DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

March 1, 1999
Approval: 3/8/99

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/121

10:00 a.m., December 15, 1997

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

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

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
	A.S. Alosaimi, Temporary
	R. Fernandez
	H. Paris, Temporary
T.A. Bernes	C.X. O'Loghlin
R.F. Cippa	U.Y. Tilyayev, Temporary
B. Esdar	W.-D. Donecker
	N. Coumbis
	A. Giustiniani, Temporary
	F. Mercusa, Temporary
	J.P. de Morais
	L.J.F. Erasmus, Temporary
A. Kafka	H.F. O'Brien
W. Kiekens	D.A.A. Daco, Temporary
K. Lissakers	B.S. Newman
	S.D. Melese-d'Hospital, Temporary
	S. Rouai, Temporary
	A. Vernikov
G. O'Donnell	J. Shields
	J. Roaf, Temporary
A.S. Shaalan	W.F. Abdelati, Temporary
M.R. Sivaraman	H.B. Disanayaka
	R.P.Watal, Temporary
E. Srejber	A.R. Palmason, Temporary
G.F. Taylor	O. Kwon
	M.A. Cilento, Temporary
	J. Guzmán-Calafell
	J.L. Pascual, Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha
K. Yao	A. Barro Chambrier
Y. Yoshimura	
Zamani A.G.	S. Joyosumarto
Zhang Z.	Wang X., Temporary
A.G. Zoccali	D. Merino, Temporary

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

Also Present

IBRD: E. Somensatto, Europe and Central Asia Regional Office; H.G. Broadman, East Asia and Pacific Regional Office. African Department: E.A. Calamitsis, Director. Asia and Pacific Department: H. Neiss, Director; A. Singh, Deputy Director; D.J. Goldsbrough, Deputy Director; T.S. Callen, J.P. Gordon, K.M. Meesook, I. Otani. European I Department: M.C. Deppler, Director; C.T. Beaumont, L.D. Everaert, A.K. McGuirk, J. Wieczorek. European II Department: J. Odling-Smee, Director; B.J. Aitken, O.P. Brekk, M.J. Buchanan, D.A. Citrin, D.J. Donovan, O. Havrylyshyn, J.R. Márquez-Ruarte. External Relations Department: P.C. Hole, Deputy Director; C. Hellemaa, M.E. Hansen. Fiscal Affairs Department: P.S. Heller, Deputy Director; M. Cangiano, N.A. Chalk. Legal Department: F.P. Gianviti, Director; W.E. Holder, Deputy Director; P. De Boeck, H. Elizalde, J.L. Hagan, Jr., H.N. Schiffman. Middle Eastern Department: P. Chabrier, Director. Monetary and Exchange Affairs Department: W.E. Alexander, P.T. Downes, J.E. Leimone. Policy Development and Review Department: J.T. Boorman, Director; A.G.G. Bennett, D. Burton, A.J. Dougherty, J. Fernandez-Ansola, J. Ferran, M. Fisher, Z. Murgasova, M.S. Schadler, T. van der Willigen. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, Deputy Director; R. Sahay, A.J. Tweedie. Secretary's Department: P. Gotur, A. Mountford, B. Sarr. Statistics Department: C.S. Carson, Director. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Director; D. Gupta, Deputy Director; J.C. Corr, B.E. Keuppens, M.G. Kuhn, B.N. Yuen. Western Hemisphere Department: C.M. Loser, Director. Office of the Managing Director: M. Russo, Special Advisor; B. Christensen, J.A. Clément, M.Cross, O.J. Evans, F.J. Gaitan; Office of Internal Audit and Inspection: E. Brau, Director. Advisors to Executive Directors: M. Askari-Rankouhi, J.A. Costa, S.S. Farid, P.M. Fremann, C.M. Gonzalez, K.M. Heinonen, G.M. Iradian, J. Jonáš, J.M. Jones, R. Kannan, H. Kaufmann, M.F. Melhem, H. Mori, H. Ogushi, Y. Patel, L.B.J. van Geest. Assistants to Executive Directors: N.R.F. Blancher, P.I. Botoucharov, J. Chelsky, H.W. Cocker, A.L. Coronel, J.K. Honeyfield, M. Kell, K. Kpetigo, T.-M. Kudiwu, K. Lai, M.Z. Maatan, I. Moon, L. Palei, L. Pinzani, J. Salleh, O. Schmalzriedt, T.T. Schneider.

1. REPUBLIC OF KOREA—REPORT BY STAFF

The Executive Directors, meeting in restricted session, heard a report by the staff on recent developments in the Republic of Korea.

2. SUPPLEMENTAL RESERVE FACILITY

The Executive Directors considered a staff paper on the Supplemental Reserve Facility (EBS/97/225, 12/5/97; and Sup. 1, 12/12/97). They also had before them a background paper on charges on the Supplemental Reserve Facility (EBS/97/234, 12/12/97).

The Chairman suggested that, in order to keep the important discussion focused, Directors should make clear in their first round of interventions their views on such specific issues as the establishment of the Supplemental Reserve Facility (SRF), the repurchase period, and the level of charges. Such focused comments would facilitate preparations for the second round of discussions, as well as for the conclusion of the deliberations.

Ms. Lissakers made the following statement:

> The Fund has demonstrated over its history that it has an impressive ability to adapt its policies and practices to meet the changing needs of its members. In the last few years the Fund has responded to the challenge of the crises of the 21st century by substantially increasing the size of programs through the liberal use of exceptional circumstances provisions, and by accelerating our response time through the Emergency Financing Mechanism. I think the basic approach continues to rely on instruments that are designed primarily to deal with balance of payments problems centered on macroeconomic imbalances and related structural problems, while the current Asian crisis, and to a lesser extent the 1994/95 Mexican crisis, had their origins in asset deflation arising from a loss of investor confidence, exacerbated by possible contagion effects rather than serious macroeconomic imbalances. While the problem may be in the private rather than the public sector, the raison d'etre for the Fund involvement remains the achievement of an orderly resolution that avoids excessive disruption of the domestic or the international economy.
>
> On the basic approach laid out in the staff paper and draft decision, we agree that a special facility is best suited to deal with confidence-based financial crises. It would avoid distorting the structures of Stand-By and Extended Arrangements in order to make them fit situations in which they were not designed, and as special facilities would also provide greater flexibility in designing the terms and conditions specifically appropriate to the unique circumstances of financial crises without creating possible precedents for access under our normal programs.
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> We are also in broad agreement with the basic approach to the new facility suggested by the staff which builds on the Fund's experience in the Mexican and Asian crisis. However, some refinements of the specific provisions could help to differentiate the facility from other the Fund financing and highlight the unique nature of the problem being addressed.
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> With regard to eligibility, the facility should be available to members experiencing a short-term financial crisis arising from a loss of investor confidence that poses a threat to the monetary system, or poses the risk of contagion. While the facility would obviously be available to all members, we expect that the principal

beneficiaries would be emerging market economies with extensive links to international capital markets.

With regard to access, the Fund should be expected to play the central role in dealing with these situations, and would normally provide, in cooperation with other international financial institutions, the bulk of the necessary financing, although bilateral financing can also play a role. In these circumstances, we agree that there should be no preset access limits based on quota, but rely instead on the kinds of judgments already used in determining access under the exceptional circumstances policy. Access to the facility should, however, normally be limited to the first year of the associated Stand-By or Extended Arrangement. We agree with the one year access proposed.

While recourse to the facility would reduce the need to front-load an underlying Stand-By or Extended Arrangement, we may actually want to use the facility even when the normal access limits are not breached; so we could accept a flexible trigger, as it were. Although, I recognize that the staff is proposing keying off the annual access limit which would probably be acceptable to us, as well.

On conditionality, as use of the special facility would be linked to a Stand-By or Extended Arrangement, there would not be a need for a separate program. However, we do think that there should be scope under the facility for tightening conditionality as necessary, if we think that the circumstances have developed in a way that requires additional measures. I think that should be understood at the outset when the facility is used, that there will be considerable amount of flexibility in terms of the conditionality that is added or adjusted because of the potentially volatile and uncertain nature of the problems we are dealing with.

The repurchase period, we think, should be substantially shorter than traditional the Fund financing to reflect the short-term nature of the problem and to return the potentially very large resource disbursements to the Fund as quickly as possible. We are dealing with problems that could pose potentially very large demands on our resources, and the instrument should be designed to bring those resources back as fast as possible. That can and should be done through two mechanisms. One is the shorter repurchase period, with the addition of the early repurchase expectation that the staff has also built into the proposal. But, in terms of repurchase obligation, we think the staff proposal leaves a potentially too long period for return of the resources. In our view, the repurchases should begin within one to one and a half years after the initial purchase and should be completed within two to two and-a-half years from the date of the purchase.

Charges similarly should reflect the extraordinary nature and scope of what the facility makes possible. We are temporarily replacing market financing, and the charges should reflect that fact. This should not be a subsidy in terms of low interest rates under those circumstances, particularly as the staff has proposed medium-term money. Normally, for this kind of financing a swap arrangement of 60 to 90 days would be in order, but we are persuaded by the staff argument that having such a short maturity structure could potentially undermine market confidence when we are trying to do just the opposite. But, therefore, if we are going to accept a longer maturity—and I consider what I propose to be longer maturities—it is doubly important that the charges provide an added incentive for early repurchases. Therefore, we would suggest the top end of the range proposed by the staff, and in addition would propose

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that there be some form of gradation of the charges, so that charges would rise either with the magnitude of the drawing or the time the money is outstanding, or both.

One possibility for adjusting charges to size, rather than have it based on quota or access levels, would be to simply take the size of the package that has been negotiated and divide it into two, three, or four pieces, and say the first piece will cost X, the second piece will cost X plus one, and the third piece more. That is what we did in the Mexico program. The other would be to scale it according to maturities.

With regard to use of the income generated by lending from the facility and the higher charges, we think for now it should be put in a new precautionary balance account, at least until the short-term financing is repaid. We are prepared to be pragmatic and inventive regarding the future use of the windfall income. But I think we should avoid the temptation to spend the money before it materializes.

So to conclude, I think the establishment of the new facility can enhance the Fund's ability to respond to recent crises, help to restore confidence at this difficult juncture, and through an appropriate repurchase and rate structure, minimize the moral hazard of providing very large financing to substitute for market access.

I think while it is important to consider all the issues very carefully, a prolonged delay in reaching these key decisions could have significant longer run costs for the stability of the system. I think that prudence suggests that a good outcome not be lost by an effort to achieve perfection.

The Chairman said that he agreed with Ms. Lissakers that the Board must act quickly in the present circumstances; through the Board's traditional spirit of compromise, a rapid decision could be achieved.

Mr. Rouai asked whether the grading of charges proposed by Ms. Lissakers was possible under the Fund's Articles, given that it would lead to different charges for different countries.

The General Counsel responded that he would have to examine the specific proposal put forward by Ms. Lissakers. However, it was possible to have charges increasing over time from the date of the purchase, as well as a higher rate of charge based on the level of outstanding purchases.

Ms. Lissakers said that her proposal had been to take the sum of the package that was negotiated—in the Korean case SDR 20 billion—and simply divide that in thirds, so that the first third would cost a certain amount, and if the second third was disbursed, that amount would cost more.

The Chairman said that he was aware that Mr. O'Donnell was considering a proposal similar to that of Ms. Lissakers. He invited Mr. O'Donnell to share his thoughts with Directors.

Mr. O'Donnell explained that there were two elements to the issue of charges. One was whether one wanted to encourage early repayment, in which case, as the length of time that a charge was outstanding increased, the charge would increase. Ms. Lissakers was taking a slightly different tack. Possibly, in addition, one could have a proportion of the total, say, 25 percent of the SDR 21 billion for Korea available at a slightly higher rate, which was a slightly different proposal from that of Ms. Lissakers. The proposals had similar elements, but were not exactly the same.

The Chairman said that he understood the General Counsel's wish to study carefully any proposal in writing. However, in view of the shortness of time, he invited the General Counsel to react to the explanations by Mr. O'Donnell and Ms. Lissakers.

The General Counsel responded that he wished to be cautious regarding the matter, and to reserve comment. It was not clear whether the new proposal would be based on the level of holdings; the staff would need to analyze various aspects.

The Chairman suggested that, in the interest of time, staff from the Legal Department consult with Ms. Lissakers while the Board discussion continued.

Ms. Lissakers considered that the process of establishing the SRF should not be unduly complicated. Her proposal and Mr. O'Donnell's proposal shared the principle of gradation, which would act as a strong incentive for an early repayment to the Fund of potentially substantial resources. That incentive would be achieved by pricing the use of Fund resources according to the length of use and/or the amount, as well as in relation to market pricing, for which SRF funds would be substituting temporarily.

Mr. Taylor said that he understood the principle behind the gradation of charges, but he asked how it would be made operational.

Mr. Kafka stated that he shared Mr. Taylor's concern. He asked whether the progression in charges would be defined in terms of the absolute amount of financing, a percentage of the whole amount, or as a proportion of the whole amount.

The Chairman asked Mr. O'Donnell to circulate his proposal in writing to the Board.

Mr. O'Donnell said that he would circulate a diagram outlining his proposal. He stressed that, as one element of his proposal, the amount of charge should be related to the period outstanding; however, that was different from the issue of having a higher charge for the proportion of the amount originally decided.

The General Counsel stated that he suspected that some Directors were considering applying charges to absolute amounts, which would not be legally feasible under the Articles. The calculation of charges, if it was based on level of holdings, had to be determined in relation to the member's quota.

The Chairman pointed out that an added complication might be that calculated quotas and actual quotas occasionally differed.

Mr. O'Donnell made the following statement:

> Let me start by saying that we strongly support the creation of this new facility, and very much along the lines proposed by the staff. We think the crucial elements of it are to allow very high access—much higher access than normal for these particular special cases—but in return for that much higher access there should be a higher rate of charge. It should be short term in duration, and it should be tied to Fund conditionality. Those are our key points.

If we start by considering who should be eligible for the new facility, we agree with the principle that the facility should be available to all Fund members. But there should be a clear understanding that its relevance and its suitability will be for countries with large-scale access to international capital markets who are facing liquidity problems which are a serious threat to the international monetary system, or that carry serious risk of contagion. Now, that language is along the lines of the Managing Director's summing up for the Emergency Financing Mechanism, which I think provides a possible model that we draw on. But if we are establishing a new facility which has the possibility of giving much larger access, we must be careful to minimize the moral hazard implication of this; therefore, we need to think carefully about a number of issues.

Let me start with the question of the rate of charge. Our position is that we should be setting the charge high enough to give a strong incentive for early repayment, so we would be very much at the top end of the kinds of numbers mentioned in the staff paper, i.e., around 400 basis points as a spread over the rate of charge.

On the amount of funds available, we welcome the language that is in the draft decision that says the amount of financing made available under the new facility will depend in part on the country's record of using Fund resources in the past and of cooperating with Fund surveillance. There is a possibility that we have considered, but that may be too complicated for this case, so I will just mention it to the Board for consideration. This is going back to the case where the Fund has repeatedly gone to a country and issued warnings that if there is no change in behavior, then there is a real problem. If I were given complete control, it would be nice to be able to say that if the Fund had issued—let me put it this way—a "yellow card" to a member, that when it actually came to draw on this facility, we should take account of the number of "yellow cards," or indeed the fact that it had probably been given a "red card" in the end for using this facility, that this might be used to raise the rate of charge. That probably gets us into an area that is a bit too complicated to define of what constitutes a yellow card.

In terms of whether one has access to 100 percent of normal limits and then moves into this new facility, we take a rather flexible approach to this, and we could live with the proposal that is in the staff's paper. It would be nice to have a blended approach to these things.

On the repayment period, this is where I hope the document that is being circulated is relevant. (See attachment). Like I say, we think this system should be set up so there is an encouragement to repay. Now, this starts by having something which in this little chart I have called X, which is the premium or the spread over the Fund's rate of charge. So if, for example, under this facility a country borrowed money and repaid it all within, say, six months, the rate of charge would simply be this figure X.

Let me take as an example simply 400 basis points. If one were to say a spread of 400 basis points over the rate of charge, anything you repaid in the first six months, you would pay at a spread of 400 basis points. If on the other hand you kept that money for the full two-year period, you would, under this scenario, be paying 400 plus the 150; so you pay 550 on the whole of that money. There might be differences of view about where X should be set. I have proposed 400. I have proposed a tiering structure so that every six months this goes up by 50 basis points, with the idea being this gives a strong encouragement to repay. I think some kind of principle and scheme like this would give all the right incentives and it builds in a certain element of rules rather than discretion to the process which those of us who favor transparency are very keen on.

In terms of conditionality, we agree that this new facility should be available only to countries signed up to either a Stand-By or Extended Arrangement, and that conditionality should be very closely linked to that. We think tough conditionality is extremely important to safeguard the high levels of lending envisaged.

In terms of financing the new facility, our prime concern is to get it up and running as soon as possible, and ideally Korea's next tranche of its Stand-By Arrangement would be under this new facility. Therefore, in the interest of speed in the first instance, we would take financing from the General Resources Account. However, we do not think that should preclude the option of the Fund borrowing either from the General Arrangements to Borrow or the New Arrangements to Borrow, once it is ratified by enough participants, or indeed from members on a bilateral basis to support the facility.

In terms of what to do with the income, we are grateful to the staff for their helpful paper which sets out the options. We do not think we need to resolve that question now. My preferred option follows what Ms. Lissakers put forward: all additional net income should be collected into a new contingent account. We could then think about what to do with it. I should state very clearly our preferences that an element of this should be allocated to reserves, because that is only prudent, but we also hope that some of the money can be used to help all the members of the Fund partly to reduce charges, but also—and this is a strong feeling within the United Kingdom—for ESAF-HIPC.

The First Deputy Managing Director considered that Mr. O'Donnell's suggestion that the Fund could issue "yellow cards" to countries that repeatedly ignored the Fund's warnings might create the moral hazard of the Fund issuing such cards at every opportunity. Also, it might reward those countries that concealed information from the Fund.

Mr. O'Donnell said that he agreed with the First Deputy Managing Director on the possible problems. However, in the end, one could argue that the incentive effect caused by the desire to avoid having "yellow cards" might provide the desired result.

Mr. Sivaraman made the following statement:

The proposal to have a Supplemental Reserve Facility has come at a time when the Fund is required to provide assistance on an exceptional basis on scales which have not been seen hitherto. These lendings are taking place to restore market confidence, that is to restore normalcy in a crisis-ridden economy. We must not forget the fact that while we talk about restoring market confidence, it is the very same players whose confidence we want to restore had apparently not undertaken normal prudential precautions while lending. They were motivated by short-term gains while lending money to banking institutions which re-lent this money without proper evaluation of its ultimate use. While it is imperative to restore normalcy quickly in such situations, we must also bear in mind that when there are genuine balance of payments requirements of certain countries for reasons beyond their control, the assistance is provided on a much lower scale, but with similar conditionality. The assistance which is given under exceptional circumstances should, therefore, come out of a different facility carrying a higher price tag. My authorities would strongly support the setting up of the Supplemental Reserve Facility.

As regards the rate of charge to be levied for access to this facility, I suggest we adopt a graduated scale varying from 2 to 4 percent, depending upon the extent of access, similar to what Mr. O'Donnell has suggested. The staff will have to work out the amounts at which the different rates will operate. Calculations, of course may be cumbersome regarding repurchases, as Mr. O'Donnell tried to explain. However, I think this will be very fair to have such a graduated levy.

As regards the period for which the facility should be available, the suggestion of the staff is reasonable regarding access, and repurchase should be made within two years of the last purchase under the facility depending upon the amount. We could make it 18 months or 24 months. We cannot treat this facility as some kind of a cash credit or overdraft facility of a member when it is in crisis. There was some suggestion that it should be for a period of 60 to 90 days. I think it would be very difficult to anybody to repay within 60 to 90 days because there will have to be some time interval before the economy is able to generate surpluses to pay the amount. Prescriptions of very short periods may be an open invitation for defaults.

I believe access to this facility will start as soon as a country draws 100 percent of its quota from the Stand-By Arrangement. Paragraph 20 of the staff paper states this facility will be available to a member only in combination with Stand-By or Extended Arrangement. In order to take care of the concerns expressed by a few members that their calculated quotas do not actually represent what they should really have, and it varies to a significant extent from the actual quotas, I would like to suggest that where drawings exceed 200 percent of the quota, which is a normal cumulative access limit laid out in the Articles, access to this facility could be considered instead of the 100 percent that has been suggested by the staff. This is only a suggestion.

As the facility will be in combination with one of the other facilities, conditionality will necessarily derive from the linkage with other facilities to which the member will have access. I think it is difficult to have a separate set of conditionality for drawing under this facility.

