as possible, the staff would not advise the authorities to consider such administrative controls, until they had exhausted all other possibilities.

Directors were correct that the inclusion of privatization receipts as revenues was not conventional accounting or standard Fund practice, the staff representative continued. The receipts had been included above the line, exceptionally, essentially for political reasons; given Estonia's especially delicate political situation—a minority government—it was vital that the large privatization receipts be treated as transparently as possible, which their inclusion above the line would allow. The authorities' budget, which had just been adopted by parliament, did not include any privatization receipts—neither as nontax revenues nor as financing. However, in the letter of intent, the staff had insisted that all such receipts—which would amount to a substantial 1–2 percent of GDP a year for the next five years—be treated as transparently as possible. In any other country, the staff would have asked the authorities to use privatization receipts to reduce state debt. But Estonia had little such debt (it had either been repaid or was highly concessional). Including privatization receipts as fiscal revenues above the line was not optimal, but in the circumstances, it was preferable than including them nowhere, which would have been less transparent.

The fiscal adjustment under way was considerable, the staff representative stated. Essentially to "sterilize" the large fiscal surpluses (including privatization proceeds), the government had created the Stabilization Reserve Fund (SRF), which invested the surpluses with the Bank of Estonia or abroad—but not within the domestic banking system. If there had been no currency board in Estonia, and the country's banks had not been able to borrow easily abroad, the authorities could have deposited the large fiscal surpluses with the central bank. However, there was a currency board, and overseas borrowing by Estonian banks would have resulted in continued rapid credit growth, as banks would still have had incentives to keep lending without much effect on domestic demand.

Estonia's inflation rate of 11–12 percent a year was a cause for concern, particularly given the currency's peg to the deutsche mark, and needed to be reduced as rapidly as possible, the staff representative said. While the authorities wished to do the latter, political constraints had prevented them from increasing the prices of nontradables rapidly over the past few years (thus price convergence between tradables and nontradables had been slow). To put that problem in perspective, Estonia's overall price level was about 40 percent of Austria's (as noted in the October 1997 *World Economic Outlook*); Latvia's was 45 percent; Russia's was 50 percent; and the Czech and Slovak Republics' were 58 percent. Thus, even if price increases of tradables slowed greatly over the next two to three years, overall inflation would not decline as fast as one would hope. Given the need for substantial increases in nontradables' prices, the program's 1998 inflation target of 8 percent was more ambitious than it appeared to be. The prospect of increases in nontradables' prices was one reason why the staff had advised the authorities to monitor wages closely, and another reason why it believed that the currency board and the exchange rate peg needed to be kept under close review in coming years.

The staff had not discussed a possible Extended Arrangement with the authorities in the previous year or two, the staff representative remarked. The authorities had neither raised the matter with the staff nor discussed the possibility of drawing the Fund resources available to them under the Stand-By Arrangement. There were no particular advantages of having a precautionary Extended Arrangement versus a series of precautionary Stand-By Arrangements in the case of Estonia.

The staff representative from the Policy Development and Review Department explained that the staff generally preferred to avoid proposing precautionary Extended Arrangements. It was possible under the latter for a country to miss performance criteria in successive reviews, yet be able to draw a substantial accumulation of backlogged purchases in the event that it suddenly met the most recent criteria. That problem was unlikely in the case of Estonia, but it had been evident with some countries in the past—albeit not recently. While the problem was not a pressing one, it had defined, to some extent, the staff's views on the appropriateness of precautionary Extended Arrangements, in principle. Moreover, in the case of Estonia, the question of how much longer the country needed the support of the Fund was outstanding; hence, the staff preferred to provide support under shorter term Stand-By Arrangements than medium-term Extended Arrangements.

Mr. Andersen made the following concluding remarks:

> I would like to thank my colleagues for the interest they have shown in Estonia in spite of the very heavy Board schedule for the time being and for their constructive and valuable comments which I certainly will pass on to my Estonian authorities.