Let me now turn to the paper on the charges and the Supplemental Reserve Facility. First, I congratulate the Treasurer for this very lucid paper, which I have already done. I think this is the first time I see a paper written in "king's English" or "queen's English" without any long, winding sentences.

The higher rate of charge that is being levied can be considered as a punitive levy. The proceeds from such a levy should generally be used for a higher purpose. In my view, it will not be fair to put it into a general pool, and use it for reducing the basic rate of charge. We should not use this opportunity for reducing the basic rate of charge, because some countries are in distress and they require the exceptional facility. We should not use this higher rate of charge just for reducing the basic rate of charges. It is fixed under different principles. The proceeds of this charge, over and above the normal rate of charge, should be applied partly to augment the ESAF-HIPC Trust, and also to reduce to a certain extent the impact of the burdensharing arrangement. In my view, two-thirds of this pool can be transferred to the ESAF-HIPC Trust and the balance can be reduced used to reduce the impact of the burdensharing arrangement. Such an arrangement, in my view, would be free from criticism that members have tried to use this opportunity to reduce their cost of operations of the Fund at the expense of a few unfortunate members.

Mr. Kiekens made the following statement:

The staff recommends establishing a new facility to provide financial assistance to countries that face a loss of market confidence which results in large capital outflows. I agree that the Fund should provide, in exceptional circumstances, large financial support for short periods at higher interest rates. However, it is preferable not to formalize the Fund's preparedness to act as a lender of last resort by establishing a special facility that entitles countries to receive extraordinary amounts of financial support, of course, on condition that they intend to implement adequate adjustment policies.

It seems to me unwise to create a new instrument that will easily be seen as the Fund's "bail-out facility," in the midst of a financial crisis and following very substantial bail-out interventions. It risks sending the wrong signal to governments and the financial markets that from now on, the Fund considers these exceptional interventions as routine. If countries conduct sound policies, the need for large-scale emergency bailouts should remain exceptional.

Hastily creating such a new facility under the pressure of the scheduled date of Korea's second drawing would give the impression that the Fund deals with the crisis on a piecemeal basis, without taking stock of recent policy actions and evidence that the Fund's programs in Asia are succeeding. Also, we need to finish our discussion on the implications for the financial role of the Fund of the amendment of the Article of Agreement making the promotion of free capital movements a purpose of the Fund. In this connection, as we all know, how to amend Article VI is still to be settled. In addition, it would be useful to hold the long planned discussion, and learn its results, concerning the Fund's policy of lending to countries that, in exceptional circumstances, activate policies aimed at an orderly resolution of their public or private external debt.

The new facility formalizes the Fund's lender of last resort function and creates for its members an entitlement to such lending. This may diminish the incentive both for governments to pursue sound policies and for financial agents to assess risk correctly and impose discipline on borrowers. It is a longstanding and generally accepted wisdom that although last resort lending may sometimes be unavoidable and even desirable, it is better not to provide assurances about its availability or conditions.

For all these reasons, I prefer to maintain the present approach and to provide very high access to deal with loss of market confidence by using the exceptional circumstances clause of the present Stand-By Arrangement instrument. I agree that the rules for Stand-By Arrangements, as well as for the Extended Fund Facility, should be amended to provide for higher charges and shorter repurchase periods for countries obtaining, under these facilities, cumulative access beyond a given threshold of, say, 300 percent of quota.

Financing under other facilities such as the Systemic Transformation Facility (STF) and the CCFF would not be counted against this threshold. The higher charges and shortened repurchase periods would apply to all Fund members whose access exceeds the common threshold, and would not violate the principle of the uniformity of treatment. They would apply generally and would not be decided on a case-by-case basis when waiving the access limit of 200 percent of quota as permitted under Article V, Section 4 of the Articles of Agreement. Higher charges can be decided by a 70 percent majority, and would apply on charges due under all existing arrangements after the increase.

Higher charges are justified both by the additional risk to the Fund resulting from very high access, and as an encouragement to replace the Fund's financing with market financing as soon as possible.

Refinancing on the markets, however, will usually take some time. I therefore propose applying, from the outset and throughout the whole period of outstanding drawings, the basic risk premium that can be set at 2 percent. This basic risk premium can then be complemented by an incentive surcharge starting 60 days after each drawing and gradually increasing by another 2 percent, making the total surcharge 4 percent after a year's time.

On how to shorten the repurchase periods, I can agree with the regime the staff proposes in paragraph 19.

The additional income derived from the higher charges should be applied to the Fund's precautionary balances, preferably by adding them to the Fund's general reserves.

If the Board prefers to adopt the Supplemental Reserve Facility (SRF), I suggest introducing several features aimed at reducing moral hazard, particularly for financial agents, and signaling that access to the Fund's lender of last resort facility is not a foregone conclusion. Countries that guarantee, without Fund approval, the liabilities of their commercial banks above a reasonable limit would not be eligible for access under the SRF. State guarantees existing at the time the instrument is adopted should be phased out within three years. Also, access should be limited to the refinancing of a part of the countries external debt falling due during the drawing periods. Finally, very high access—say, above 500 percent of quota—would only be decided with a qualified majority of 70 percent of total voting power.

Both Ms. Lissakers and Mr. O'Donnell have suggested that the facility should only be available for cases that are a threat to the IMS or that may give rise to contagion effects. For this reason, this facility would not be accessible for small or very small countries, which in my opinion is contrary to the principle of equal treatment and, indeed, adds to the market perception that "for the Fund, large countries are too large to fail."

Mr. Esdar made the following statement:

This Board today is confronted with a very difficult challenge. We have to make difficult and far-reaching decisions which will have a significant impact on the

Fund's future role in the international monetary system. Before coming to my statement, I have to admit that I share many concerns expressed by Mr. Kiekens.

Due to the external circumstances, we do not have the usual time to discuss and closely scrutinize the elements of our decision. This requires a certain element of caution, but we have also to be prepared to take some risk and to adjust or modify our decision if necessary. Therefore, to start with, I would suggest to establish this new facility only for a period of two years. This would reflect appropriately the fact that we are entering new territory and that this is very much part of our learning to cope with the new challenges stemming from the transfer to globalization. Here it will be particularly important to strengthen the structure and supervision of each country's financial system, as well as its economic management, in order to safeguard better against sudden losses of market confidence and contagion effects.

We have to meet today two objectives. First, on the one hand, we have to find appropriate ways to support member countries where a crisis of confidence has developed, with the risk of significant outflows of capital. We have to provide sufficient resources to rebuild confidence based on a convincing adjustment and restructuring program. This requires strong conditionality and prior action in crucial areas. Therefore, we strongly support the suggestion to base such programs on the conditionality of Stand-By or Extended arrangements.

In this context, a possible blending between Stand-By and EFF resources, on the one hand, and resources provided under the Supplemental Reserve Facility should be decided on a case-by-case basis. In my view, we need some flexibility in this regard. The staff's suggestion to first completely exhaust access limits of traditional facilities before resorting to the SRF might unduly limit the required flexibility.

The nature of emergency programs sometimes will provide only a limited time frame for negotiations, and we probably have to accept that some details can be negotiated only in the course of the program. Therefore, prior actions are even more important in those programs, not only to justify large up-front drawings, but also to prove the commitment of the authorities to reform. Those prior actions have to focus particularly on causes of the financial crisis, on reform on the financial sector, but also on the appropriate monetary and exchange rate policy response. I would suggest that these conditionality and prior action requirements would be explicitly addressed in the text of the decision.

As already mentioned, the objective of this facility would be to support countries whose balance of payments problems may pose a potential threat to the monetary system or which carry serious risk of contagion and that are particularly exposed to possible large swings in market sentiment. The text of the decision in this regard is very vague, and I would strongly suggest to reflect this general objective of the SRF more precisely in the first paragraph. Here I am very much on the side of Ms. Lissakers and Mr. O'Donnell, and I do not think that the provision of uniformity of treatment prevents being more clear in our decision.

Secondly, on the other hand, we have also to be aware that, if the Fund provides significant financial support, it may generate or strengthen already existing severe bail-out expectations and moral hazard effects. We also have to safeguard the Fund's resources for those members with traditional balance of payments needs and to limit the Fund's financial involvement as far as possible. The core business of the Fund to help those members should not be undermined.

We have to be aware that the Fund resources are limited and that they have to be protected. This can be done, first of all, by providing appropriate incentives for early repayment through charges which are in line or even above market rates, but also by shorter repayment periods. However, as a consequence of this new facility, the Fund takes a much higher risk. Against this background, I support the suggestion to use the additional income generated by higher charges to strengthen the Fund's precautionary balances; that means its reserves. However, as a second-best option, we could also accept the idea of establishing an additional contingency account.

On charges, I very much support the proposal of Mr. O'Donnell. A staggered schedule of increasing spreads would be the most efficient way to encourage early repurchases. But I could also live with Ms. Lissakers's proposal or with a combination of both, pending the view of the Legal Department.

To start with a spread of 400 basis points for repurchases within the first six months after a drawing and to increase the spread progressively for longer repurchase periods seems to be highly appropriate. There should be a firm obligation to repay after 12 to 18 months, perhaps in two instalments. If we apply this system to each tranche, we get a somewhat more balanced repurchase structure and avoid bunching. There also could be early repurchase expectations during the interim period until the repurchase obligation will come into effect, if justified by circumstances.

Finally, coming back to the need to prevent bail-out expectations, we should make all efforts to ensure an appropriate participation of private creditors right from the beginning in order to ensure adequate burden sharing and to limit the risk of moral hazard and to confirm the Fund's basic catalytic role, and finally also to ensure the financial viability of the programs we agree. This participation of private creditors will mean in many cases that private creditors or banks have to roll over their short-term claims. It might be worth while to consider whether the Fund could encourage such a rollover obligation by helping to back up interest payments on the short-term debts that fall due.

We have to make every effort to involve private creditors at a very early stage of program discussions. A support in backing up interest payments could provide a strong incentive for creditors to agree on the necessary participation. It would be in their own interests, especially, if their own commitment to participate in the overall package would help to avoid defaults. In this regard, reference to Article VI might help to convince them.

This is only one potential option. There are other elements which might help to integrate the private sector adequately in emergency packages. The credibility of the Fund's program advice and conditionality, as well as its financial integrity, is at stake here. The international community expects us to find the solution for this problem rapidly. Here the recent G-10 study on liquidity crisis might provide additional useful guidance for our work on this urgent matter.

I was, to be frank, disappointed that this issue was not discussed in detail in the paper. I am aware that there was only very limited time, but, on the other hand, it is a crucial issue to avoid undue recourse to the Fund's resources. While I noticed in the paper the general assumption that the Fund would provide the resources through such a facility only in the context of an overall financial package involving other lenders, I still think that this assumption is too vague and too unfocused. We have to address directly the need to involve private creditors.

Against this background, I would suggest to add a special first paragraph to the decision which, first, clarifies the objective of the new facility—that means the need to prevent serious impairments of the monetary system—and, second, which makes clear that this facility is not intended to bail out private creditors and which emphasizes the need for adequate participation also of private creditors. It could also make clear that under certain circumstances a standstill could not be excluded. My authorities have prepared a draft of a text for the first paragraph, and I will circulate it to the Board.

To conclude, we are prepared to support the establishment of this new facility if those suggestions and modifications in the text of the decision can be accepted. Having said this, let me express my concern that the focus of our discussion by recent events has turned too much on crisis handling and financing. We again have to put more emphasis on crisis prevention and the appropriate policy response. I am very much concerned that the problems we are confronted with today, to a significant extent, have been caused and exaggerated by an inappropriate and delayed policy response. Obviously, Fund surveillance and Fund policy advice could not change this attitude. Even after programs were agreed, policy reactions sometimes were, to say the least, rather hesitant and half-hearted. We have to come back to these problems very soon, and we have to make clear that financing under the new facility will not and cannot be a substitute for policy adjustment in the respective countries at an early stage. We also have to be prepared to say no if required by circumstances. The possibility of a default or standstill has to remain a potential option if required by circumstances.

The Chairman said that he agreed with Mr. Esdar's concluding observation that the possibility of a standstill or default could not be ruled out—even with the existence of the new facility. It was important to make that clear when explaining the details of the new facility to the public, because some confusion seemed to exist in the minds of some commentators. He pointed out that many of the recommendations in the recent G-10 report alluded to by Mr. Esdar had been incorporated in the design of the new facility, as well as in other staff papers. He asked Mr. Esdar what other ideas from that report could have been included.

Mr. Esdar responded that there were two additional elements that could have been included in the staff paper on the new facility. First, the proposed decision on the facility and the staff paper explaining the details of the facility could have addressed the issue of moral hazard and of integrating private creditors in the resolution of crises for which the facility was designed. With respect to issues raised by the recent G-10 report, the Board had previously requested the opportunity to discuss the question of financing into arrears. Also, consideration should be given to ways to facilitate the creation of creditor councils or groups among bondholders; perhaps the threat of a standstill in repayments might also help in particular cases. While it was true that the current staff paper presented some interesting ideas about various instruments, the Board would need to return to such issues in detail—in particular to help ensure a more balanced burden sharing. The current experience in Korea demonstrated that, in cases where it was difficult to secure debt rollovers, the international community would need to exercise considerable leverage at an early date to convince banks that it was in their own interest to participate in such rescue packages.

The Chairman said that the staff was preparing a series of papers on such issues, which would be circulated and discussed by the Board at an early date. However, the more one descended into the intricate details of such problems, the more difficult it might be to secure a consensus on specific solutions.

Mr. Yao said that Messrs. Esdar and O'Donnell and Ms. Lissakers had defined clearly the eligibility criteria, on the basis of which they considered that only large countries that could affect the international financial market or could have contagion effects on neighbors should be eligible. However, there were small countries that had liberalized their capital account that could at any time be under attack from the market or at least have a crisis in confidence. He expressed the hope that such countries could benefit from the new facility. In the event that such countries were not eligible, he asked the staff whether there was any way to assist those small countries that find themselves in such difficulties.

The Chairman said that the General Counsel would respond to Mr. Yao's concerns.

Mr. Kiekens noted that one of the essential conditions for Mr. Esdar to support the Supplemental Reserve Facility was that a mechanism to associate other creditors with the Fund's efforts needed to be established.

The Chairman pointed out that Mr. Esdar had not made the creation of such a mechanism a condition for his support of the decision to establish the Supplemental Reserve Facility.

Mr. Kiekens asked Mr. Esdar to repeat what his condition had been.

Mr. Esdar said that his condition was to reflect adequately in the decision the need for private creditors to participate in the resolution of such crises. He would be prepared to circulate a paper on the matter, if it would be helpful.

The Chairman encouraged Mr. Esdar to circulate a paper outlining his concerns at an early date.

Mr. Kiekens said that he shared Mr. Esdar's concerns, which was why he had proposed that the Fund should be able to refinance only a part of the short-term debt falling due. More fundamentally, it could not realistically be expected that private creditors would associate themselves with such debt workouts—as was being experienced in the case of Korea—unless there was a credible, orderly adjustment instrument available in the country so that the threat to the reference to Article VI, as Mr. Esdar had noted, was realistic and could be worked out. Moral hazard could be prevented only if an effective instrument existed to force private creditors to maintain their credit temporarily, in parallel with the Fund, if such a scheme were necessary.

On the many useful proposals of the G-10 study, Mr. Kiekens continued, one in particular was interesting: "It [the whole framework of orderly work-outs or adjustments] should strengthen the ability of governments to resist pressures, to assume responsibility for the external liabilities of their private sectors." For that reason, if the new facility were to be established, it should only be accessible to countries that did not extend state guarantees to the commitments or liabilities of the private banks.

The Chairman pointed out that Mr. Kiekens's suggestion would not allow the facility to apply to the following drawing by Korea.

Mr. Kiekens noted that he had said that, for those countries that had a state guarantee in place at the time the facility was established, the guarantee should be phased out in a time period of three years.

The Chairman pointed out that such a clause was part of the Korea program.

Mr. Kiekens said that, in addition, the condition had been for countries that introduced state guarantees without the approval of the Fund—which had been the case in Korea, Thailand, and Indonesia. Such policies had caused severe problems, so there should be instruments in place to prevent the adoption of such actions.

Ms. Lissakers said that she recognized as valid the concerns expressed by Messrs. Kiekens and Yao about defining eligibility for the SRF too narrowly—particularly Mr. Kiekens's point that a narrow definition might increase moral hazard risks associated with the impression that certain countries were too big to fail. She also agreed with Mr. Yao that it would be useful to consider the design of the SRF in the context of the ongoing Board debate on the proposed amendment of the Fund's Articles on capital account liberalization.

The Chairman said that he agreed with Mr. Esdar that the experience with the SRF would be a case of "learning-by-doing." The Fund would need to be prepared to wind down the facility or modify it within two years, subject to evolving developments—particularly regarding the process of amending the Articles to deal with capital account liberalization.

Mr. Sivaraman considered that more precision was required regarding the details of the timing and eligibility of the facility. The staff paper noted that the facility would be used only when there were short-term financing needs; however, the staff paper also stated that the facility would be used in combination with a Stand-By or Extended Arrangement. He considered that Mr. Yao's concerns stemmed from a lack of clarity about when the facility would be activated. For example, he doubted whether the facility would be used if a member's financing need amounted to only 150 percent of its quota.

Mr. Kafka made the following statement:

> I would like first to thank the staff for its papers, which I found exceptionally helpful. I would also like to echo what Mr. Sivaraman has said: that these papers are remarkably well-written.
>
> The Fund has a critical role to play in containing sharp reversals in private capital flows and bringing about an early return to normal market conditions, and Fund members can come to the Fund if encountering such circumstances. That is what this institution faced in the case of Mexico in late 1994 and in the three Asian cases during this year. The proposed Supplemental Reserve Facility (SRF) would in our view formalize what the Fund has already been doing in a somewhat modified form. We find that acceptable, but have certain concerns, among them particularly those mentioned by Mr. Kiekens. But we do not think that this should prevent us from supporting the SRF.
>
> We agree that the new facility should be operated in conjunction with a Stand-By or Extended Arrangement and with the Emergency Financing Mechanism. But it seems to us that what we really need is a supplemental facility which can also function as a lender of last resort. The supplemental facility as envisaged in the paper does not quite have that characteristic. That is because it does not, like a central bank,

have a close to unlimited scope for support. But is that even conceivable? One could, of course, think—and should think—of using the SDR mechanism and raising, by amendment, which would at least be a lengthy affair, or by negotiation, the acceptance limits for SDRs.

There is another question. The staff proposed making the resources requested by members available for up to one year. A flexible approach, neither minimum nor maximum, determined on a case-by-case basis might be preferable.

Another question concerns collateral. This could be obtained as the accumulation of the difference between the normal rate of charge and a special and higher rate for the new facility, but it could also be collateral in the more customary sense of a deposit of a sum or a promise.

What about the interest rate of the facility? This is a question that to our mind could not be separated in practice from the question of collateral. One approach would be to make the surcharge refundable if all the conditions demanded by the Fund for making its resources available under the new facility are fulfilled. Another approach favored by the staff may be a nonrefundable surcharge to encourage the use of other sources of financing before turning to the Fund. Our preference is for a refundable surcharge which would reduce the borrowers' burden. I realize the problems which may be created for the facility with respect to Article VI, section 1. The requirement to impose, if demanded by the Fund, capital controls in the case of use of the facility would certainly, to our mind, seem to be justified.

There are other points which have to be decided, such as the size of any surcharge. We hope that they can be decided so that they do not delay the timetable of our progress toward a general solution to the Korean problem. Another problem is use of the additional income to be generated by the new facility. We will listen carefully to our colleagues on these and other additional points.

Mr. Zoccali made the following statement:

We welcome the attempt made by the staff and management to improve the instrumentality for dealing with disruptive turnarounds in investors confidence and sharp reversals in private capital flows. The Fund must be able to play a pivotal role in the process of restoration of market confidence that would avoid excessive disruption to national or international prosperity. We view the proposed Supplemental Reserve Facility in that light.

Regarding the general features of the recommended new special facility, some brief comments are in order.

First, on conditionality, we agree with staff's assertion in Paragraph 11 that there might be cases of countries facing a short-term financing need without an underlying balance of payments need but that since both components generally emanate from the same underlying macroeconomic and/or structural imbalances a common adjustment program under an Stand-By Arrangement or EFF is called for. However, the more critical justification, in our view, would be the one contained in footnote 7 of page 8 whereby even if the short-term need was not caused by an underlying imbalance it is likely to create such an imbalance.