As the staff representative from the European II Department has already answered comprehensively to the questions and issues raised by Directors, I will not take up much more of the Board time today, but only add a few observations.

It seems to be a common feature of discussions on transition economies as well as emerging market economies using the exchange rate as a nominal anchor that the appropriateness of such a fixed exchange rate policy is brought up in this Board, including considerations on a possible exit strategy. Estonia has been no exception in that regard, neither earlier nor today. I am glad to note the general support to the currency board arrangement and want to underscore that it is difficult to overstate the importance of this fixed exchange rate policy for Estonia. Almost everybody in the Estonian society understands and supports the exchange rate policy. Moreover, if a country has an exchange rate system that has served it rather well there is no reason to abandon it too easily. Why fix it, if it isn't broken. Apart from reiterating the strong determination of my authorities to ensure that the exchange rate policy has the necessary support from other policies, including a tight fiscal policy and strong emphasis on liberal and market-oriented structural policies, it is worth recalling that not only did the currency board arrangement proved to be a very useful anchor during the banking crises some years ago, the kroon did also survive the first strong attack very well recently. Indeed, it is quite impressive the way in which the system has stood up to the more recent financial ups and downs. Also, I would say that the exit strategy is quite clear, namely to be a full member of EMU as soon as possible when the circumstances and conditions so allow. In the meantime the intention is also quite clear, namely to continue with the currency board arrangement and just substitute the deutsche mark link with a link to the euro with the advent of the EMU according to the conversion rate of the deutsche mark.

This focus of the exchange rate policy underscores Estonia's strong interest in full integration of the Estonian economy into the European Union and they, therefore, very much welcome the decision of the European Council at the EU summit last weekend in Luxembourg to begin the accession negotiations with Estonia early next year. Estonia will be well prepared for these negotiations with considerable progress in transforming the economy into a well-functioning market economy and in transposing and implementing the so-called *acquis communitaire* relating particularly to the single market, and also the strong track record in pursuing stability-oriented policies bodes well for their endeavors.

On tariffs, I can only reiterate my authorities' strong commitment to open trade, but I guess it is quite safe to assume that there will be a need for some catching up to EU policies at some stage. Let me stress, like the staff, that Estonia's simple, open and transparent overall system is seen as an essential ingredient of their policy framework.

Finally, on behalf of my authorities, I would like to reiterate their sincere appreciation for the excellent cooperation with the staff representative from the European II Department and his team and with the Fund's resident representative for Estonia, and again I thank my colleagues for their support and valuable comments. With the ultimate goal of the Estonian authorities to fully integrate the economy into the European Union, they are of the understanding that, in this process, it is essential to continue with strong and ambitious macroeconomic policies and structural reforms, and they find the Fund's advice and support to be of significant importance in that regard.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the policies underlying Estonia's remarkable economic transition over the past few years, which were reflected, inter alia, in vigorous output growth and declining inflation. They noted that these favorable results were largely the outcome of early decisions to reduce the state sector and establish a highly open economy—based on a liberal trade and financial system—which was becoming well integrated with western Europe's advanced economies. In this connection, they welcomed the prospects of Estonia's entry into the European Union. In addition, Directors welcomed the favorable results of Estonia's adherence to the monetary and fiscal discipline implied by a currency board arrangement, which, coupled with the containment of real wage increases, had contributed to the strong macroeconomic performance.

Directors noted, however, that Estonia now faced some new problems in maintaining macroeconomic stability, namely, buoyant domestic demand fueled by rapid growth in bank credit, based in large part on substantial capital inflows, which had resulted in a sharp widening of the current account deficit to high levels. They cautioned that the banking system might overextend itself and face liquidity problems, should credit risks be poorly judged or capital inflows slow down. They also pointed out that inflation, while decreasing, was still uncomfortably high compared with that prevailing in major trading partner countries. This situation, in addition to demand-driven real wage increases—which, although relatively moderate so far, could exceed productivity gains—might result in a decline in competitiveness. Directors, therefore, emphasized the need to increase domestic savings, restrain domestic credit, strengthen the domestic financial system, and accelerate structural reforms.