Second, the envisaged facility addresses the situations where a crisis of confidence has already developed i.e. where pressures in the exchange rate and other financial markets are not only manifest but where more significant capital outflows are likely to develop. In these circumstances, we agree that access to sufficiently large Fund resources in a heavily front-loaded manner is of the essence to help contain both domestic and regional spill-over. A new facility rather than a"window" within an arrangement would most closely reflect the different nature of the required assistance. Given the need for sufficiently large resources in the context of appropriate conditionality to restore market confidence, the risk of depletion of the Fund's liquidity should be minimized. Keeping in mind the scope for contagion, supplementation of GRA resources with those of the GAB or NAB should be possible. In any event, the case for ensuring a strong Fund is very clear and justifies, in our view, the Managing Director's call for a topping-up of the quota increase agreed in Hong Kong.

Third, with respect to "moral hazard," we consider that even the certainty of Fund assistance in times of crises, which is not being proposed, does not encourage countries to act irresponsibly in view of the dire consequences of a financial crisis when it occurs. Nevertheless, it could be argued that a more explicit Fund role in liquidity supplementation could breed complacency or careless conduct on the part of lenders. The latter serves to highlight the need for mechanisms to facilitate orderly debt workout in the context of adequate bankruptcy procedures for private debt restructuring. We attach importance to the forthcoming discussion on the issue of lending into arrears to private creditors. In the interim, the constructive alternative would be to develop a strategy which serves to persuade lenders to roll-over their credits. The possibility of resorting to capital controls, referred to in paragraphs 17 and 26 of the paper as a response to the injunction in Article VI, Section 1, however, is viewed as being neither in the recipient country's best interest nor consistent with the Fund's envisaged new role or with the globalization of international financial markets. The emphasis should remain instead on the preventive strengthening of domestic banking systems, including in particular its prudential architecture.

More specifically on the operational characteristics of the proposed SRF, we agree that access should be front-loaded as needed and not be subject to the normal limits. Subsequent reviews of normal access limits should ensure that these remain adequate to facilitate macroeconomic adjustment and consistent with the emphasis in Fund-supported programs to structural reform.

The period of availability and of repayment of drawings should be scheduled flexibly, in particular, to avoid creating new uncertainties regarding the roll-over of official financing for the member. We agree, therefore, with staff's proposal of providing for an expectation of repurchases beginning after two years to be followed by a repurchase obligation after one additional year, based on the inherent uncertainty surrounding the timing of the return of confidence, particularly in cases where structural imbalances are also being addressed.

The proposed Supplemental Reserve Facility reintroduces the notion of special charges for high access situations. The size of Fund involvement in recent cases and the higher concentration of its risk of exposure could justify some differentiation in the rate of charge on the use of SRF resources. Nevertheless, the cooperative principle on which this institution was founded remains valid: Fund financing cannot be equated with that of private financial markets as it is guided both by conditionality and by systemic considerations. In addition, a higher rate of charge is not a sufficient condition for inducing the member to treat SRF resources as precautionary or for accelerating the member's return to voluntary private market financing. What is certain is that a surcharge to reflect the loss of market confidence will exacerbate the adjustment costs in the affected countries. Consequently, we could reluctantly go along with the concept but would have difficulty in supporting a surcharge exceeding the lower limit of the proposed range, over the adjusted basic rate of charge applicable to GRA resources. Mr. O'Donnell's proposed staggered surcharge could be more constructive if the concept was conceived in a reverse fashion, namely earlier than expected repurchases rewarded by an incremental step-down in the surcharge. To deal with the risk associated with SRF drawings, we would be prepared to look favorably on the establishment of an additional contingent account (SCA-3) with the possibility of reimbursing the balances accumulated from the proceeds of the surcharge.

More specifically on the paper on Charges on the Supplemental Reserve Facility, we were somewhat surprised that the commitment fee was not considered keeping in mind that the SRF is aimed at restoring confidence rapidly and thus the expectation that not all purchases under the facility would be made. This raises the issue of charges for purchases that are not expected if the facility works as intended. Some clarification from staff regarding the potential contribution to net income stemming from commitment fees on purchases not made after the arrangements expire would be useful. With regard to the service charge, we should keep in mind that the level of ½ of 1 percent was established in the Second amendment under the assumption of "normal" access under then existing facilities. As purchases under this new facility would be expected to be very large, the income to be derived would not be commensurate with its original purpose and ties in to the effective cost of the new facility for the member.

Having said this, we endorse staff's view that use of resources under the SRF would entail additional administrative expenses that should be covered by charges under the facility. Precautionary balances, on the other hand, need to be judged on their own merits, keeping also in mind the Fund's sizable hidden reserves and the significant and increasing opportunity costs of its policy of immobilization. Burden-sharing is a concept that has served the Fund well and that should be preserved.

In closing we support the initiative to give the Fund a clear role in the containment of the consequences of a sharp reversal in private capital flows including for the countries affected through contagion. We fully share Mr. Kafka's comments regarding the Fund's role as lender of last resort and the usefulness of the SDR in that context. We also find it necessary to give further consideration to effective prevention highlighting the importance of strengthening prudential regulations and the scope for Fund regional surveillance. The paper rightly points out that, for members facing risks of a financial crisis, policies designed in the context of Stand-by or Extended Arrangements could be very beneficial as a preventive response. Prequalification was referred to by Mr. O'Donnell as well as Mr. Kiekens and others. This was a feature of the short-term financing facility, analyzed in EBS/94/193, predicated on the notion that pre-announced availability and conditions of use could be more important than actual use of supplemental resources after the fact. In this regard, the linkage to a credible pre-existing Fund program deserves further consideration in order for the new facility to deter contagion for countries that are committed to maintaining open current as well as capital accounts. Lastly, irrespective of the instrumentalities in place, more effective international policy coordination among the major economies is essential keeping in mind the systemic consequences of their domestic policies actions.

The Chairman said that he was interested in Mr. Zoccali's analysis of Mr. O'Donnell's proposal for a graduated scale of charges—particularly his view that the proposal was more punishing than rewarding. He asked Mr. Zoccali and Mr. O'Donnell how the proposal could be modified to make it more rewarding than punishing.

Mr. Zoccali responded that he would start the graduating scale at the lower limit of the range proposed by the staff, and then move the charge down to the uniform rate of charge and access.

Mr. O'Donnell pointed out that there were bonuses throughout his proposal for early repayment.

Mr. Bernes made the following statement:

We welcome the proposal and support it, in principle, for the reasons which have been articulated in the paper itself and which you have spoken and which Ms. Lissakers identified. I think it is an important part of adapting our institution for the evolving realities we face. We also support the broad structure of the facility as is outlined in the paper. Therefore, I will try to make my remarks pointed to the discussion we have had today.

The first point is the question of who should be eligible for this facility. I must say, I agree with Ms. Lissakers and Mr. O'Donnell when they suggest that we must have some reference to the four countries facing a crisis of confidence where there is a threat to the international monetary system or the risk of contagion. Unlike Mr. Kiekens, I do not think this is discriminatory. I think this language, in fact, or something similar, was associated with the decision on the EFM and, in fact, reflects the reality that we are confronting, and being prepared to confront, truly exceptional circumstances, which calls for a response which is differentiated from our normal policies. To that extent, I think it is important, and it is a recognition as well that the Fund does have constraints on the resources available to it.

Secondly, with respect to both the purchase period and the repurchase period, I must say that we would have preferred a shorter period than the year that it is proposed that the window be open. I say "shorter" because I think in most cases where one is dealing with a crisis of confidence one would hope that it is really within that first four to six months that, in fact, that confidence is going to at least begin to be re-established and that the major requirements for purchases would be there. Nonetheless, to give us some flexibility, we are prepared to go along with the one-year period. With respect to the period for repurchases, I must say our preference would be that there be no grace period and that repurchases begin immediately. However, I would be prepared, as some have suggested, to have at least a grace period of six months and then have the repurchases within the following year.

On the question of charges, I think we think that there are a number of reasons why the charges should be higher than is the normal policy. This is not to penalize the country in question. Indeed, one is supporting the country in question in an exceptional way, but I think, because of the concentration of risk, in terms of both the amount of money and the geography, there is a need for a higher charge in order to protect the resources of the Fund. I think, secondly, there is a reason in terms of encouraging countries not to make purchases beyond what is absolutely required. Thirdly, there is a requirement, I think, to encourage countries to make repurchases as quickly as possible. So I think there are a number of reasons to support a higher rate of charge.

I am attracted to both Mr. O'Donnell's and Ms. Lissakers's proposals. We had our own variation, which would have, I think, had the rate of charge increase right from the date of the first purchase, but have that higher rate apply to subsequent purchases as well. I think that, if one combines the O'Donnell-Lissakers proposals, one which is both that the rate increases over time, but also as increasing amounts of the program are drawn down, I think, achieves the same purpose. I would start, I must say, at the upper end of the 200 to 400 range; that is, I would start at 400 and increase perhaps as proposed by Mr. O'Donnell and Ms. Lissakers.

On the uses of the new income, I guess I would agree with those speakers who say that in the first instance they should go into building up our reserves to reflect the much higher risk associated with it, and then any decision on the ultimate disposition of this income should await another date, but I must admit I am very attracted to what Mr. O'Donnell and Mr. Sivaraman were suggesting: that a large part of it perhaps should go to support ESAF-HIPC.

On the question of addressing the problems of moral hazard, which I think we are all very conscious of and support, it is clear that we need to have messages going out to the private sector that they have to play an appropriate role. I am skeptical about building-in conditions, though, at this time, in terms of the new facility. For instance, on not funding all of the capital outflows of private sector rollovers, I think we should recognize by looking at the case of Korea that in the program there was an expectation of a very high rollover on the part of the private sector and that they would play a part. Those expectations have not been totally met, but they are being met in part. I think we all recognize that, in fact, there was no way the Fund could finance the whole private sector role. So the private sector is going to have to play some part. So I think we should not try to build conditions into the facility, but I think we need to follow up on the discussions that Mr. Esdar was suggesting, which indeed the staff has scheduled for early next year. I think that is critical.

Finally, on the question of whether we should put a time limit on this facility, as was suggested by Mr. Esdar. Firstly, I agree with the Chairman that we should not let the best be the enemy of the good. We are moving quickly in special circumstances here, and I think we need to come to some conclusions. To our mind, that means that we do need to review the result of our work. I would suggest that what we do is we schedule a review at an appropriate time, which may be two or three years out, rather than putting a sunset clause into the facility. I think, following the review, one can then decide whether changes are necessary or appropriate.

The Chairman said that he hoped to find common ground among Board members on the matter of a review of the facility. The issues of moral hazard and the private sector's role and contribution to crisis resolution were very difficult to resolve. The Fund must certainly press for private sector involvement, and it must contribute to discussions to secure such a goal. However, beyond that, it was important to recognize that governments must be better informed about such issues and become more proactive in contributing to solutions. It would be unfortunate if, despite the efforts of the Fund to create the SRF, the situation were paralyzed by a lack of preparation on the part of the Fund's shareholders. As a result, the Board would need to be careful to find the appropriate language, knowing that the private creditor-debtor relationship was extremely complicated. No international procedures similar to national bankruptcy procedures existed, and it would take some time to formulate and implement appropriate mechanisms.

Mr. Yao made the following statement:

Mr. Bernes seems to agree with Ms. Lissakers and Mr. O'Donnell regarding the eligibility criteria on the basis that they are consistent with past discussions and that they reflect the exceptional circumstances. On this, I would agree, but we should not confuse this discussion with exceptional circumstances and exceptional countries, because the exceptional circumstances we are talking about here are countries' experiences and balance of payments difficulties due to a large short-term financing need resulting from a loss of market confidence. This is what I referred to as exceptional circumstances. Whether or not the countries are capable of having risk contagion or posing a potential threat to the market, the monetary system, I do agree that is very important, but I would need to look at the broader circumstances.

I welcome today's discussion on the establishment of the Supplemental Reserve Facility, and commend the staff for the excellent papers. In light of the crisis in the Southeast Asian region, the creation of this facility is opportune. Furthermore, the establishment of this facility will provide assurance to member countries liberalizing their capital account that the Fund will provide them adequate assistance when faced with exceptional capital account imbalances. In that regard, I cannot support Mr. Esdar's proposal, in which he states that this facility should be used for countries whose risk of contagion will be of such a scope that a member's balance of payments problem may pose a potential threat to the monetary system.

I share the view that the purpose of this facility should not be to finance capital outflow, but rather to stem such outflow through strong financial and structural programs that should address the core problems, thereby rebuilding the market confidence. I also concur with the view that this facility should not be used in anticipation of a crisis of confidence. In such circumstances, countries should decisively address the underlying problem by implementing appropriate corrective measures in the context of a traditional Stand-By or Extended Arrangement. On the main feature of this facility, I see merit in limiting the time of access to the resources to one year and repurchases beginning after two years.

Regarding the rate of charge, it could be an incentive to early repurchase if it is higher than the rate at which countries can borrow on the international financial market. In that regard, Mr. O'Donnell's proposal is appealing to this chair, except that I would hope that the first repurchase starts, instead of six months, 12 months later.

Regarding the additional income that would derive from the charges from the new facilities, I think it should be used to increase substantially the rate of accumulation of precautionary balance. I share Mr. Sivaraman's view or position on the use of these resources, with a particular emphasis to augmenting the financing of the ESAF-HIPC Trust, which presently needs additional resources.

Mr. Kiekens noted that Mr. Bernes had said that the SRF should be reserved for cases that threaten the international monetary system with a high risk of contagion; he had also referred to the fact that the Emergency Financing Mechanism was also limited to those cases. However, the Acting Chairman's summing up of that discussion read: "A number of Directors would prefer to limit the use of the emergency procedures to situations involving significant spillovers or contagion effects, but most noted that such an approach would unduly restrict the availability of emergency procedures." Moreover, the text of the decision read: "The emergency procedures would be expected to be used only in rare cases that represented or threatened to give rise to a crisis in a member's external accounts requiring immediate response from the Fund." There was no reference to the need that a case threatened the international monetary system or that there was a high risk of contagion in order to apply the Emergency Financing Mechanism.

The Chairman pointed out that, later in the summing up, there was a reference to the fact that the member would need to be faced with a truly exceptional situation threatening its financial stability, and that the rapid response of the Fund was needed to forestall or to contain significant damage to the country itself or to the international monetary system.

Mr. Kiekens stressed that the threat would need to be to its own financial stability. It was not necessary that, under the Fund's emergency procedures, there was a threat to the international monetary system. While the emergency procedures could be used in the event of a threat to the international monetary system, it was not the only condition.

The Chairman considered that, nevertheless, there was merit in the language in the summing up of the discussion on the Emergency Financing Mechanism.

Mr. Esdar said that he looked forward to hearing the views of the Legal Department staff on the appropriate use of the new facility, as the Fund was entering into new territory. The SRF was designed to deal with particular financing needs, against the backdrop of possible exceptional circumstances that might threaten the international monetary system. Such reasoning was behind the substantial financial support assembled to support Thailand, Indonesia, and Korea. Therefore, for reasons of prudence, it was important to limit potential access to the SRF to those countries facing such particular financing needs. Moreover, similar eligibility requirements could be found in the texts of the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB); as there was insufficient support for augmenting the proposed quota increase, it was important to consider the connection between the SRF and the GAB-NAB.

Mr. Kiekens noted that the reference in the GAB to the availability of amounts the Fund can borrow from certain members was limited to a risk or threat to the international monetary system. If a large country required exceptional financing, then the Fund would need additional resources. The policies of the Fund would be unaffected in the event that GAB resources were tapped.

The Chairman said that he agreed with Mr. Kiekens's last point.

Mr. Shaalan stated that he would favor opening up eligibility to the SRF to all Fund members. On the idea of whether factors in considering eligibility were contagion or a threat to the international monetary system, it was important to recall that at the beginning of the crisis in Thailand, it was not clear how quickly the crisis would spread. As a result, if a judgment had been made at that early date, it might have been possible to conclude that there would not be a risk of contagion.

Mr. Esdar considered that Thailand was a good example, because it had been concluded that there was a threat of contagion, first, by using the agreed emergency procedures, and second, by providing a significant amount of access to Fund resources above the normal limits. At the time of the Board discussion on the Stand-By Arrangement for Thailand, he had justified the exceptional financing by noting the potential threat to the international monetary system and the threat of contagion. It was important to recall that there was much flexibility embedded in the formulation of what constituted such threats.

Mr. Kiekens said that he agreed with Mr. Esdar that it would be preferable to have flexibility rather than rigid rules to determine what constituted threats to the international monetary system. However, he remained opposed to limiting eligibility to the SRF to major countries, while excluding small countries.

The Chairman recalled that it had not been proposed to exclude small countries. However, the phenomenon of contagion had not been thoroughly researched, so it was difficult to make definitive statements on the matter. For example, it was possible that two small countries in different parts of the world suffering from a similar financial crisis might present a systemic threat, while a large country facing a similar crisis might not. He concluded that it was important to retain sufficient flexibility in the formulation of the SRF.

Mr. Giustiniani made the following statement:

> Let me start by saying that we strongly support the establishment of this new facility, even though we share some of the concerns expressed by Mr. Esdar and Mr. Kiekens. We have always advocated higher charges for access to Fund resources well above the usual limits, and the establishment of this new facility is a step in that direction.
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> The main advantage of establishing a new facility is to allow us to better tailor the main characteristics of this facility to the particular circumstances in which such a new arrangement is expected to be activated. In particular, it allows us to better price the risk that this institution is taking in cases of exceptional access. However, the envisaged rate financing of the SRF does not eliminate the problem of moral hazard; at best, it may help to mitigate it. As in the case of domestic financial industry, there is obviously a need for striking an adequate balance between ensuring stability and containing moral hazard. It is of paramount importance that neither the debtor countries nor their creditors should be expected to be isolated from the adverse economic consequences of a crisis by the provision of large-scale official financing. In this regard, I share Mr. Esdar's concern.
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> I believe that strong conditionality should be attached to the access to this new facility since the exceptional access to Fund resources is expected to signal to the market the confidence of this institution in the country's policies and long-term

prospects. Drawing under these new facilities must be allowed only in the presence of a strong and comprehensive program, envisaging those measures necessary to tackle the problems that undermine market confidence. It should be acknowledged that the up-front in disbursement should be matched by an up-front in policy action and, consequently, significant prior actions should be envisaged, but appropriate attention should also be given to other ways how to limit moral hazard. Probably some of the concerns and proposals expressed by Mr. Kiekens may warrant deeper thought by the Board.

Turning now to the specific elements of this new facility, as far as the eligibility criteria are concerned, I certainly share the concern expressed by previous speakers in trying to better qualify the terms and the conditions that are expected to trigger this new facility. Probably some wording around that has been used in the GAB could be considered. Probably also the text that Mr. Esdar just circulated may be a better basis for discussion. We can refine that.

As far as the blend of resources is concerned, we certainly agree with the fact that access to the SRF should be associated with either a Stand-By or Extended Arrangement. The limits that are proposed in the decision should be considered as indicative. As Ms. Lissakers said, there should be some expectation that access to the SRF could kick in before the achievement of the usual annual access limits and, in this regard, I would like to ask the staff a clarification on one point. If I understood correctly the decision, the cumulative limit of 300 percent is going to be considered only in the case of a country with outstanding credit and 100 percent should be applied to a country with no credit from the Fund, so I would like to better understand this point.

As far as the rate of charge is concerned, I consider the hypothesis of a spread of 400 points as a floor rather than a ceiling. Such a spread is usually paid by many emerging markets in normal circumstances, and also in the case of Italy under the crisis beginning of 1995 the spread between the Italian T-bills and the bund reached 650 percent so, therefore, the 400 percent spread is really a low limit.

As far as retro charges are concerned, certainly we agree with the proposal put forward by Ms. Lissakers and also Mr. O'Donnell, and probably a combination of the two may be the final result.

On the time structure of the facility, here we have our problem. In principle, I believe that the period during which resources would be made available, i.e. up to one year, is too long. Drawings under this facility are indeed expected to restore confidence and be made in circumstances of liquidity impairment, so we have in mind a very peculiar event that is short term in nature. Consequently, in my opinion it would be more reasonable to reduce the availability period to six months.

However, if I understood correctly, the Fund does not have the possibility, as in typical loans among central banks, to renew outstanding credits when they fall due. If this is correct, I can along with the hypothesis of an access period of up to one year. But, certainly we do not agree on the envisaged repurchase schedule, and we consider this too long. Two reasons induced me to support a shortening of this period. First, Fund resources are limited and, therefore, a rapid reflow of funds has to be envisaged in order to safeguard the revolving character of Fund resources and its liquidity. Second, the imposition of a spread, whatever it may turn out to be decided, on the adjusted rate of charge may turn out not to be such a strong incentive for an early repurchase of the outstanding credit if market rates remain above the one charged by the Fund.

Regarding the repurchase period, I have said that we should consider the possibility shortening this period. Our proposal is in fact to have an early repurchase expectation after six months, while after one year the expectation should be converted into an obligation. But we would also be interested in hearing more about Mr. Bernes' proposal of a grace period of six months, but after that I think the old payment will need to be made. Perhaps something along these lines may be considered, but at this point, this is our position.

As far as the income or the extra income coming from charges of this new facility, we are inclined to consider the option of building up reserves, and here just a couple of numbers. I made some back-of-the-envelope calculations and, according to the staff, the ratio between the precautionary balances and total outstanding credit outstanding is projected to fall from 9.5 to 7.6 percent, and in the period between 1993 and 1997 it averaged 10.3 percent. So, if we want to bring back precautionary balances to 7.6 percent, they have to be increased by roughly SDR 1 billion. If we want to bring them back to the average of 10.3 percent—and obviously this was in normal circumstances, without taking into account the risks that we are considering now, which could also favor an increase in reserves in proportion to the total credit outstanding—would require SDR 1.4 billion.

But, in this case, whether it should be normal reserves or a special contingency account, maybe the first option is preferable. Anyhow, if we are going to consider a special contingency account and what we are going to do with those resources when the need may be over, I think that the benefits should be shared by the whole membership, as Mr. O'Donnell said, and this implies also creditor countries. Consequently, I would be more inclined to reconsider also the policy of burdensharing instead of already committing resources for HIPC or for reducing charges.

The Chairman asked Mr. Giustiniani whether an early repurchase expectation after six months would be realistic.

Mr. Giustiniani responded that, as other Directors had noted, the current crisis was essentially a crisis of confidence, which should be restored rather quickly. Also, very strong conditionality and prior actions should be attached to the use of the SRF, which would enhance the restoration of confidence.

Mr. Morais made the following statement:

The facility that is being proposed reflects the new reality facing the Fund, one in which increased global financial integration has created this situation where emerging market economies are more vulnerable to changes in the behavior of international investors. If the Mexican case were considered an isolated incident, the recent crisis in economies with enviable records of growth and development leaves no doubt that the global financial system has entered a fundamentally new era. The response of the Fund has entailed a strategy based on two pillars: encouraging strong adjustment, and the timely commitment of a large volume of financial support aimed at restoring confidence. The new facility must remain wedded to this approach in order to be effective.

In establishing this facility, it must be clear that the first line of defense against such problems is improved surveillance and the willingness of a member country to implement the required reform. The cooperation of major market participants seems to me an important element in an effort to prevent macroeconomic and structural imbalances from erupting into a full blown crisis. It is less difficult for a country to implement far-reaching reform in a relatively stable environment than when the authorities have to deal with crises of confidence at the same time. Besides, given the morphous nature of market confidence, it is difficult to predict when it will be regained once a crisis has emerged. It is also difficult to predict the recessionary impact of adjustment policies, and much less so what it would mean for future developments in the real sector of the economy.

The staff proposal appears to be a reasonable attempt to prepare the Fund for the challenges of integrated capital markets and free capital movements, and we are prepared to go along with the consensus to establish the new facility. We can also go along with a higher rate of charge. We do not think, however, that a one-year period for repurchase is long enough.

On the use of proceeds accruing from the use of the facility, we are prepared to consider some addition to the Fund's precautionary balances. As other Directors, we also agree that a greater part of the proceeds be used to meet shortfalls in the ESAF-HIPC Trust.

Mr. Fernandez made the following statement:

First, it will be no surprise that I support the proposal and the general features of this new facility. The case for an adaptation of Fund instruments has been made before by several speakers, so I will not come back on this.

As a consequence, although I share the very legitimate concerns of Mr. Kiekens regarding the risk of setting up what could be read as a bailout facility, I do not think the alternative proposal would change anything of the problem. I would therefore rather call for early discussions on topics suggested by Mr. Kiekens and Mr. Esdar, and look for safeguards. I support, in principle, Mr. Esdar's proposal to associate private sector creditors to negotiations in their very early stages in a way to be clarified soon. In fact, in doing so, we would basically resort to the procedures which were called for by the summing up of a Board meeting, putting in place the Emergency Financing Mechanism in September 1995, which stated that, "consultations with key creditors would be initiated at the onset of the emergency."

Regarding eligibility, I also share the view that we should clarify the circumstances in which the facility is activated, and I find the proposed formulations of Ms. Lissakers and Mr. O'Donnell well crafted; this is the proposal related to the threat to the monetary system and the serious risks of contagion. Obviously, the institution of such a facility raises numerous questions. We could debate at length some points made in the paper. For example, the thought that the SRF is put in place only when there is a good chance of a rapid turnaround in confidence, or the thought that the SRF not be used as a means of bailing out private creditors, or many others. More thorough and relaxed discussions will be necessary, and reviewing the facility will be a necessary and crucial exercise. But I agree with Mr. Bernes that this review will be a better means of achieving our goals than to establish such a facility only for two years, as suggested by Mr. Esdar.

Turning now to the specific characteristics of the SRF, I find Mr. O'Donnell's suggestions convincing and I can support them. First, I agree with the staff that this facility should be linked to a Stand-By or Extended Agreement, which should be the anchor of conditionality, and conditionality will have to be all the more strong in such cases. But I am not sure at all it should be granted that the SRF features would only kick in above the access limit. I would favor, like other speakers, flexibility on this matter.

Second, I support the idea of a progressive surcharge. Although I find Ms. Lissakers's second idea interesting—this was the idea of connecting the charge to the size of tranches being drawn; I guess I still have to think a bit about this. The point, I am sure, is that I can support Mr. O'Donnell's proposal, which is illustrated in the chart. This clearly would provide a strong incentive for members to treat access as precautionary and to make early repurchases.

Third, I could go along with a starting point at 400 basis points, which is in fact quite low, and only as far as it is a starting point. I can also support an increase, for instance, of 50 basis points every six months.

Fourth, I can support the availability for one year, a repayment obligation after 18 months, and installments due in the next six months, although this seems to be on the longer end.

Fifth, turning to the issue of the use of the income deriving from the SRF, I agree with the staff that it is desirable to strengthen the prudential stance of the Fund. For this highest priority, the establishment of an additional contingent account could be warranted. Nevertheless, I could also agree that some of the overall increase in revenue deriving from these programs could be used to reduce the basic rate of charge. These two points are perfectly in line with the facility. But I have also some sympathy for the proposal related to the ESAF-HIPC Trust.

Lastly, I would like to state that in our minds an early implementation of this new facility is an integral part of the Korean program.

Mr. Zhang made the following statement:

First, I would like to thank the staff for preparing a paper on the Supplemental Reserve Facility so quickly after the Manila meeting in November. My authorities, in principle, support the Fund in establishing the proposed Facility to provide short-term and large funding to members with the intention of restoring market confidence and stopping further capital outflows. This should also strengthen the Fund's capacity to play a central role in responding to financial crises.

I agree with the staff analysis and assessment on the rationale and necessity for establishing the Facility. The crisis in Mexico in late 1994 and in Asia since August this year have clearly demonstrated both how vulnerabilities can increase so rapidly in the financial sector, and how large, sudden, and disruptive the turnarounds in investor confidence can be. They have indeed created a new kind of problem for the Fund; that is how to help members contain sharp reversals in private capital flows and bring about an early return to normal market conditions.

The Facility is but one of the three pillars mentioned in the Manila Framework to address the currency turmoil problem and restore macroeconomic stability. The first pillar is surveillance. Indeed the Manila meeting explicitly pointed out that surveillance needs to be addressed effectively as soon as possible. Surveillance is a very crucial preventive measure which should help lay a solid foundation for monitoring capital flows and put all of us on the alert with necessary transparency.

The second pillar involves the enhancement of the regulatory capacity and the strengthening of the financial infrastructure. There are already initiatives in the region, and collaborative efforts with the Fund, the World Bank, and other multilateral institutions would certainly be useful and more productive.

The third pillar is the financing arrangement. This pillar is of a remedial nature and, for it to be successful, we must have a good grip on the vexing question of moral hazard.

This is a difficult issue and we cannot avoid the question of how the funds provided would not be used to fund capital outflows or repayments to private sector lenders. If official funds continue to be poured in that allow private sector creditors to exist, there will never be enough official funds. How do we ensure that there is a private sector "standstill" is the key question. For the Fund, and for economies providing supplemental financing, this is a question that would constrain their ability to take part and effectively support the programs. The answer lies in the need for the Fund and other relevant institutions to help coordinate the standstill or rescheduling of debts with private sector creditors of the borrowing member. I agree with Mr. Esdar that the private sector should be included in the package.

Coming back to the staff paper, I concur with the staff that the purpose of the Facility is not to finance such outflows but rather to stop them. The Facility is not intended to intervene with the normal process of bankruptcy and investor losses if banks and enterprises were insolvent. It is indeed important that creditors would have to bear the credit risks rather than relying on bail-out by the official sector. We emphasize that the design of conditionalities should stress improving the soundness of the banking sector, particularly the intermediate role of the banks and strengthening of the legal system, especially the legalities relating to bankruptcies and prudential supervision, to minimize the risks of moral hazard. The importance is not only to help members overcome their current difficulties, but also to build up their capacity to resist attacks in the future.

We can go along with the staff recommendation that conditionality under this Facility would be linked to the conditionality of the associated stand-by or Extended Arrangement. The suggestion in the staff paper of a tight program and additional reviews is a sound one if we want to ensure the success of the program. However, I would caution that we have all learned from the recent Asian experience and the program should take full account of the local situation and the ramifications for other economies. It should avoid an over-kill which would fail to achieve the objective of the program. We would like to urge the staff to work out an optimal level of adjustment and indeed this question has already been discussed in recent revisions of emergency cases.

As the supplemental reserve facility could call for more resources from the Fund and in fact the liquidity ratio has lowered rapidly, we urge an early completion of the eleventh review of Fund quotas. We are pleased that bilateral support has played an important role in dealing with the crisis situation in Asia. However, with the establishment of the Facility it is desirable to have permanent and accountable additional funding. In this context, it is ideal to consider making use of the GAB. In addition, we also urge the faster establishment of the New Arrangements to Borrow.

The paper has argued well on the need for a high rate of charge to provide the right incentive. To facilitate the implementation of the Facility, it might be useful to have unified, standardized, and concrete guidelines on how the actual spread within the range of 200 to 400 basis points above the basic rate of charge would be determined. We believe this could improve the transparency of running this Facility and increase objectivity in determining the charge. It seems appropriate to me that different rates of surcharge should be decided according to the different levels of access in terms of their quota. The staff's elaboration is appreciated.

With regard to the timing of repurchasing as described in No. 6 of the draft decision, we believe that it is advisable to provide a longer duration for program members from what was proposed by the staff which would give a better leeway for the members concerned to effectively adjust their economies. And we believe that the members would certainly lose no time in making advance repurchase when conditions permit, since restoration of market confidence is of the greatest importance to themselves.

On the issue of the impact of additional large income from the Facility on the Fund income position, we would like to underscore the risks involved in this new Facility due to its underlying feature of large amounts of credit and front loading. Therefore, it is imperative to maintain a precautionary stance on the possible large income derived from implementation of the Facility. However, we have also noticed that negotiation of the programs and extension of credits under the Supplemental Reserve Facility-like circumstances added to administrative expenses. It seems to me appropriate and reasonable to conceive that a part of the additional income would accrue to the Fund and would enter into the calculation of the basic rate of charge to achieve the Fund's net income target. The rest would be kept in a contingency manner. We can go along with establishment of SCA-3 if consensus can be reached to that effect. As the staff paper on this issue was made available to us only last Friday, we should give our authorities sufficient time on this important issue and we should avoid making hasty decisions. However, I believe that this would certainly not negatively affect the establishment of the Facility.

Mr. Rouai made the following statement:

The proposal to create a Supplemental Reserve Facility is built, among other things, on two ideas that are previously discussed by the Board, namely the short-term financing facility and the application of higher charges on large-scale use of Fund resources. Our chair supported the former and expressed misgivings about the latter. I view today's discussions from two angles. On the one hand and under the fast track angle, I support the establishment of the SRF to deal with the present case. On the other hand, major issues, including the moral hazard aspect associated with this facility and the role of creditors in similar support operations, remain unresolved and need to be addressed urgently.

Two characteristics differentiate between regular Fund facilities and the SRF, namely, the repurchase period and the applicable rate of charge on which I shall concentrate my comments.

On the repurchase period, while I can support the shortening proposed by the staff, I recommend an element of flexibility in the application of the expectation/obligation nature of repurchases. While one would expect a financial crisis to end after two years, I would like to point out that most, if not all, the recent programs approved by the Board were designed with the expectation that a large part of the initial stock of short-term external debt will be rolled over. A bunching of external debt obligations could therefore occur if Fund repurchases and repayments of short term-debt overlap. This could be amplified if the repurchase period is further reduced as some Directors are proposing, which could add another element of unpredictability and nervousness not helpful to restoring market confidence. For these considerations, I expect that program reviews pay particular attention to the issue of short- term debt with regard to its level, the conditions associated with its rollover, and the need to reduce altogether the reliance on short-term financing.

With regard to the rate of charge to be applied to the SRF, this chair had the opportunity to express misgivings about higher charges for large use of Fund resources. In addition, with the inclusion into the SRF of shorter repayments maturities, the main incentive behind the idea of higher charges, namely early repurchases, has been eliminated. Nevertheless, I agree that large and front-loaded resources create additional Fund exposure to risk. It is with this consideration in mind that I propose the following :

The surcharge, which should be equivalent to 200 basic points, should be calculated over the adjusted rate of charge and not on the basic rate of charge. Borrowings under the SRF will therefore be subject to contributions to SCA_1 and to adjustments for deferred charges. This will allow a substantial increase in the net income target of the Fund and a constitution of added precautionary balances, and will take care of the issue of additional risk to the Fund.

The added resources generated by the surcharge should be deposited in a new Special Contingency Account. Since the reasoning behind the surcharge is to encourage countries to make early repurchases, these contributions should be refunded at the time of the repurchase when the covered risk is no longer there. I cannot support any other use of income derived from the surcharge because the SRF and its income are of a temporary nature and should not be considered as a permanent source of financing for the Fund. This is particularly true with regard to the use of the added income for the ESAF-HIPC financing.

Such decision will certainly further discourage bilateral contributions. In addition, the experience of SCA_1 and SCA_2 shows that it is rather difficult to reach a conclusion that the resources in these accounts are no longer needed in order to be used for other purposes. Mrs. Lissakers's and Mr. O'Donnell's proposals regarding the rate of charge and the structure of the SRF are risky. Let me take the case of a country with an SRF, combined with an Stand-By Arrangement or an EFF, and suppose that six months later market confidence and access are restored. Under normal circumstances, like in the Mexico case, the country will refrain from further purchases. However, if we apply a gradual structure of changes to the SRF, we may encourage the country to continue its purchases under the Stand-By Arrangement/EFF in order to repay the more expensive purchases under the SRF. On the issue of a separate facility versus a window within an arrangement, I would like the staff to confirm my reading of footnote 17, which covers Mr. Kiekens's proposal of not to have a separate facility, but a window within a Fund arrangement. If I am correct, higher charges, except in a refundable form, would not be available.

On other technical aspects of the SRF, this facility is built on the assumption that financial crisis include two elements: an underlying BOP need, which should be financed by regular Stand-By Arrangement or EFF; and a short-term financing need resulting from the loss of market confidence to be financed by the SRF. However, the staff report is not clear on the phasing of the financing between the two elements. There is a concern that there will be a tendency to reduce the regular Fund financing and to augment financing under the SRF since the latter is more advantageous to the Fund with regard to higher charges and short repurchase period. In order to introduce an element of objectivity, the underlying BOP need should be fixed at the level of the annual access under the access limits policy. This level is now 100 percent of quota. All other resources provided by the Fund beyond 100 percent of quota will be financed under the SRF.

Although it appears that the SRF is not designed to include ESAF-eligible countries, there are clearly some ESAF-eligible countries who share the characteristics of SRF-eligible countries.

Turning now to the remaining unresolved issues, the application of higher charges and shorter repurchase periods constitute only an added cost for the eligible countries, but it is not clear that they constitute a strong enough insurance against moral hazards risk. It is important to reduce the risks for countries confronted with problems associated with shifts in market confidence. In this context, there are two steps the Fund could take. One, since short-term external debt seems to be the one common element at the origin of the crisis and for the determination of the access under the SRF, the amounts to be used should be those communicated to the staff at the occasion of the latest Article IV consultation. This will encourage countries to pay close attention to the evolution of this aggregate. Once transparency is assured, the Board will have the opportunity to better assess the risks associated with short-term debt and recommend appropriate actions. The second common characteristic to the recent country crises is the rapid loss of market confidence, in particular when the real extent of the crises is exposed. One remedy is to urgently strengthen the work on adherence to the SDDS by emerging economies and to strongly encourage the publication of PINs.

Mr. Cippa made the following statement:

We consider the proposed new short-term financing facility a potentially effective way to respond to crisis situations characterized by liquidity shortages due to capital outflow and loss in market confidence. As the financing need of emerging countries facing a crisis is mainly short term in nature, the argument goes that in such circumstances the Fund should not extend credit under stand-by or Extended Arrangements since their terms and access limits were not designed for that purpose. In our view, this argument needs to be judged against equally well-founded concerns about market incentives and, in particular, about the signaling effect of formalizing the extensions of credit in situations which, until not so far ago, were deemed exceptional. With Mr. Kiekens's word, we must avoid that access to the new facility becomes routine.

Events are pressing for a swift decision. We fully understand this, and in accepting to decide today, like Mr. Esdar, we are willing to take considerable risks. But we must also be aware that there are fundamental issues involved which would have required further considerations. Moral hazard and the role of the Fund as lender of last resort are among these issues that would have required a more detailed discussion prior to the establishment of the facility. For these reasons, we think that the new facility should be created for a limited period of two years, after which a review should take place. A continuation of the facility should be made subject to the assessment made at the time of the review.

Furthermore, I fully share the urgency of exploring ways to involve more actively private sector operations in this kind of exercise. If very high access is warranted to counter a systemic risk, it should be coupled with the appropriate stringent conditionality and payment modalities. There must be a strong adjustment program combined with an exceptionally high rate of charge.

We are in favor of a substantial interest premium with a rate of charge of at least 4 percent above the SDR basic rate of charge. Even though this might still be rather low under the circumstances, the incentives are thus set for early corrections of misguided policies and for the intended early repurchases. As regards Ms. Lissakers's proposal to link the rate of charge with the size of the loan, I think we could go along with that. I see Mr. O'Donnell's proposal more difficult to implement.

Concerning the size of purchases under the new facility, we agree that setting specific access limits linked to quotas may not be appropriate in dealing with confidence crises. However, it is also clear that the Fund's involvement cannot be without limits. The protection of Fund resources is crucial to us and we would expect that no decision will be taken that would put at risk the financial solidity of the institution. A point we would like to stress is that the Fund should not be obliged to finance a large and sustained capital outflow. If market confidence cannot be restored within a short period of time and outflows cannot be reversed, other measures perhaps consistent with Article VI of the Articles may have to be envisaged.

On maturity, we do not see why repayment of credit within a shorter time frame than two years cannot be envisaged. Essentially for the same reason expressed by Mr. Giustiniani, we are in favor of repurchases beginning after one year with the maturity of the outstanding loans shortened accordingly. There should also be a well-defined deadline by which purchases are expected to have been made. The proposed mechanism of initially formulating an expectation is not appropriate for the intended short-term purpose of the facility. We also support the fact that the new facility is envisaged to be available only for one year following the approval.

The use of the new facility will undoubtedly contribute considerably to the net income of the Fund. In this respect, we do not think it to be wise to lower the rate of charge on the use of other Fund resources. This compensation for additional income would amount to cheaper Fund support for other, more traditional debtors. It is not clear what the incentive effect of such a constellation would be. Using the additional income to help finance the costs from persistent overdue obligations amounts to using highly variable income for special use. Alleviating the burden on both creditors and debtors who up to now shared in financing the cost of overdue obligations will also take some peer pressure from those members in arrears toward the Fund. For these two reasons, we can support this option.

In discussing the status report on the options for financing the ESAF and the HIPC Initiative last November, we have already made clear that we oppose financing the administrative cost of conducting the ESAF-HIPC Trust with the Fund's net income. Using the additional income from the Supplemental Reserve Facility for this purpose would again amount to exactly the same. There is no evident connection between the SRF and the ESAF-HIPC Trust. Furthermore, such financing would not contribute to transparency of the cost of the ESAF and HIPC Initiative, either.

Since the Fund evidently incurs additional risk in extending large-scale support, there is an evident need to bolster precautionary balances. Therefore, we consider it natural to use the additional income of such risky arrangements for the accumulation of necessary additional reserves. We do not see, however, why the additional income should be paid into a special contingency account. As long as the SRF remains established, additional reserves will remain necessary to cover additional risks. The balance of such a special account could therefore never be reimbursed. For this reason, we would not support holding such additional reserves in a special contingency account.