Directors stressed that strong macroeconomic policies were especially important at a time of considerable volatility in international financial markets, to bolster policy credibility and market confidence. They underscored the importance of generating the fiscal surpluses targeted for 1997 and 1998, and to transfer these surpluses—including privatization proceeds—to the recently established Stabilization Reserve Fund. They supported the authorities' decision to refrain from spending any excess in revenues over and above the level of expenditures presently targeted in the program, as an important signal of the authorities' commitment to prudent economic management. Directors also endorsed the government's emphasis on lowering the still-high ratio of its expenditure to GDP. They urged the authorities to continue to focus on rationalizing public outlays, notably in the administrative budgets of the central and local governments.

Directors generally agreed that the currency board arrangement has been, and remains, an effective tool in Estonia, providing a transparent and credible framework for economic expectations. However, a few Directors recommended that the authorities consider carefully the options open to them in the event that it might become desirable to adopt a less rigid exchange rate framework. Directors viewed with concern the rapid expansion of domestic bank credit, all the more so because the pace of such growth could outstrip the banks' ability to assess risks properly. They commended the Bank of Estonia for aggressively availing itself of the policy instruments at its disposal—within the limitations imposed by the currency board arrangement—to reduce the growth rate of commercial bank credit and to strengthen the banking system. They encouraged the authorities to implement vigorously the reinforcement of bank prudential standards in the coming months; to extend this effort to nonbank financial intermediaries; and to strengthen bank supervision. With considerable volatility still evident in international markets, Directors counseled the authorities to monitor very closely financial developments in Estonia and to stand ready to take additional action if necessary.

Directors welcomed the authorities' commitment to revitalize structural reforms following the regrettable slowdown in 1996 and much of 1997. They emphasized that such reforms were essential for raising private savings and improving the efficiency and productivity of the economy. They urged the authorities to press ahead with privatization of the large infrastructure enterprises, reform of the pension system, and to improve anti-monopoly regulation and promote competition. In the financial area, Directors stressed the importance of rapidly adopting the amended credit institutions law and revised securities legislation to strengthen the financial system and to render it more transparent.

Directors commended the authorities for Estonia's tariff-free trade regime and urged them to make every effort to maintain it for as long as possible.

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

The Executive Board took the following decision:

1. The government of the Republic of Estonia has requested a Stand-By Arrangement in an amount equivalent to SDR 16.1 million for a period of 15 months commencing on December 17, 1997.

2. The Fund approves the Stand-By Arrangement set forth in EBS/97/212, Supplement 2.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 11628-(97/123), adopted
December 17, 1997

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/97/122 (12/16/97) and EBM/97/123 (12/17/97).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 97/65 and 97/87 are approved.

APPROVAL: December 16, 1998

REINHARD H. MUNZBERG
Secretary

TABLE 1

Date	t	t+6	t+12	t+18	t+24	t+30
Surcharge	300	350	400	450	500	
Repurchase expectations			0.5	0.5		
Repurchase obligations				← 0.5 →		
					← 0.5 →	

TABLE 2

Purchase	1 billion		Weighted average surcharge on total purchases (basis points)	Average actual maturity (years)
Portions	0.5 billion	0.5 billion		
Initial maturity	1 year	1.5 years		
Effective average rate of surcharge: (basis points)				
(1) If initial expectation met:	325	350	340	1.25
(2) If initial expectation not met and expectation/ obligation set six months later:	350	375	364	1.75
(3) If initial expectation not met and expectation/ obligation set 1 year later:	375	400	389	2.25