Mr. Shaalan made the following statement:

In accordance with your wishes I shall put aside my prepared statement and concentrate on the various practical issues before us.

First, we support the proposed new facility which aims at larger access and a shorter period of repayment and higher charges. This appears to be an appropriate response to the new environment we find ourselves in.

On eligibility, of course the facility should be open to all members , while in practice it will be used mainly by emerging market countries. We would not, like Ms. Lissakers, link it only to situations where there is a threat to the monetary system or the risk of contagion. In addition to the reservations expressed by Mr. Kiekens in this regard, this will just add a new operationally difficult dimension. Here, we would appreciate staff confirmation that establishment of this facility will in no way jeopardize the existence of the exceptional circumstances clause.

On access limits, we agree that there should be no access limits. The facility would be make resources available for one year, but we can be pragmatic about that.

On conditionality, we agree that it should be based on the conditionality of the accompanying Stand-By or EFF arrangement.

On the repurchase period, we have no problem with the staff proposal. That is, repurchases are to begin after two years and should be completed in four quarters thereafter. We would have no difficulties with Mr. O' Donnell's proposal of graduated charges related to the period the credit is outstanding, provided that they would start at the lower end of the 200 to 400 basis points range. We also could support Ms. Lissakers' proposal relating the charges to the size of the drawings, depending on the position of the legal counsel on its feasibility.

On the rate of charge, for the variety of reasons cited by many speakers and in the interest of promoting the revolving nature of the Fund's resources, we would be inclined to favor the higher end of the proposed range , only as an outer limit.

Finally, we thank the Treasurer and his staff for the excellent paper they have provided us, on such short notice, on the possible treatment of the income to be generated by the new facility. Clearly there are a number of important issues involved here. We would, however, suggest that for today's discussion we limit our consideration to the issue of what to do with the income to be generated from the surcharge to be added to the basic rate of charge, since this is the only new dimension that arises out of the establishment of this new facility. Doing so would, in effect, mean the adoption of staff's alternative (ii) in Table 2 on page 6 of EBS/97/234. Thus we are of the view that we should include the proceeds of the service charge and of the margin between the rate of remuneration and the basic rate of charge when estimating net income and when determining what the rate of charge coefficient should be. In the usual manner, at the end of the year any excess income should be used to reduce the rate of charge coefficient.

The question that would then remain for consideration today is what to do with the proceeds from the surcharge. In our view, we should discard the third and fourth options presented by staff which have to do with reducing burden sharing and with ESAF/HIPC, simply because it would be very much a case of mixing apples and oranges, and would further complicate Fund finances and make them even less transparent than they are at present. We can see merit in using the proceeds to enhance the Fund's precautionary balances and remain open to either placing them in a separate contingent account or adding them to the Fund's General and Special Reserves. We would appreciate further clarification by staff on the advantages and disadvantages of each of these two alternatives.

To conclude I would like to support Mr. Kiekens' statement on the need to get back to emphasizing the prevention of crises. As the major international financial institution entrusted with safeguarding the stability of the world's financial system, it is incumbent on the Fund to focus its attention at this stage on the increasingly evident dangers of premature capital account liberalization not only to the domestic economies in question, but to the global economy as a whole. So far we have given increasing prominence to the potential gains of capital account liberalization. We must now place increased emphasis on identifying the preconditions for safe liberalization, as well as on the conditions that would help minimize the risks of contagion when crises do erupt, as they inevitably will. We therefore look forward to more work by staff in this direction. Such work is the necessary complement to the initiative before us today. Today's proposal is aimed at containing the damage of crises after they occur. We must simultaneously seek to improve the global financial system to minimize the incidence of such crises.

Ms. Lissakers considered that, with regard to the pace of capital account opening, if one looked at the concentration of financial flows to Korea in the interbank market and other short-term flows, one could see an example of the dangers of tardy capital market opening, not of premature opening. That was further underscored by the fact that the Korean authorities themselves recognized that accelerating capital account liberalization was part of the solution.

The Chairman considered that both Mr. Shaalan and Ms. Lissakers would agree that an orderly capital account liberalization was desirable.

Mr. Shaalan said that he did not fully agree with the Chairman's characterization of his position. It was important not to lose sight of the fact that hasty capital liberalization, without a highly developed and regulated financial market, could be a danger. He said that he would return to the matter later in the current discussion.

The Chairman considered that Mr. Shaalan would agree with the assertion that, in the case of Korea, at least two things had been at the root of the problems: insufficient and inappropriately sequenced capital account liberalization, and an extremely weak financial system. Those two elements of the current problems had to be corrected.

Mr. Zamani added that the reputable foreign banks that had become engaged in Korea should have been able to ascertain the full extent of the emerging problems; the blame for the current crisis could be spread more widely than just the Korean authorities.

Ms. Lissakers said that she agreed with Mr. Zamani's comments; the home country regulatory authorities of the banks that had provided the financing flows also had to improve their operations.

The Chairman said that he also agreed, and that not enough attention had been paid to the work of such regulatory authorities in the recent past.

Mr. Wijnholds made the following statement:

Before turning to the features of the new facility, I would like to take a step back and look at the Fund's approach to crises. In my view, it takes three things to be an effective crisis manager: strong prevention mechanisms, mechanisms to rapidly mobilize large-scale resources, and mechanisms to limit moral hazard by ensuring appropriate burden sharing. These three parts need to be balanced. We have to ensure that the Fund is taking a balanced approach in this respect. I would have therefore strongly preferred to discuss the issue of a new facility in the context of a more fundamental analysis of our approach to crises.

I am concerned that markets could interpret the proposed decision as a signal that the Fund now has a special 'bail out facility', and that the Fund is letting investors off the hook. The Thai program did discuss a lot of burden sharing issues, but it is much less emphasized in the Korean program. Let me stress that when I talk about burden sharing, it is not only the effectiveness of bankruptcy laws and the design of financial restructuring that I have in mind. Moral suasion with respect to continued participation of banks in extending credits, which could well be in their own interest, is another element. Also, a general standstill on certain payments, followed by negotiations with foreign creditors, is an option under certain circumstances. Indeed, this is an option that deserves serious consideration, as was stressed in the 1995 G-10 report. In this light my Dutch authorities and I are very disappointed about the time it is taking for us to discuss the recommendation from the same G-10 report to extend our lending into arrears policy. I hope this discussion will not be postponed any longer. In addition, it would be useful to have a discussion exclusively on the issue of moral hazard and burden sharing. This should include a discussion on the effectiveness of bankruptcy laws, burden sharing in financial sector restructuring, how to orchestrate a standstill and the use of moral suasion to ensure roll-overs.

The staff paper before us mentions that an adequate burden sharing will be a point of attention in requests for support under the new facility. However, staff suggests that the possibility of a debt restructuring will only be considered at a later stage, if the large financing package fails to placate the markets. To ensure fair burden sharing, the SRF document should have contained a complete description of how private creditors will be treated. I would also leave the option open to use moral suasion or a standstill from the start of the program. The argument that we should not interfere in commercial decisions strikes me as rather awkward. If this really would be our philosophy, it seems to me that we should not provide any assistance.

There are obviously attractive elements in this new facility. There is no doubt in my mind that it is appropriate to put a higher charge on these large packages, and to shorten the repayment period. However, I wonder whether there really is a need for a new facility. As Mr. Kiekens argued, higher charges and shorter repayment purchases seem also legally possible under our current facilities. I would be interested to hear the Legal Department's views on this. Footnote 17 on p. 11 does not seem to tell the whole story. My preference is for a solution as proposed by Mr. Kiekens, i.e., a system of differentiated charges, say beyond the ceilings under our present access policy. Nevertheless, I would like to express my views on the features of the SRF proposal.

First, I would favor a surcharge of 400 basis points. Many emerging markets already pay such spreads in normal times. If the idea of the surcharge is to induce countries to return to the markets as soon as possible, anything below this level will be ineffective. I am also attracted by the suggestions of some Board members to increase the rate of charge as the time outstanding rises.

Second, I am presuming that the establishment of the new facility does not mean that the Fund no longer has a catalytic role. The lack of clear access limits under the SRF could give the wrong impression here. I wonder whether some check could be built in that precludes unlimited use of Fund resources. Fund participation should be part of a concerted effort to address a crisis, with support from other sources and appropriate burden sharing. I therefore strongly support the addition of most of the language proposed by Mr. Esdar to be added to the decision. Here I would propose to use the language utilized in the summing up by the Chairman on the Emergency Financing Mechanism: "to contain significant damage to the country itself or to the international monetary system ..."

Third, given the special circumstances under which this facility will be used, perhaps we should look at some special conditions, as well. One condition could be that the Letter of Intent is published. This would allow for maximum transparency and accountability. Another condition could be that there is a minimum period for the negotiation of an SRF-supported program. This could deter countries from waiting until the last moment, and guarantees the staff some time to put a program together. As we saw in Korea, the marginal return of an additional day in terms of the quality of the program can be quite high in the initial one or two weeks.

Fourth, I have a real concern about the implementation of a program when we frontload money and backload the implementation. This is partly inevitable in these operations, but we should use our financial leverage to the maximum extent. Therefore, I would prefer to have a staggered approach to the first tranche, as we are doing in Korea—rather than only one or two tranches.

Fifth, I would prefer to have a repurchase obligation rather than an expectation which can be changed into an obligation by the Board. In addition, the proposed two-year grace period seems to be more than adequate—and as others, I would prefer a shorter repayment period.

Sixth, I would favor that the bulk of additional income of the SRF purchases goes to precautionary balances, reflecting the risks that accompany very large access to our reserves.

Seventh, I support the German proposal for limiting the validity of the decision to a two-year period.

Finally, if there is to be a press release after this discussion, I would find it very important that we stress that the Fund will also pay attention to issues of burden sharing and moral hazard when applying this facility.

The Chairman said that he agreed in particular with Mr. Wijnholds's point on encouraging countries not to wait until they were in the midst of a crisis to come to the Fund for assistance. It would be useful to hear Directors' views on how to make such a procedure operational.

After adjourning at 1:10 p.m, the meeting reconvened at 2:30 p.m.

Mr. Guzmán-Calafell made the following statement:

Against the backdrop of an increasing integration of capital markets worldwide, and the dominance of capital movements in balance of payments transactions, the economic crisis that emerged in Mexico in 1994 and several Asian countries in 1997 has posed new challenges to the Fund. A number of adjustments have been introduced to Fund policies and procedures to enhance the ability of the institution to meet these challenges. These adjustments have gone a long way toward achieving the intended results, as evidenced by the impressive speed with which the recent Stand-By Arrangement with Korea was concluded. Nevertheless, it is clear that we must continue to look for further improvements in the operative framework of the Fund to allow the institution the capacity of response which is needed under the present conditions of the world economy. In this context, today's discussion is welcome. Let me say at the outset that I agree that there are grounds to support the creation of a special facility aimed at dealing with short-term financing needs resulting from sudden shifts in market confidence and reflected in pressures on the capital account. The recent experience suggestions that these may be frequent features of economic crises under among the Fund's member countries in the coming years. Therefore, we have to equip the Fund with the tools needed to react very rapidly in response to external problems originating the capital account, and be ready to accept that in the future, the provision of financial support beyond current access limits will tend to lose its existing exceptional character.

As evidenced by the comments of previous speakers, it is far easier to agree with the overall idea of a facility of this nature than with its specific features. Obviously, in delineating the latter, we must be guided by the need to ensure that the creation of a new facility represents an improvement over existing policies. With this in mind, I would like to concentrate my remarks on three issues. The financing of underlying versus short-term financing needs, the repurchase periods and the use of a short charge on the rate of charge on the financing for the under the new facility.

The staff notes that financial crisis may comprise two components, an underlying balance of payments need and an additional and often larger short-term need in that in view of the different characteristics, it is appropriate to separate their financing while keeping both in a common adjustment program. I agree with the rationale that supports this idea, but it is not very difficult to see that in practice it would be very difficult to calculate with certainty the specific amount of financing that would need to be devoted to either of these components. Furthermore, an attempt to make calculations of this nature is likely to raise issues of uniformity of treatment given the different costs involved in the use of one sort of financing or another. For these reasons, support under the supplemental reserve facility must always be accompanied by the maximum financing available for the member country under Stand-By or Extended Arrangements in accordance with the annual or cumulative limits.

According to the staff, the new facility would be used only in circumstances where there is a good chance of a rapid turnaround of confidence. Therefore, it makes sense to think about somehow short repurchase periods. However, I have some concerns. As noted in the report, the exact timing of the return of confidence is uncertain, and may vary substantially from one country to another. Furthermore, a significant portion of the external financing obtained by the member country from other sources to face the crisis will normally mature in the short term and may coincide with repurchases to the Fund, thus raising the danger have a concentration of amortizations and renewed payments problems. If this is the case, shortening the repurchase period would be self-defeating. Two recommendations emerge with these elements in mind. First, heeding the staff's call for flexibility in deciding the timing of repurchases is essential and this flexibility should also apply to the availability of access under the supplemental reserve facility.

Prudence suggests the adoption of a repurchase period of three years with quarterly installments commencing two years from the date of each purchase. As proposed by the staff, the latter should initially comprise an expectation which the Board could extend before being replaced by an obligation.

Let me turn now to the proposal to set the rate of charge 200 to 400 basis points above the rate of charge applicable to the use of general resources account resources. The staff argue that the higher rate of charge is justified by, one, the incentive it creates for the member to treat available resources as precautionary; two, to make early repurchases when conditions warrant; and three, as a means to compensate the Fund for the additional exposure to risk resulting from these operations. I understand the concerns behind these arguments, but the use of a higher rate of charge to face them raises a number of question marks. Let me mention a few.

This measure magnifies the external burden and therefore complicates economic adjustment for those countries facing the most serious payments problems. It is fair to ask if this is consistent with the cooperative nature of this institution. Moreover, many of these countries will either face extreme difficulties to obtain external financing or simply lose access to private capital markets for some time. Under these circumstances, they will tend to use financing available at any cost, and therefore they will not there will not be main many incentives to treat Fund resources as precautionary even under a higher rate of charge.

The measure is intended to compensate the Fund for the additional exposure to risk, but in fact by complicating the member country's payments problems, it increases risks to the Fund. There is also an inconsistency in arguing a higher risk to the Fund and simultaneously expressing the expectation of a rapid turnaround of confidence in these cases. It is true that a higher rate of charge may provide incentives for early repurchases. Nevertheless, given its other adverse effects, it is far from clear that this is the best way to achieve this objective. We have an early repurchase policy and we are going to discuss it at the Board in the short term. If we have reasons to believe this policy is not working adequately, we should search the means to enhance its effectiveness. In addition, if the higher rate of charge is going to encourage early repurchases, I wonder why do we need to shorten the repurchase period and conversely, if we introduce shorter repurchase periods, why do we want to encourage early repurchases? There is also a danger that the introduction of higher charges will encourage other creditors to increase interest rates on financing granted to the affect the member country. Notwithstanding these shortcomings the Board decides to introduce higher charges for financial support provided under the SRF, we should seek to inflict the least possible damage to the borrowing member countries and therefore set the rate of charge at most at 200 basis points above the basic rate of charge applicable to the use of general resources account resources under other facilities and policies. I agree that the working of these and other features of the supplemental reserve facility should be subject to periodic review by the Board.

I do not support the introduction of a graduated charges. I may be wrong, but I believe that there is a direct relationship between the amount of resources a country is using and the magnitude of its economic problems. I am also tempted to think that if a country extends the use of Fund resources over time, this will be because its economic situation is worse than anticipated. I fail to see the logic for adopting a policy that increases the costs of adjustment in parallel with the seriousness of the economic situation, particularly considering that our early repurchase policy should provide margins of safety against possible abuses.

Let me now say a few words on the use of income deriving from credit under the new facility. I believe that we cannot be but consistent with the principles leading to the introduction of a higher charges for the SRF in the first place. According to the proponents of the higher charges, one of its main merits is that it compensates the Fund for the higher exposure to risk. It is only logical, therefore, to allocate income derived from the surcharge to the Fund's precautionary balances. Since this is a cooperative institution, the best way to accomplish this objective is by holding these precautionary balances in a new, special contingent account and once the risk for which the contingent ESAF was established disappears, any balances in the account should be returned to the members who paid the surcharge. In addition, since as explained by the staff the operation of the SRF adds to administrative expenses, a part of the additional income generated by the new facility must enter into the calculation of the basic rate of charge. Any remaining amounts could be used either to reduce further the rate of charge, or to help finance the present burden sharing arrangements.

Mr. Vernikov made the following statement:

The new facility is needed to deal with rapid and significant swings in market sentiments. I tend to agree with the staff that it is imperative that the Fund itself is able to provide not only its expertise and opinion on the market developments, but necessary sizable assistance as well. I see merit in separating medium- to long-term assistance provided through EFF and/or Stand-by arrangements from essentially short-term funds needed to deal with overreaction of the markets. At the same time, I should note that it would be preferable to have in the staff's paper a menu of options. The staff could pay more attention to alternative solutions and, in particular, to the windows approach.

As for the timing of purchases and repurchases, front loading of disbursements is probably inevitable. Otherwise, the facility can not be operational. One year is sufficient time to access the new facility. Although all of us would prefer to ensure early repurchases, I do not see an adequate mechanism to enforce them. We probably need to limit the time of the use of resources under the new facility. Concentration of repurchases in the third year seems to be appropriate.

The level of interest rate to be used in a new facility is obviously a matter of disagreement.

I would like to point your attention to what the staff says in section II, paragraph 6 of the paper on charges, on "the progression of charges both with increasing access and over time ... the Fund's charges not only were difficult to understand and lacked transparency, but also did not appear to contribute to avoidance of prolonged use of Fund credit as had been intended." In light of this previous experience, the Fund should not be overly optimistic regarding the stimulating power of the higher rates of charge.

Overall, I share the reasoning presented by Mr. Guzmán against the high rates of charge.

There is also a trade off between the shortening of the time for the use of resources, on one side, and the rate of charge, on the other. A shorter time limit decreases the need for surcharges.

Like many of my colleagues, I favor a lower and nongraduated rate of charge. As a compromise, why don't we start with a zero surcharge for six months and then use graduation as proposed by Mr. O'Donnell?

In any situation, there will be significant income generated by the new facility.

I support the staff's proposal to use such income for a reduction in the general rate of charge and for the changes in the burden sharing mechanism.

I do not favor the establishment of the SCA-3 account since such accounts are hard to deal with. Our experience with the SCA-2 shows that the process of liquidation is lengthy and cumbersome.

I consider it inappropriate to use the additional income for financing of ESAF-HIPC.

Finally, I think we should respect our decision to dispose extra Fund income retroactively at the end of 1998 financial year.

Mr. Yoshimura made the following statement:

In response to the new types of economic problems that we have faced in Mexico and Asian countries, the Fund should be well equipped with appropriate tools to effectively discharge its duty. In this respect, in recognition that the Fund has been faced with difficulties to cope with the new type of problems that are mainly caused by the loss of market confidence, the paper presents a useful basis for creating a new facility for the Fund to fulfill this task. I appreciate the staff's effort to present before us the well-documented paper so swiftly on the possible framework of the new facility which the staff calls the supplementary reserve facility. I broadly agree with the framework of the Supplemental Reserve Facility proposed in the paper, but let me add a few words on the framework of the SRF.

On the rate of charge under this facility, the paper proposes that it be set 200 to 400 basis points higher than the adjusted basic rate of charge. Within this range, while it is a reasonable argument that higher charges will provide more incentive to repurchase earlier than scheduled, our position is more inclined to the lower end of the range as we believe that the lower end number could do the job and facilitate the early repurchase. However, considering that it is most of the important for us to reach a common understanding as to the appropriate structural charge, I can be flexible on this

March 1, 1999
Approval: 3/8/99

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/121

10:00 a.m., December 15, 1997

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

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

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
	A.S. Alosaimi, Temporary
	R. Fernandez
	H. Paris, Temporary
T.A. Bernes	C.X. O'Loghlin
R.F. Cippa	U.Y. Tilyayev, Temporary
B. Esdar	W.-D. Donecker
	N. Coumbis
	A. Giustiniani, Temporary
	F. Mercusa, Temporary
	J.P. de Morais
	L.J.F. Erasmus, Temporary
A. Kafka	H.F. O'Brien
W. Kiekens	D.A.A. Daco, Temporary
K. Lissakers	B.S. Newman
	S.D. Melese-d'Hospital, Temporary
	S. Rouai, Temporary
	A. Vernikov
G. O'Donnell	J. Shields
	J. Roaf, Temporary
A.S. Shaalan	W.F. Abdelati, Temporary
M.R. Sivaraman	H.B. Disanayaka
	R.P.Watal, Temporary
E. Srejber	A.R. Palmason, Temporary
G.F. Taylor	O. Kwon
	M.A. Cilento, Temporary
	J. Guzmán-Calafell
	J.L. Pascual, Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha
K. Yao	A. Barro Chambrier
Y. Yoshimura	
Zamani A.G.	S. Joyosumarto
Zhang Z.	Wang X., Temporary
A.G. Zoccali	D. Merino, Temporary

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

Also Present

IBRD: E. Somensatto, Europe and Central Asia Regional Office; H.G. Broadman, East Asia and Pacific Regional Office. African Department: E.A. Calamitsis, Director. Asia and Pacific Department: H. Neiss, Director; A. Singh, Deputy Director; D.J. Goldsbrough, Deputy Director; T.S. Callen, J.P. Gordon, K.M. Meesook, I. Otani. European I Department: M.C. Deppler, Director; C.T. Beaumont, L.D. Everaert, A.K. McGuirk, J. Wieczorek. European II Department: J. Odling-Smee, Director; B.J. Aitken, O.P. Brekk, M.J. Buchanan, D.A. Citrin, D.J. Donovan, O. Havrylyshyn, J.R. Márquez-Ruarte. External Relations Department: P.C. Hole, Deputy Director; C. Hellemaa, M.E. Hansen. Fiscal Affairs Department: P.S. Heller, Deputy Director; M. Cangiano, N.A. Chalk. Legal Department: F.P. Gianviti, Director; W.E. Holder, Deputy Director; P. De Boeck, H. Elizalde, J.L. Hagan, Jr., H.N. Schiffman. Middle Eastern Department: P. Chabrier, Director. Monetary and Exchange Affairs Department: W.E. Alexander, P.T. Downes, J.E. Leimone. Policy Development and Review Department: J.T. Boorman, Director; A.G.G. Bennett, D. Burton, A.J. Dougherty, J. Fernandez-Ansola, J. Ferran, M. Fisher, Z. Murgasova, M.S. Schadler, T. van der Willigen. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, Deputy Director; R. Sahay, A.J. Tweedie. Secretary's Department: P. Gotur, A. Mountford, B. Sarr. Statistics Department: C.S. Carson, Director. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Director; D. Gupta, Deputy Director; J.C. Corr, B.E. Keuppens, M.G. Kuhn, B.N. Yuen. Western Hemisphere Department: C.M. Loser, Director. Office of the Managing Director: M. Russo, Special Advisor; B. Christensen, J.A. Clément, M.Cross, O.J. Evans, F.J. Gaitan; Office of Internal Audit and Inspection: E. Brau, Director. Advisors to Executive Directors: M. Askari-Rankouhi, J.A. Costa, S.S. Farid, P.M. Fremann, C.M. Gonzalez, K.M. Heinonen, G.M. Iradian, J. Jonáš, J.M. Jones, R. Kannan, H. Kaufmann, M.F. Melhem, H. Mori, H. Ogushi, Y. Patel, L.B.J. van Geest. Assistants to Executive Directors: N.R.F. Blancher, P.I. Botoucharov, J. Chelsky, H.W. Cocker, A.L. Coronel, J.K. Honeyfield, M. Kell, K. Kpetigo, T.-M. Kudiwu, K. Lai, M.Z. Maatan, I. Moon, L. Palei, L. Pinzani, J. Salleh, O. Schmalzriedt, T.T. Schneider.

1. REPUBLIC OF KOREA—REPORT BY STAFF

The Executive Directors, meeting in restricted session, heard a report by the staff on recent developments in the Republic of Korea.

2. SUPPLEMENTAL RESERVE FACILITY

The Executive Directors considered a staff paper on the Supplemental Reserve Facility (EBS/97/225, 12/5/97; and Sup. 1, 12/12/97). They also had before them a background paper on charges on the Supplemental Reserve Facility (EBS/97/234, 12/12/97).

The Chairman suggested that, in order to keep the important discussion focused, Directors should make clear in their first round of interventions their views on such specific issues as the establishment of the Supplemental Reserve Facility (SRF), the repurchase period, and the level of charges. Such focused comments would facilitate preparations for the second round of discussions, as well as for the conclusion of the deliberations.

Ms. Lissakers made the following statement:

> The Fund has demonstrated over its history that it has an impressive ability to adapt its policies and practices to meet the changing needs of its members. In the last few years the Fund has responded to the challenge of the crises of the 21st century by substantially increasing the size of programs through the liberal use of exceptional circumstances provisions, and by accelerating our response time through the Emergency Financing Mechanism. I think the basic approach continues to rely on instruments that are designed primarily to deal with balance of payments problems centered on macroeconomic imbalances and related structural problems, while the current Asian crisis, and to a lesser extent the 1994/95 Mexican crisis, had their origins in asset deflation arising from a loss of investor confidence, exacerbated by possible contagion effects rather than serious macroeconomic imbalances. While the problem may be in the private rather than the public sector, the raison d'etre for the Fund involvement remains the achievement of an orderly resolution that avoids excessive disruption of the domestic or the international economy.
>
> On the basic approach laid out in the staff paper and draft decision, we agree that a special facility is best suited to deal with confidence-based financial crises. It would avoid distorting the structures of Stand-By and Extended Arrangements in order to make them fit situations in which they were not designed, and as special facilities would also provide greater flexibility in designing the terms and conditions specifically appropriate to the unique circumstances of financial crises without creating possible precedents for access under our normal programs.
>
> We are also in broad agreement with the basic approach to the new facility suggested by the staff which builds on the Fund's experience in the Mexican and Asian crisis. However, some refinements of the specific provisions could help to differentiate the facility from other the Fund financing and highlight the unique nature of the problem being addressed.
>
> With regard to eligibility, the facility should be available to members experiencing a short-term financial crisis arising from a loss of investor confidence that poses a threat to the monetary system, or poses the risk of contagion. While the facility would obviously be available to all members, we expect that the principal

beneficiaries would be emerging market economies with extensive links to international capital markets.

With regard to access, the Fund should be expected to play the central role in dealing with these situations, and would normally provide, in cooperation with other international financial institutions, the bulk of the necessary financing, although bilateral financing can also play a role. In these circumstances, we agree that there should be no preset access limits based on quota, but rely instead on the kinds of judgments already used in determining access under the exceptional circumstances policy. Access to the facility should, however, normally be limited to the first year of the associated Stand-By or Extended Arrangement. We agree with the one year access proposed.

While recourse to the facility would reduce the need to front-load an underlying Stand-By or Extended Arrangement, we may actually want to use the facility even when the normal access limits are not breached; so we could accept a flexible trigger, as it were. Although, I recognize that the staff is proposing keying off the annual access limit which would probably be acceptable to us, as well.

On conditionality, as use of the special facility would be linked to a Stand-By or Extended Arrangement, there would not be a need for a separate program. However, we do think that there should be scope under the facility for tightening conditionality as necessary, if we think that the circumstances have developed in a way that requires additional measures. I think that should be understood at the outset when the facility is used, that there will be considerable amount of flexibility in terms of the conditionality that is added or adjusted because of the potentially volatile and uncertain nature of the problems we are dealing with.

The repurchase period, we think, should be substantially shorter than traditional the Fund financing to reflect the short-term nature of the problem and to return the potentially very large resource disbursements to the Fund as quickly as possible. We are dealing with problems that could pose potentially very large demands on our resources, and the instrument should be designed to bring those resources back as fast as possible. That can and should be done through two mechanisms. One is the shorter repurchase period, with the addition of the early repurchase expectation that the staff has also built into the proposal. But, in terms of repurchase obligation, we think the staff proposal leaves a potentially too long period for return of the resources. In our view, the repurchases should begin within one to one and a half years after the initial purchase and should be completed within two to two and-a-half years from the date of the purchase.

Charges similarly should reflect the extraordinary nature and scope of what the facility makes possible. We are temporarily replacing market financing, and the charges should reflect that fact. This should not be a subsidy in terms of low interest rates under those circumstances, particularly as the staff has proposed medium-term money. Normally, for this kind of financing a swap arrangement of 60 to 90 days would be in order, but we are persuaded by the staff argument that having such a short maturity structure could potentially undermine market confidence when we are trying to do just the opposite. But, therefore, if we are going to accept a longer maturity—and I consider what I propose to be longer maturities—it is doubly important that the charges provide an added incentive for early repurchases. Therefore, we would suggest the top end of the range proposed by the staff, and in addition would propose

that there be some form of gradation of the charges, so that charges would rise either with the magnitude of the drawing or the time the money is outstanding, or both.

One possibility for adjusting charges to size, rather than have it based on quota or access levels, would be to simply take the size of the package that has been negotiated and divide it into two, three, or four pieces, and say the first piece will cost X, the second piece will cost X plus one, and the third piece more. That is what we did in the Mexico program. The other would be to scale it according to maturities.

With regard to use of the income generated by lending from the facility and the higher charges, we think for now it should be put in a new precautionary balance account, at least until the short-term financing is repaid. We are prepared to be pragmatic and inventive regarding the future use of the windfall income. But I think we should avoid the temptation to spend the money before it materializes.

So to conclude, I think the establishment of the new facility can enhance the Fund's ability to respond to recent crises, help to restore confidence at this difficult juncture, and through an appropriate repurchase and rate structure, minimize the moral hazard of providing very large financing to substitute for market access.

I think while it is important to consider all the issues very carefully, a prolonged delay in reaching these key decisions could have significant longer run costs for the stability of the system. I think that prudence suggests that a good outcome not be lost by an effort to achieve perfection.

The Chairman said that he agreed with Ms. Lissakers that the Board must act quickly in the present circumstances; through the Board's traditional spirit of compromise, a rapid decision could be achieved.

Mr. Rouai asked whether the grading of charges proposed by Ms. Lissakers was possible under the Fund's Articles, given that it would lead to different charges for different countries.

The General Counsel responded that he would have to examine the specific proposal put forward by Ms. Lissakers. However, it was possible to have charges increasing over time from the date of the purchase, as well as a higher rate of charge based on the level of outstanding purchases.

Ms. Lissakers said that her proposal had been to take the sum of the package that was negotiated—in the Korean case SDR 20 billion—and simply divide that in thirds, so that the first third would cost a certain amount, and if the second third was disbursed, that amount would cost more.

The Chairman said that he was aware that Mr. O'Donnell was considering a proposal similar to that of Ms. Lissakers. He invited Mr. O'Donnell to share his thoughts with Directors.

Mr. O'Donnell explained that there were two elements to the issue of charges. One was whether one wanted to encourage early repayment, in which case, as the length of time that a charge was outstanding increased, the charge would increase. Ms. Lissakers was taking a slightly different tack. Possibly, in addition, one could have a proportion of the total, say, 25 percent of the SDR 21 billion for Korea available at a slightly higher rate, which was a slightly different proposal from that of Ms. Lissakers. The proposals had similar elements, but were not exactly the same.

The Chairman said that he understood the General Counsel's wish to study carefully any proposal in writing. However, in view of the shortness of time, he invited the General Counsel to react to the explanations by Mr. O'Donnell and Ms. Lissakers.

The General Counsel responded that he wished to be cautious regarding the matter, and to reserve comment. It was not clear whether the new proposal would be based on the level of holdings; the staff would need to analyze various aspects.

The Chairman suggested that, in the interest of time, staff from the Legal Department consult with Ms. Lissakers while the Board discussion continued.

Ms. Lissakers considered that the process of establishing the SRF should not be unduly complicated. Her proposal and Mr. O'Donnell's proposal shared the principle of gradation, which would act as a strong incentive for an early repayment to the Fund of potentially substantial resources. That incentive would be achieved by pricing the use of Fund resources according to the length of use and/or the amount, as well as in relation to market pricing, for which SRF funds would be substituting temporarily.

Mr. Taylor said that he understood the principle behind the gradation of charges, but he asked how it would be made operational.

Mr. Kafka stated that he shared Mr. Taylor's concern. He asked whether the progression in charges would be defined in terms of the absolute amount of financing, a percentage of the whole amount, or as a proportion of the whole amount.

The Chairman asked Mr. O'Donnell to circulate his proposal in writing to the Board.

Mr. O'Donnell said that he would circulate a diagram outlining his proposal. He stressed that, as one element of his proposal, the amount of charge should be related to the period outstanding; however, that was different from the issue of having a higher charge for the proportion of the amount originally decided.

The General Counsel stated that he suspected that some Directors were considering applying charges to absolute amounts, which would not be legally feasible under the Articles. The calculation of charges, if it was based on level of holdings, had to be determined in relation to the member's quota.

The Chairman pointed out that an added complication might be that calculated quotas and actual quotas occasionally differed.

Mr. O'Donnell made the following statement:

> Let me start by saying that we strongly support the creation of this new facility, and very much along the lines proposed by the staff. We think the crucial elements of it are to allow very high access—much higher access than normal for these particular special cases—but in return for that much higher access there should be a higher rate of charge. It should be short term in duration, and it should be tied to Fund conditionality. Those are our key points.

If we start by considering who should be eligible for the new facility, we agree with the principle that the facility should be available to all Fund members. But there should be a clear understanding that its relevance and its suitability will be for countries with large-scale access to international capital markets who are facing liquidity problems which are a serious threat to the international monetary system, or that carry serious risk of contagion. Now, that language is along the lines of the Managing Director's summing up for the Emergency Financing Mechanism, which I think provides a possible model that we draw on. But if we are establishing a new facility which has the possibility of giving much larger access, we must be careful to minimize the moral hazard implication of this; therefore, we need to think carefully about a number of issues.

Let me start with the question of the rate of charge. Our position is that we should be setting the charge high enough to give a strong incentive for early repayment, so we would be very much at the top end of the kinds of numbers mentioned in the staff paper, i.e., around 400 basis points as a spread over the rate of charge.

On the amount of funds available, we welcome the language that is in the draft decision that says the amount of financing made available under the new facility will depend in part on the country's record of using Fund resources in the past and of cooperating with Fund surveillance. There is a possibility that we have considered, but that may be too complicated for this case, so I will just mention it to the Board for consideration. This is going back to the case where the Fund has repeatedly gone to a country and issued warnings that if there is no change in behavior, then there is a real problem. If I were given complete control, it would be nice to be able to say that if the Fund had issued—let me put it this way—a "yellow card" to a member, that when it actually came to draw on this facility, we should take account of the number of "yellow cards," or indeed the fact that it had probably been given a "red card" in the end for using this facility, that this might be used to raise the rate of charge. That probably gets us into an area that is a bit too complicated to define of what constitutes a yellow card.

In terms of whether one has access to 100 percent of normal limits and then moves into this new facility, we take a rather flexible approach to this, and we could live with the proposal that is in the staff's paper. It would be nice to have a blended approach to these things.

On the repayment period, this is where I hope the document that is being circulated is relevant. (See attachment). Like I say, we think this system should be set up so there is an encouragement to repay. Now, this starts by having something which in this little chart I have called X, which is the premium or the spread over the Fund's rate of charge. So if, for example, under this facility a country borrowed money and repaid it all within, say, six months, the rate of charge would simply be this figure X.

Let me take as an example simply 400 basis points. If one were to say a spread of 400 basis points over the rate of charge, anything you repaid in the first six months, you would pay at a spread of 400 basis points. If on the other hand you kept that money for the full two-year period, you would, under this scenario, be paying 400 plus the 150; so you pay 550 on the whole of that money. There might be differences of view about where X should be set. I have proposed 400. I have proposed a tiering structure so that every six months this goes up by 50 basis points, with the idea being this gives a strong encouragement to repay. I think some kind of principle and scheme like this would give all the right incentives and it builds in a certain element of rules rather than discretion to the process which those of us who favor transparency are very keen on.

In terms of conditionality, we agree that this new facility should be available only to countries signed up to either a Stand-By or Extended Arrangement, and that conditionality should be very closely linked to that. We think tough conditionality is extremely important to safeguard the high levels of lending envisaged.

In terms of financing the new facility, our prime concern is to get it up and running as soon as possible, and ideally Korea's next tranche of its Stand-By Arrangement would be under this new facility. Therefore, in the interest of speed in the first instance, we would take financing from the General Resources Account. However, we do not think that should preclude the option of the Fund borrowing either from the General Arrangements to Borrow or the New Arrangements to Borrow, once it is ratified by enough participants, or indeed from members on a bilateral basis to support the facility.

In terms of what to do with the income, we are grateful to the staff for their helpful paper which sets out the options. We do not think we need to resolve that question now. My preferred option follows what Ms. Lissakers put forward: all additional net income should be collected into a new contingent account. We could then think about what to do with it. I should state very clearly our preferences that an element of this should be allocated to reserves, because that is only prudent, but we also hope that some of the money can be used to help all the members of the Fund partly to reduce charges, but also—and this is a strong feeling within the United Kingdom—for ESAF-HIPC.

The First Deputy Managing Director considered that Mr. O'Donnell's suggestion that the Fund could issue "yellow cards" to countries that repeatedly ignored the Fund's warnings might create the moral hazard of the Fund issuing such cards at every opportunity. Also, it might reward those countries that concealed information from the Fund.

Mr. O'Donnell said that he agreed with the First Deputy Managing Director on the possible problems. However, in the end, one could argue that the incentive effect caused by the desire to avoid having "yellow cards" might provide the desired result.

Mr. Sivaraman made the following statement:

The proposal to have a Supplemental Reserve Facility has come at a time when the Fund is required to provide assistance on an exceptional basis on scales which have not been seen hitherto. These lendings are taking place to restore market confidence, that is to restore normalcy in a crisis-ridden economy. We must not forget the fact that while we talk about restoring market confidence, it is the very same players whose confidence we want to restore had apparently not undertaken normal prudential precautions while lending. They were motivated by short-term gains while lending money to banking institutions which re-lent this money without proper evaluation of its ultimate use. While it is imperative to restore normalcy quickly in such situations, we must also bear in mind that when there are genuine balance of payments requirements of certain countries for reasons beyond their control, the assistance is provided on a much lower scale, but with similar conditionality. The assistance which is given under exceptional circumstances should, therefore, come out of a different facility carrying a higher price tag. My authorities would strongly support the setting up of the Supplemental Reserve Facility.

As regards the rate of charge to be levied for access to this facility, I suggest we adopt a graduated scale varying from 2 to 4 percent, depending upon the extent of access, similar to what Mr. O'Donnell has suggested. The staff will have to work out the amounts at which the different rates will operate. Calculations, of course may be cumbersome regarding repurchases, as Mr. O'Donnell tried to explain. However, I think this will be very fair to have such a graduated levy.

As regards the period for which the facility should be available, the suggestion of the staff is reasonable regarding access, and repurchase should be made within two years of the last purchase under the facility depending upon the amount. We could make it 18 months or 24 months. We cannot treat this facility as some kind of a cash credit or overdraft facility of a member when it is in crisis. There was some suggestion that it should be for a period of 60 to 90 days. I think it would be very difficult to anybody to repay within 60 to 90 days because there will have to be some time interval before the economy is able to generate surpluses to pay the amount. Prescriptions of very short periods may be an open invitation for defaults.

I believe access to this facility will start as soon as a country draws 100 percent of its quota from the Stand-By Arrangement. Paragraph 20 of the staff paper states this facility will be available to a member only in combination with Stand-By or Extended Arrangement. In order to take care of the concerns expressed by a few members that their calculated quotas do not actually represent what they should really have, and it varies to a significant extent from the actual quotas, I would like to suggest that where drawings exceed 200 percent of the quota, which is a normal cumulative access limit laid out in the Articles, access to this facility could be considered instead of the 100 percent that has been suggested by the staff. This is only a suggestion.

As the facility will be in combination with one of the other facilities, conditionality will necessarily derive from the linkage with other facilities to which the member will have access. I think it is difficult to have a separate set of conditionality for drawing under this facility.

Let me now turn to the paper on the charges and the Supplemental Reserve Facility. First, I congratulate the Treasurer for this very lucid paper, which I have already done. I think this is the first time I see a paper written in "king's English" or "queen's English" without any long, winding sentences.

The higher rate of charge that is being levied can be considered as a punitive levy. The proceeds from such a levy should generally be used for a higher purpose. In my view, it will not be fair to put it into a general pool, and use it for reducing the basic rate of charge. We should not use this opportunity for reducing the basic rate of charge, because some countries are in distress and they require the exceptional facility. We should not use this higher rate of charge just for reducing the basic rate of charges. It is fixed under different principles. The proceeds of this charge, over and above the normal rate of charge, should be applied partly to augment the ESAF-HIPC Trust, and also to reduce to a certain extent the impact of the burdensharing arrangement. In my view, two-thirds of this pool can be transferred to the ESAF-HIPC Trust and the balance can be reduced used to reduce the impact of the burdensharing arrangement. Such an arrangement, in my view, would be free from criticism that members have tried to use this opportunity to reduce their cost of operations of the Fund at the expense of a few unfortunate members.