FIGURE 1

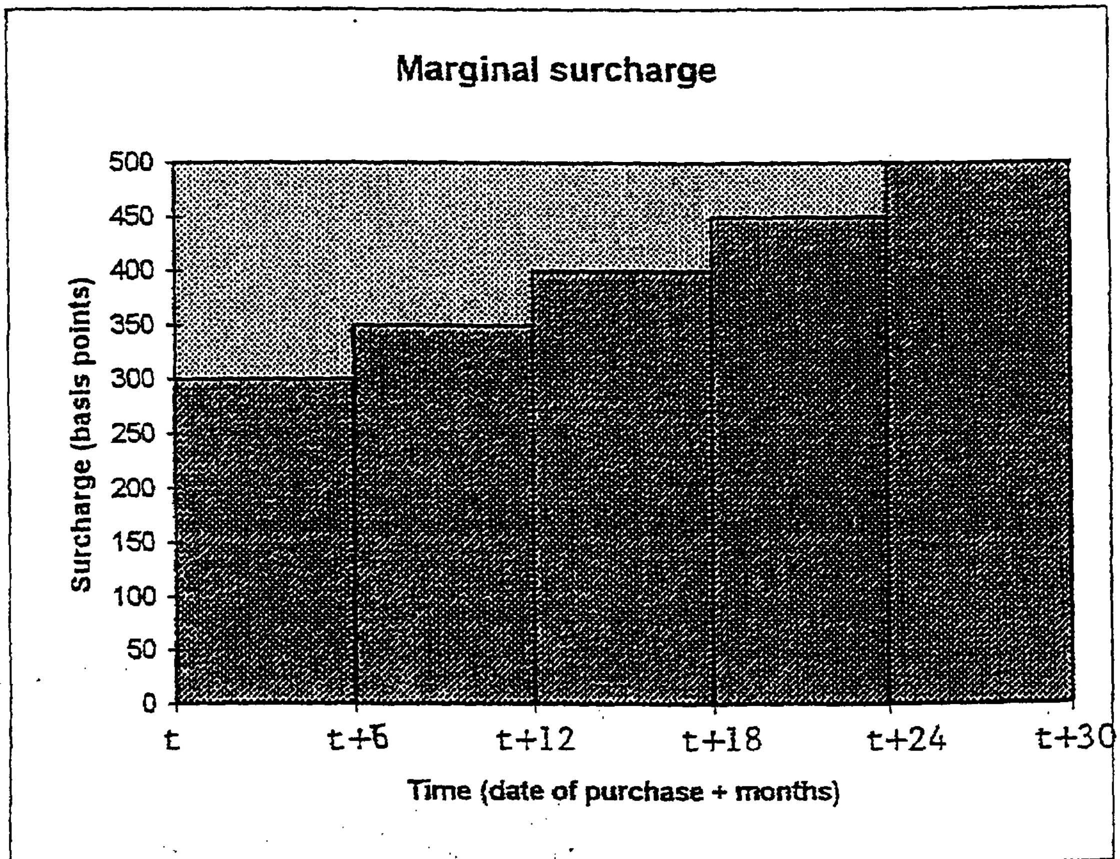
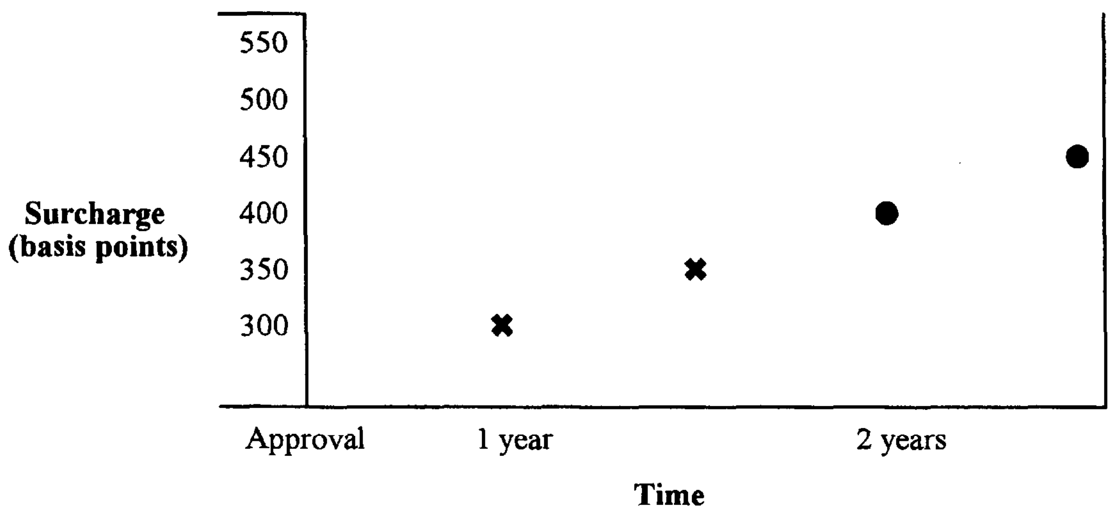