Mr. Kiekens made the following statement:

The staff recommends establishing a new facility to provide financial assistance to countries that face a loss of market confidence which results in large capital outflows. I agree that the Fund should provide, in exceptional circumstances, large financial support for short periods at higher interest rates. However, it is preferable not to formalize the Fund's preparedness to act as a lender of last resort by establishing a special facility that entitles countries to receive extraordinary amounts of financial support, of course, on condition that they intend to implement adequate adjustment policies.

It seems to me unwise to create a new instrument that will easily be seen as the Fund's "bail-out facility," in the midst of a financial crisis and following very substantial bail-out interventions. It risks sending the wrong signal to governments and the financial markets that from now on, the Fund considers these exceptional interventions as routine. If countries conduct sound policies, the need for large-scale emergency bailouts should remain exceptional.

Hastily creating such a new facility under the pressure of the scheduled date of Korea's second drawing would give the impression that the Fund deals with the crisis on a piecemeal basis, without taking stock of recent policy actions and evidence that the Fund's programs in Asia are succeeding. Also, we need to finish our discussion on the implications for the financial role of the Fund of the amendment of the Article of Agreement making the promotion of free capital movements a purpose of the Fund. In this connection, as we all know, how to amend Article VI is still to be settled. In addition, it would be useful to hold the long planned discussion, and learn its results, concerning the Fund's policy of lending to countries that, in exceptional circumstances, activate policies aimed at an orderly resolution of their public or private external debt.

The new facility formalizes the Fund's lender of last resort function and creates for its members an entitlement to such lending. This may diminish the incentive both for governments to pursue sound policies and for financial agents to assess risk correctly and impose discipline on borrowers. It is a longstanding and generally accepted wisdom that although last resort lending may sometimes be unavoidable and even desirable, it is better not to provide assurances about its availability or conditions.

For all these reasons, I prefer to maintain the present approach and to provide very high access to deal with loss of market confidence by using the exceptional circumstances clause of the present Stand-By Arrangement instrument. I agree that the rules for Stand-By Arrangements, as well as for the Extended Fund Facility, should be amended to provide for higher charges and shorter repurchase periods for countries obtaining, under these facilities, cumulative access beyond a given threshold of, say, 300 percent of quota.

Financing under other facilities such as the Systemic Transformation Facility (STF) and the CCFF would not be counted against this threshold. The higher charges and shortened repurchase periods would apply to all Fund members whose access exceeds the common threshold, and would not violate the principle of the uniformity of treatment. They would apply generally and would not be decided on a case-by-case basis when waiving the access limit of 200 percent of quota as permitted under Article V, Section 4 of the Articles of Agreement. Higher charges can be decided by a 70 percent majority, and would apply on charges due under all existing arrangements after the increase.

Higher charges are justified both by the additional risk to the Fund resulting from very high access, and as an encouragement to replace the Fund's financing with market financing as soon as possible.

Refinancing on the markets, however, will usually take some time. I therefore propose applying, from the outset and throughout the whole period of outstanding drawings, the basic risk premium that can be set at 2 percent. This basic risk premium can then be complemented by an incentive surcharge starting 60 days after each drawing and gradually increasing by another 2 percent, making the total surcharge 4 percent after a year's time.

On how to shorten the repurchase periods, I can agree with the regime the staff proposes in paragraph 19.

The additional income derived from the higher charges should be applied to the Fund's precautionary balances, preferably by adding them to the Fund's general reserves.

If the Board prefers to adopt the Supplemental Reserve Facility (SRF), I suggest introducing several features aimed at reducing moral hazard, particularly for financial agents, and signaling that access to the Fund's lender of last resort facility is not a foregone conclusion. Countries that guarantee, without Fund approval, the liabilities of their commercial banks above a reasonable limit would not be eligible for access under the SRF. State guarantees existing at the time the instrument is adopted should be phased out within three years. Also, access should be limited to the refinancing of a part of the countries external debt falling due during the drawing periods. Finally, very high access—say, above 500 percent of quota—would only be decided with a qualified majority of 70 percent of total voting power.

Both Ms. Lissakers and Mr. O'Donnell have suggested that the facility should only be available for cases that are a threat to the IMS or that may give rise to contagion effects. For this reason, this facility would not be accessible for small or very small countries, which in my opinion is contrary to the principle of equal treatment and, indeed, adds to the market perception that "for the Fund, large countries are too large to fail."

Mr. Esdar made the following statement:

This Board today is confronted with a very difficult challenge. We have to make difficult and far-reaching decisions which will have a significant impact on the

Fund's future role in the international monetary system. Before coming to my statement, I have to admit that I share many concerns expressed by Mr. Kiekens.

Due to the external circumstances, we do not have the usual time to discuss and closely scrutinize the elements of our decision. This requires a certain element of caution, but we have also to be prepared to take some risk and to adjust or modify our decision if necessary. Therefore, to start with, I would suggest to establish this new facility only for a period of two years. This would reflect appropriately the fact that we are entering new territory and that this is very much part of our learning to cope with the new challenges stemming from the transfer to globalization. Here it will be particularly important to strengthen the structure and supervision of each country's financial system, as well as its economic management, in order to safeguard better against sudden losses of market confidence and contagion effects.

We have to meet today two objectives. First, on the one hand, we have to find appropriate ways to support member countries where a crisis of confidence has developed, with the risk of significant outflows of capital. We have to provide sufficient resources to rebuild confidence based on a convincing adjustment and restructuring program. This requires strong conditionality and prior action in crucial areas. Therefore, we strongly support the suggestion to base such programs on the conditionality of Stand-By or Extended arrangements.

In this context, a possible blending between Stand-By and EFF resources, on the one hand, and resources provided under the Supplemental Reserve Facility should be decided on a case-by-case basis. In my view, we need some flexibility in this regard. The staff's suggestion to first completely exhaust access limits of traditional facilities before resorting to the SRF might unduly limit the required flexibility.

The nature of emergency programs sometimes will provide only a limited time frame for negotiations, and we probably have to accept that some details can be negotiated only in the course of the program. Therefore, prior actions are even more important in those programs, not only to justify large up-front drawings, but also to prove the commitment of the authorities to reform. Those prior actions have to focus particularly on causes of the financial crisis, on reform on the financial sector, but also on the appropriate monetary and exchange rate policy response. I would suggest that these conditionality and prior action requirements would be explicitly addressed in the text of the decision.

As already mentioned, the objective of this facility would be to support countries whose balance of payments problems may pose a potential threat to the monetary system or which carry serious risk of contagion and that are particularly exposed to possible large swings in market sentiment. The text of the decision in this regard is very vague, and I would strongly suggest to reflect this general objective of the SRF more precisely in the first paragraph. Here I am very much on the side of Ms. Lissakers and Mr. O'Donnell, and I do not think that the provision of uniformity of treatment prevents being more clear in our decision.

Secondly, on the other hand, we have also to be aware that, if the Fund provides significant financial support, it may generate or strengthen already existing severe bail-out expectations and moral hazard effects. We also have to safeguard the Fund's resources for those members with traditional balance of payments needs and to limit the Fund's financial involvement as far as possible. The core business of the Fund to help those members should not be undermined.

We have to be aware that the Fund resources are limited and that they have to be protected. This can be done, first of all, by providing appropriate incentives for early repayment through charges which are in line or even above market rates, but also by shorter repayment periods. However, as a consequence of this new facility, the Fund takes a much higher risk. Against this background, I support the suggestion to use the additional income generated by higher charges to strengthen the Fund's precautionary balances; that means its reserves. However, as a second-best option, we could also accept the idea of establishing an additional contingency account.

On charges, I very much support the proposal of Mr. O'Donnell. A staggered schedule of increasing spreads would be the most efficient way to encourage early repurchases. But I could also live with Ms. Lissakers's proposal or with a combination of both, pending the view of the Legal Department.

To start with a spread of 400 basis points for repurchases within the first six months after a drawing and to increase the spread progressively for longer repurchase periods seems to be highly appropriate. There should be a firm obligation to repay after 12 to 18 months, perhaps in two instalments. If we apply this system to each tranche, we get a somewhat more balanced repurchase structure and avoid bunching. There also could be early repurchase expectations during the interim period until the repurchase obligation will come into effect, if justified by circumstances.

Finally, coming back to the need to prevent bail-out expectations, we should make all efforts to ensure an appropriate participation of private creditors right from the beginning in order to ensure adequate burden sharing and to limit the risk of moral hazard and to confirm the Fund's basic catalytic role, and finally also to ensure the financial viability of the programs we agree. This participation of private creditors will mean in many cases that private creditors or banks have to roll over their short-term claims. It might be worth while to consider whether the Fund could encourage such a rollover obligation by helping to back up interest payments on the short-term debts that fall due.

We have to make every effort to involve private creditors at a very early stage of program discussions. A support in backing up interest payments could provide a strong incentive for creditors to agree on the necessary participation. It would be in their own interests, especially, if their own commitment to participate in the overall package would help to avoid defaults. In this regard, reference to Article VI might help to convince them.

This is only one potential option. There are other elements which might help to integrate the private sector adequately in emergency packages. The credibility of the Fund's program advice and conditionality, as well as its financial integrity, is at stake here. The international community expects us to find the solution for this problem rapidly. Here the recent G-10 study on liquidity crisis might provide additional useful guidance for our work on this urgent matter.

I was, to be frank, disappointed that this issue was not discussed in detail in the paper. I am aware that there was only very limited time, but, on the other hand, it is a crucial issue to avoid undue recourse to the Fund's resources. While I noticed in the paper the general assumption that the Fund would provide the resources through such a facility only in the context of an overall financial package involving other lenders, I still think that this assumption is too vague and too unfocused. We have to address directly the need to involve private creditors.

Against this background, I would suggest to add a special first paragraph to the decision which, first, clarifies the objective of the new facility—that means the need to prevent serious impairments of the monetary system—and, second, which makes clear that this facility is not intended to bail out private creditors and which emphasizes the need for adequate participation also of private creditors. It could also make clear that under certain circumstances a standstill could not be excluded. My authorities have prepared a draft of a text for the first paragraph, and I will circulate it to the Board.

To conclude, we are prepared to support the establishment of this new facility if those suggestions and modifications in the text of the decision can be accepted. Having said this, let me express my concern that the focus of our discussion by recent events has turned too much on crisis handling and financing. We again have to put more emphasis on crisis prevention and the appropriate policy response. I am very much concerned that the problems we are confronted with today, to a significant extent, have been caused and exaggerated by an inappropriate and delayed policy response. Obviously, Fund surveillance and Fund policy advice could not change this attitude. Even after programs were agreed, policy reactions sometimes were, to say the least, rather hesitant and half-hearted. We have to come back to these problems very soon, and we have to make clear that financing under the new facility will not and cannot be a substitute for policy adjustment in the respective countries at an early stage. We also have to be prepared to say no if required by circumstances. The possibility of a default or standstill has to remain a potential option if required by circumstances.

The Chairman said that he agreed with Mr. Esdar's concluding observation that the possibility of a standstill or default could not be ruled out—even with the existence of the new facility. It was important to make that clear when explaining the details of the new facility to the public, because some confusion seemed to exist in the minds of some commentators. He pointed out that many of the recommendations in the recent G-10 report alluded to by Mr. Esdar had been incorporated in the design of the new facility, as well as in other staff papers. He asked Mr. Esdar what other ideas from that report could have been included.

Mr. Esdar responded that there were two additional elements that could have been included in the staff paper on the new facility. First, the proposed decision on the facility and the staff paper explaining the details of the facility could have addressed the issue of moral hazard and of integrating private creditors in the resolution of crises for which the facility was designed. With respect to issues raised by the recent G-10 report, the Board had previously requested the opportunity to discuss the question of financing into arrears. Also, consideration should be given to ways to facilitate the creation of creditor councils or groups among bondholders; perhaps the threat of a standstill in repayments might also help in particular cases. While it was true that the current staff paper presented some interesting ideas about various instruments, the Board would need to return to such issues in detail—in particular to help ensure a more balanced burden sharing. The current experience in Korea demonstrated that, in cases where it was difficult to secure debt rollovers, the international community would need to exercise considerable leverage at an early date to convince banks that it was in their own interest to participate in such rescue packages.

The Chairman said that the staff was preparing a series of papers on such issues, which would be circulated and discussed by the Board at an early date. However, the more one descended into the intricate details of such problems, the more difficult it might be to secure a consensus on specific solutions.

Mr. Yao said that Messrs. Esdar and O'Donnell and Ms. Lissakers had defined clearly the eligibility criteria, on the basis of which they considered that only large countries that could affect the international financial market or could have contagion effects on neighbors should be eligible. However, there were small countries that had liberalized their capital account that could at any time be under attack from the market or at least have a crisis in confidence. He expressed the hope that such countries could benefit from the new facility. In the event that such countries were not eligible, he asked the staff whether there was any way to assist those small countries that find themselves in such difficulties.

The Chairman said that the General Counsel would respond to Mr. Yao's concerns.

Mr. Kiekens noted that one of the essential conditions for Mr. Esdar to support the Supplemental Reserve Facility was that a mechanism to associate other creditors with the Fund's efforts needed to be established.

The Chairman pointed out that Mr. Esdar had not made the creation of such a mechanism a condition for his support of the decision to establish the Supplemental Reserve Facility.

Mr. Kiekens asked Mr. Esdar to repeat what his condition had been.

Mr. Esdar said that his condition was to reflect adequately in the decision the need for private creditors to participate in the resolution of such crises. He would be prepared to circulate a paper on the matter, if it would be helpful.

The Chairman encouraged Mr. Esdar to circulate a paper outlining his concerns at an early date.

Mr. Kiekens said that he shared Mr. Esdar's concerns, which was why he had proposed that the Fund should be able to refinance only a part of the short-term debt falling due. More fundamentally, it could not realistically be expected that private creditors would associate themselves with such debt workouts—as was being experienced in the case of Korea—unless there was a credible, orderly adjustment instrument available in the country so that the threat to the reference to Article VI, as Mr. Esdar had noted, was realistic and could be worked out. Moral hazard could be prevented only if an effective instrument existed to force private creditors to maintain their credit temporarily, in parallel with the Fund, if such a scheme were necessary.

On the many useful proposals of the G-10 study, Mr. Kiekens continued, one in particular was interesting: "It [the whole framework of orderly work-outs or adjustments] should strengthen the ability of governments to resist pressures, to assume responsibility for the external liabilities of their private sectors." For that reason, if the new facility were to be established, it should only be accessible to countries that did not extend state guarantees to the commitments or liabilities of the private banks.

The Chairman pointed out that Mr. Kiekens's suggestion would not allow the facility to apply to the following drawing by Korea.

Mr. Kiekens noted that he had said that, for those countries that had a state guarantee in place at the time the facility was established, the guarantee should be phased out in a time period of three years.

The Chairman pointed out that such a clause was part of the Korea program.

Mr. Kiekens said that, in addition, the condition had been for countries that introduced state guarantees without the approval of the Fund—which had been the case in Korea, Thailand, and Indonesia. Such policies had caused severe problems, so there should be instruments in place to prevent the adoption of such actions.

Ms. Lissakers said that she recognized as valid the concerns expressed by Messrs. Kiekens and Yao about defining eligibility for the SRF too narrowly—particularly Mr. Kiekens's point that a narrow definition might increase moral hazard risks associated with the impression that certain countries were too big to fail. She also agreed with Mr. Yao that it would be useful to consider the design of the SRF in the context of the ongoing Board debate on the proposed amendment of the Fund's Articles on capital account liberalization.

The Chairman said that he agreed with Mr. Esdar that the experience with the SRF would be a case of "learning-by-doing." The Fund would need to be prepared to wind down the facility or modify it within two years, subject to evolving developments—particularly regarding the process of amending the Articles to deal with capital account liberalization.

Mr. Sivaraman considered that more precision was required regarding the details of the timing and eligibility of the facility. The staff paper noted that the facility would be used only when there were short-term financing needs; however, the staff paper also stated that the facility would be used in combination with a Stand-By or Extended Arrangement. He considered that Mr. Yao's concerns stemmed from a lack of clarity about when the facility would be activated. For example, he doubted whether the facility would be used if a member's financing need amounted to only 150 percent of its quota.

Mr. Kafka made the following statement:

> I would like first to thank the staff for its papers, which I found exceptionally helpful. I would also like to echo what Mr. Sivaraman has said: that these papers are remarkably well-written.
>
> The Fund has a critical role to play in containing sharp reversals in private capital flows and bringing about an early return to normal market conditions, and Fund members can come to the Fund if encountering such circumstances. That is what this institution faced in the case of Mexico in late 1994 and in the three Asian cases during this year. The proposed Supplemental Reserve Facility (SRF) would in our view formalize what the Fund has already been doing in a somewhat modified form. We find that acceptable, but have certain concerns, among them particularly those mentioned by Mr. Kiekens. But we do not think that this should prevent us from supporting the SRF.
>
> We agree that the new facility should be operated in conjunction with a Stand-By or Extended Arrangement and with the Emergency Financing Mechanism. But it seems to us that what we really need is a supplemental facility which can also function as a lender of last resort. The supplemental facility as envisaged in the paper does not quite have that characteristic. That is because it does not, like a central bank,

have a close to unlimited scope for support. But is that even conceivable? One could, of course, think—and should think—of using the SDR mechanism and raising, by amendment, which would at least be a lengthy affair, or by negotiation, the acceptance limits for SDRs.

There is another question. The staff proposed making the resources requested by members available for up to one year. A flexible approach, neither minimum nor maximum, determined on a case-by-case basis might be preferable.

Another question concerns collateral. This could be obtained as the accumulation of the difference between the normal rate of charge and a special and higher rate for the new facility, but it could also be collateral in the more customary sense of a deposit of a sum or a promise.

What about the interest rate of the facility? This is a question that to our mind could not be separated in practice from the question of collateral. One approach would be to make the surcharge refundable if all the conditions demanded by the Fund for making its resources available under the new facility are fulfilled. Another approach favored by the staff may be a nonrefundable surcharge to encourage the use of other sources of financing before turning to the Fund. Our preference is for a refundable surcharge which would reduce the borrowers' burden. I realize the problems which may be created for the facility with respect to Article VI, section 1. The requirement to impose, if demanded by the Fund, capital controls in the case of use of the facility would certainly, to our mind, seem to be justified.

There are other points which have to be decided, such as the size of any surcharge. We hope that they can be decided so that they do not delay the timetable of our progress toward a general solution to the Korean problem. Another problem is use of the additional income to be generated by the new facility. We will listen carefully to our colleagues on these and other additional points.

Mr. Zoccali made the following statement:

We welcome the attempt made by the staff and management to improve the instrumentality for dealing with disruptive turnarounds in investors confidence and sharp reversals in private capital flows. The Fund must be able to play a pivotal role in the process of restoration of market confidence that would avoid excessive disruption to national or international prosperity. We view the proposed Supplemental Reserve Facility in that light.

Regarding the general features of the recommended new special facility, some brief comments are in order.

First, on conditionality, we agree with staff's assertion in Paragraph 11 that there might be cases of countries facing a short-term financing need without an underlying balance of payments need but that since both components generally emanate from the same underlying macroeconomic and/or structural imbalances a common adjustment program under an Stand-By Arrangement or EFF is called for. However, the more critical justification, in our view, would be the one contained in footnote 7 of page 8 whereby even if the short-term need was not caused by an underlying imbalance it is likely to create such an imbalance.

Second, the envisaged facility addresses the situations where a crisis of confidence has already developed i.e. where pressures in the exchange rate and other financial markets are not only manifest but where more significant capital outflows are likely to develop. In these circumstances, we agree that access to sufficiently large Fund resources in a heavily front-loaded manner is of the essence to help contain both domestic and regional spill-over. A new facility rather than a"window" within an arrangement would most closely reflect the different nature of the required assistance. Given the need for sufficiently large resources in the context of appropriate conditionality to restore market confidence, the risk of depletion of the Fund's liquidity should be minimized. Keeping in mind the scope for contagion, supplementation of GRA resources with those of the GAB or NAB should be possible. In any event, the case for ensuring a strong Fund is very clear and justifies, in our view, the Managing Director's call for a topping-up of the quota increase agreed in Hong Kong.

Third, with respect to "moral hazard," we consider that even the certainty of Fund assistance in times of crises, which is not being proposed, does not encourage countries to act irresponsibly in view of the dire consequences of a financial crisis when it occurs. Nevertheless, it could be argued that a more explicit Fund role in liquidity supplementation could breed complacency or careless conduct on the part of lenders. The latter serves to highlight the need for mechanisms to facilitate orderly debt workout in the context of adequate bankruptcy procedures for private debt restructuring. We attach importance to the forthcoming discussion on the issue of lending into arrears to private creditors. In the interim, the constructive alternative would be to develop a strategy which serves to persuade lenders to roll-over their credits. The possibility of resorting to capital controls, referred to in paragraphs 17 and 26 of the paper as a response to the injunction in Article VI, Section 1, however, is viewed as being neither in the recipient country's best interest nor consistent with the Fund's envisaged new role or with the globalization of international financial markets. The emphasis should remain instead on the preventive strengthening of domestic banking systems, including in particular its prudential architecture.