Marginal surcharge
Surcharge (basis points)
500
450
400
350
300
250
200
150
100
50
0
t
t+6
t+12
t+18
t+24
t+30
Time (date of purchase + months)

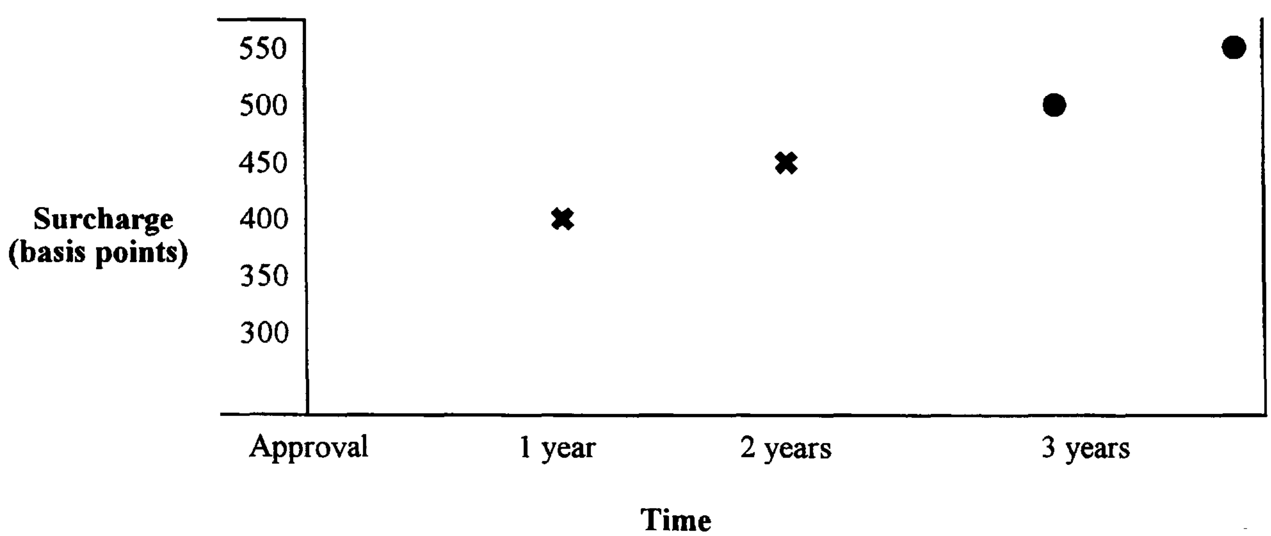
FIGURE 2

Rates of Charge When
(i) repurchase expectations met
(ii) repurchase obligations met

Expectations Met



Latest Possible Obligations Met



✖ denotes point of repurchases for purchase on approval

● denotes point of repurchases for latest possible purchase