More specifically on the operational characteristics of the proposed SRF, we agree that access should be front-loaded as needed and not be subject to the normal limits. Subsequent reviews of normal access limits should ensure that these remain adequate to facilitate macroeconomic adjustment and consistent with the emphasis in Fund-supported programs to structural reform.

The period of availability and of repayment of drawings should be scheduled flexibly, in particular, to avoid creating new uncertainties regarding the roll-over of official financing for the member. We agree, therefore, with staff's proposal of providing for an expectation of repurchases beginning after two years to be followed by a repurchase obligation after one additional year, based on the inherent uncertainty surrounding the timing of the return of confidence, particularly in cases where structural imbalances are also being addressed.

The proposed Supplemental Reserve Facility reintroduces the notion of special charges for high access situations. The size of Fund involvement in recent cases and the higher concentration of its risk of exposure could justify some differentiation in the rate of charge on the use of SRF resources. Nevertheless, the cooperative principle on which this institution was founded remains valid: Fund financing cannot be equated with that of private financial markets as it is guided both by conditionality and by systemic considerations. In addition, a higher rate of charge is not a sufficient condition for inducing the member to treat SRF resources as precautionary or for accelerating the member's return to voluntary private market financing. What is certain is that a surcharge to reflect the loss of market confidence will exacerbate the adjustment costs in the affected countries. Consequently, we could reluctantly go along with the concept but would have difficulty in supporting a surcharge exceeding the lower limit of the proposed range, over the adjusted basic rate of charge applicable to GRA resources. Mr. O'Donnell's proposed staggered surcharge could be more constructive if the concept was conceived in a reverse fashion, namely earlier than expected repurchases rewarded by an incremental step-down in the surcharge. To deal with the risk associated with SRF drawings, we would be prepared to look favorably on the establishment of an additional contingent account (SCA-3) with the possibility of reimbursing the balances accumulated from the proceeds of the surcharge.

More specifically on the paper on Charges on the Supplemental Reserve Facility, we were somewhat surprised that the commitment fee was not considered keeping in mind that the SRF is aimed at restoring confidence rapidly and thus the expectation that not all purchases under the facility would be made. This raises the issue of charges for purchases that are not expected if the facility works as intended. Some clarification from staff regarding the potential contribution to net income stemming from commitment fees on purchases not made after the arrangements expire would be useful. With regard to the service charge, we should keep in mind that the level of ½ of 1 percent was established in the Second amendment under the assumption of "normal" access under then existing facilities. As purchases under this new facility would be expected to be very large, the income to be derived would not be commensurate with its original purpose and ties in to the effective cost of the new facility for the member.

Having said this, we endorse staff's view that use of resources under the SRF would entail additional administrative expenses that should be covered by charges under the facility. Precautionary balances, on the other hand, need to be judged on their own merits, keeping also in mind the Fund's sizable hidden reserves and the significant and increasing opportunity costs of its policy of immobilization. Burden-sharing is a concept that has served the Fund well and that should be preserved.

In closing we support the initiative to give the Fund a clear role in the containment of the consequences of a sharp reversal in private capital flows including for the countries affected through contagion. We fully share Mr. Kafka's comments regarding the Fund's role as lender of last resort and the usefulness of the SDR in that context. We also find it necessary to give further consideration to effective prevention highlighting the importance of strengthening prudential regulations and the scope for Fund regional surveillance. The paper rightly points out that, for members facing risks of a financial crisis, policies designed in the context of Stand-by or Extended Arrangements could be very beneficial as a preventive response. Prequalification was referred to by Mr. O'Donnell as well as Mr. Kiekens and others. This was a feature of the short-term financing facility, analyzed in EBS/94/193, predicated on the notion that pre-announced availability and conditions of use could be more important than actual use of supplemental resources after the fact. In this regard, the linkage to a credible pre-existing Fund program deserves further consideration in order for the new facility to deter contagion for countries that are committed to maintaining open current as well as capital accounts. Lastly, irrespective of the instrumentalities in place, more effective international policy coordination among the major economies is essential keeping in mind the systemic consequences of their domestic policies actions.

The Chairman said that he was interested in Mr. Zoccali's analysis of Mr. O'Donnell's proposal for a graduated scale of charges—particularly his view that the proposal was more punishing than rewarding. He asked Mr. Zoccali and Mr. O'Donnell how the proposal could be modified to make it more rewarding than punishing.

Mr. Zoccali responded that he would start the graduating scale at the lower limit of the range proposed by the staff, and then move the charge down to the uniform rate of charge and access.

Mr. O'Donnell pointed out that there were bonuses throughout his proposal for early repayment.

Mr. Bernes made the following statement:

We welcome the proposal and support it, in principle, for the reasons which have been articulated in the paper itself and which you have spoken and which Ms. Lissakers identified. I think it is an important part of adapting our institution for the evolving realities we face. We also support the broad structure of the facility as is outlined in the paper. Therefore, I will try to make my remarks pointed to the discussion we have had today.

The first point is the question of who should be eligible for this facility. I must say, I agree with Ms. Lissakers and Mr. O'Donnell when they suggest that we must have some reference to the four countries facing a crisis of confidence where there is a threat to the international monetary system or the risk of contagion. Unlike Mr. Kiekens, I do not think this is discriminatory. I think this language, in fact, or something similar, was associated with the decision on the EFM and, in fact, reflects the reality that we are confronting, and being prepared to confront, truly exceptional circumstances, which calls for a response which is differentiated from our normal policies. To that extent, I think it is important, and it is a recognition as well that the Fund does have constraints on the resources available to it.

Secondly, with respect to both the purchase period and the repurchase period, I must say that we would have preferred a shorter period than the year that it is proposed that the window be open. I say "shorter" because I think in most cases where one is dealing with a crisis of confidence one would hope that it is really within that first four to six months that, in fact, that confidence is going to at least begin to be re-established and that the major requirements for purchases would be there. Nonetheless, to give us some flexibility, we are prepared to go along with the one-year period. With respect to the period for repurchases, I must say our preference would be that there be no grace period and that repurchases begin immediately. However, I would be prepared, as some have suggested, to have at least a grace period of six months and then have the repurchases within the following year.

On the question of charges, I think we think that there are a number of reasons why the charges should be higher than is the normal policy. This is not to penalize the country in question. Indeed, one is supporting the country in question in an exceptional way, but I think, because of the concentration of risk, in terms of both the amount of money and the geography, there is a need for a higher charge in order to protect the resources of the Fund. I think, secondly, there is a reason in terms of encouraging countries not to make purchases beyond what is absolutely required. Thirdly, there is a requirement, I think, to encourage countries to make repurchases as quickly as possible. So I think there are a number of reasons to support a higher rate of charge.

I am attracted to both Mr. O'Donnell's and Ms. Lissakers's proposals. We had our own variation, which would have, I think, had the rate of charge increase right from the date of the first purchase, but have that higher rate apply to subsequent purchases as well. I think that, if one combines the O'Donnell-Lissakers proposals, one which is both that the rate increases over time, but also as increasing amounts of the program are drawn down, I think, achieves the same purpose. I would start, I must say, at the upper end of the 200 to 400 range; that is, I would start at 400 and increase perhaps as proposed by Mr. O'Donnell and Ms. Lissakers.

On the uses of the new income, I guess I would agree with those speakers who say that in the first instance they should go into building up our reserves to reflect the much higher risk associated with it, and then any decision on the ultimate disposition of this income should await another date, but I must admit I am very attracted to what Mr. O'Donnell and Mr. Sivaraman were suggesting: that a large part of it perhaps should go to support ESAF-HIPC.

On the question of addressing the problems of moral hazard, which I think we are all very conscious of and support, it is clear that we need to have messages going out to the private sector that they have to play an appropriate role. I am skeptical about building-in conditions, though, at this time, in terms of the new facility. For instance, on not funding all of the capital outflows of private sector rollovers, I think we should recognize by looking at the case of Korea that in the program there was an expectation of a very high rollover on the part of the private sector and that they would play a part. Those expectations have not been totally met, but they are being met in part. I think we all recognize that, in fact, there was no way the Fund could finance the whole private sector role. So the private sector is going to have to play some part. So I think we should not try to build conditions into the facility, but I think we need to follow up on the discussions that Mr. Esdar was suggesting, which indeed the staff has scheduled for early next year. I think that is critical.

Finally, on the question of whether we should put a time limit on this facility, as was suggested by Mr. Esdar. Firstly, I agree with the Chairman that we should not let the best be the enemy of the good. We are moving quickly in special circumstances here, and I think we need to come to some conclusions. To our mind, that means that we do need to review the result of our work. I would suggest that what we do is we schedule a review at an appropriate time, which may be two or three years out, rather than putting a sunset clause into the facility. I think, following the review, one can then decide whether changes are necessary or appropriate.

The Chairman said that he hoped to find common ground among Board members on the matter of a review of the facility. The issues of moral hazard and the private sector's role and contribution to crisis resolution were very difficult to resolve. The Fund must certainly press for private sector involvement, and it must contribute to discussions to secure such a goal. However, beyond that, it was important to recognize that governments must be better informed about such issues and become more proactive in contributing to solutions. It would be unfortunate if, despite the efforts of the Fund to create the SRF, the situation were paralyzed by a lack of preparation on the part of the Fund's shareholders. As a result, the Board would need to be careful to find the appropriate language, knowing that the private creditor-debtor relationship was extremely complicated. No international procedures similar to national bankruptcy procedures existed, and it would take some time to formulate and implement appropriate mechanisms.

Mr. Yao made the following statement:

Mr. Bernes seems to agree with Ms. Lissakers and Mr. O'Donnell regarding the eligibility criteria on the basis that they are consistent with past discussions and that they reflect the exceptional circumstances. On this, I would agree, but we should not confuse this discussion with exceptional circumstances and exceptional countries, because the exceptional circumstances we are talking about here are countries' experiences and balance of payments difficulties due to a large short-term financing need resulting from a loss of market confidence. This is what I referred to as exceptional circumstances. Whether or not the countries are capable of having risk contagion or posing a potential threat to the market, the monetary system, I do agree that is very important, but I would need to look at the broader circumstances.

I welcome today's discussion on the establishment of the Supplemental Reserve Facility, and commend the staff for the excellent papers. In light of the crisis in the Southeast Asian region, the creation of this facility is opportune. Furthermore, the establishment of this facility will provide assurance to member countries liberalizing their capital account that the Fund will provide them adequate assistance when faced with exceptional capital account imbalances. In that regard, I cannot support Mr. Esdar's proposal, in which he states that this facility should be used for countries whose risk of contagion will be of such a scope that a member's balance of payments problem may pose a potential threat to the monetary system.

I share the view that the purpose of this facility should not be to finance capital outflow, but rather to stem such outflow through strong financial and structural programs that should address the core problems, thereby rebuilding the market confidence. I also concur with the view that this facility should not be used in anticipation of a crisis of confidence. In such circumstances, countries should decisively address the underlying problem by implementing appropriate corrective measures in the context of a traditional Stand-By or Extended Arrangement. On the main feature of this facility, I see merit in limiting the time of access to the resources to one year and repurchases beginning after two years.

Regarding the rate of charge, it could be an incentive to early repurchase if it is higher than the rate at which countries can borrow on the international financial market. In that regard, Mr. O'Donnell's proposal is appealing to this chair, except that I would hope that the first repurchase starts, instead of six months, 12 months later.

Regarding the additional income that would derive from the charges from the new facilities, I think it should be used to increase substantially the rate of accumulation of precautionary balance. I share Mr. Sivaraman's view or position on the use of these resources, with a particular emphasis to augmenting the financing of the ESAF-HIPC Trust, which presently needs additional resources.

Mr. Kiekens noted that Mr. Bernes had said that the SRF should be reserved for cases that threaten the international monetary system with a high risk of contagion; he had also referred to the fact that the Emergency Financing Mechanism was also limited to those cases. However, the Acting Chairman's summing up of that discussion read: "A number of Directors would prefer to limit the use of the emergency procedures to situations involving significant spillovers or contagion effects, but most noted that such an approach would unduly restrict the availability of emergency procedures." Moreover, the text of the decision read: "The emergency procedures would be expected to be used only in rare cases that represented or threatened to give rise to a crisis in a member's external accounts requiring immediate response from the Fund." There was no reference to the need that a case threatened the international monetary system or that there was a high risk of contagion in order to apply the Emergency Financing Mechanism.

The Chairman pointed out that, later in the summing up, there was a reference to the fact that the member would need to be faced with a truly exceptional situation threatening its financial stability, and that the rapid response of the Fund was needed to forestall or to contain significant damage to the country itself or to the international monetary system.

Mr. Kiekens stressed that the threat would need to be to its own financial stability. It was not necessary that, under the Fund's emergency procedures, there was a threat to the international monetary system. While the emergency procedures could be used in the event of a threat to the international monetary system, it was not the only condition.

The Chairman considered that, nevertheless, there was merit in the language in the summing up of the discussion on the Emergency Financing Mechanism.

Mr. Esdar said that he looked forward to hearing the views of the Legal Department staff on the appropriate use of the new facility, as the Fund was entering into new territory. The SRF was designed to deal with particular financing needs, against the backdrop of possible exceptional circumstances that might threaten the international monetary system. Such reasoning was behind the substantial financial support assembled to support Thailand, Indonesia, and Korea. Therefore, for reasons of prudence, it was important to limit potential access to the SRF to those countries facing such particular financing needs. Moreover, similar eligibility requirements could be found in the texts of the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB); as there was insufficient support for augmenting the proposed quota increase, it was important to consider the connection between the SRF and the GAB-NAB.

Mr. Kiekens noted that the reference in the GAB to the availability of amounts the Fund can borrow from certain members was limited to a risk or threat to the international monetary system. If a large country required exceptional financing, then the Fund would need additional resources. The policies of the Fund would be unaffected in the event that GAB resources were tapped.

The Chairman said that he agreed with Mr. Kiekens's last point.

Mr. Shaalan stated that he would favor opening up eligibility to the SRF to all Fund members. On the idea of whether factors in considering eligibility were contagion or a threat to the international monetary system, it was important to recall that at the beginning of the crisis in Thailand, it was not clear how quickly the crisis would spread. As a result, if a judgment had been made at that early date, it might have been possible to conclude that there would not be a risk of contagion.

Mr. Esdar considered that Thailand was a good example, because it had been concluded that there was a threat of contagion, first, by using the agreed emergency procedures, and second, by providing a significant amount of access to Fund resources above the normal limits. At the time of the Board discussion on the Stand-By Arrangement for Thailand, he had justified the exceptional financing by noting the potential threat to the international monetary system and the threat of contagion. It was important to recall that there was much flexibility embedded in the formulation of what constituted such threats.

Mr. Kiekens said that he agreed with Mr. Esdar that it would be preferable to have flexibility rather than rigid rules to determine what constituted threats to the international monetary system. However, he remained opposed to limiting eligibility to the SRF to major countries, while excluding small countries.

The Chairman recalled that it had not been proposed to exclude small countries. However, the phenomenon of contagion had not been thoroughly researched, so it was difficult to make definitive statements on the matter. For example, it was possible that two small countries in different parts of the world suffering from a similar financial crisis might present a systemic threat, while a large country facing a similar crisis might not. He concluded that it was important to retain sufficient flexibility in the formulation of the SRF.

Mr. Giustiniani made the following statement:

> Let me start by saying that we strongly support the establishment of this new facility, even though we share some of the concerns expressed by Mr. Esdar and Mr. Kiekens. We have always advocated higher charges for access to Fund resources well above the usual limits, and the establishment of this new facility is a step in that direction.
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> The main advantage of establishing a new facility is to allow us to better tailor the main characteristics of this facility to the particular circumstances in which such a new arrangement is expected to be activated. In particular, it allows us to better price the risk that this institution is taking in cases of exceptional access. However, the envisaged rate financing of the SRF does not eliminate the problem of moral hazard; at best, it may help to mitigate it. As in the case of domestic financial industry, there is obviously a need for striking an adequate balance between ensuring stability and containing moral hazard. It is of paramount importance that neither the debtor countries nor their creditors should be expected to be isolated from the adverse economic consequences of a crisis by the provision of large-scale official financing. In this regard, I share Mr. Esdar's concern.
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> I believe that strong conditionality should be attached to the access to this new facility since the exceptional access to Fund resources is expected to signal to the market the confidence of this institution in the country's policies and long-term

prospects. Drawing under these new facilities must be allowed only in the presence of a strong and comprehensive program, envisaging those measures necessary to tackle the problems that undermine market confidence. It should be acknowledged that the up-front in disbursement should be matched by an up-front in policy action and, consequently, significant prior actions should be envisaged, but appropriate attention should also be given to other ways how to limit moral hazard. Probably some of the concerns and proposals expressed by Mr. Kiekens may warrant deeper thought by the Board.

Turning now to the specific elements of this new facility, as far as the eligibility criteria are concerned, I certainly share the concern expressed by previous speakers in trying to better qualify the terms and the conditions that are expected to trigger this new facility. Probably some wording around that has been used in the GAB could be considered. Probably also the text that Mr. Esdar just circulated may be a better basis for discussion. We can refine that.

As far as the blend of resources is concerned, we certainly agree with the fact that access to the SRF should be associated with either a Stand-By or Extended Arrangement. The limits that are proposed in the decision should be considered as indicative. As Ms. Lissakers said, there should be some expectation that access to the SRF could kick in before the achievement of the usual annual access limits and, in this regard, I would like to ask the staff a clarification on one point. If I understood correctly the decision, the cumulative limit of 300 percent is going to be considered only in the case of a country with outstanding credit and 100 percent should be applied to a country with no credit from the Fund, so I would like to better understand this point.

As far as the rate of charge is concerned, I consider the hypothesis of a spread of 400 points as a floor rather than a ceiling. Such a spread is usually paid by many emerging markets in normal circumstances, and also in the case of Italy under the crisis beginning of 1995 the spread between the Italian T-bills and the bund reached 650 percent so, therefore, the 400 percent spread is really a low limit.

As far as retro charges are concerned, certainly we agree with the proposal put forward by Ms. Lissakers and also Mr. O'Donnell, and probably a combination of the two may be the final result.

On the time structure of the facility, here we have our problem. In principle, I believe that the period during which resources would be made available, i.e. up to one year, is too long. Drawings under this facility are indeed expected to restore confidence and be made in circumstances of liquidity impairment, so we have in mind a very peculiar event that is short term in nature. Consequently, in my opinion it would be more reasonable to reduce the availability period to six months.

However, if I understood correctly, the Fund does not have the possibility, as in typical loans among central banks, to renew outstanding credits when they fall due. If this is correct, I can along with the hypothesis of an access period of up to one year. But, certainly we do not agree on the envisaged repurchase schedule, and we consider this too long. Two reasons induced me to support a shortening of this period. First, Fund resources are limited and, therefore, a rapid reflow of funds has to be envisaged in order to safeguard the revolving character of Fund resources and its liquidity. Second, the imposition of a spread, whatever it may turn out to be decided, on the adjusted rate of charge may turn out not to be such a strong incentive for an early repurchase of the outstanding credit if market rates remain above the one charged by the Fund.

Regarding the repurchase period, I have said that we should consider the possibility shortening this period. Our proposal is in fact to have an early repurchase expectation after six months, while after one year the expectation should be converted into an obligation. But we would also be interested in hearing more about Mr. Bernes' proposal of a grace period of six months, but after that I think the old payment will need to be made. Perhaps something along these lines may be considered, but at this point, this is our position.

As far as the income or the extra income coming from charges of this new facility, we are inclined to consider the option of building up reserves, and here just a couple of numbers. I made some back-of-the-envelope calculations and, according to the staff, the ratio between the precautionary balances and total outstanding credit outstanding is projected to fall from 9.5 to 7.6 percent, and in the period between 1993 and 1997 it averaged 10.3 percent. So, if we want to bring back precautionary balances to 7.6 percent, they have to be increased by roughly SDR 1 billion. If we want to bring them back to the average of 10.3 percent—and obviously this was in normal circumstances, without taking into account the risks that we are considering now, which could also favor an increase in reserves in proportion to the total credit outstanding—would require SDR 1.4 billion.

But, in this case, whether it should be normal reserves or a special contingency account, maybe the first option is preferable. Anyhow, if we are going to consider a special contingency account and what we are going to do with those resources when the need may be over, I think that the benefits should be shared by the whole membership, as Mr. O'Donnell said, and this implies also creditor countries. Consequently, I would be more inclined to reconsider also the policy of burdensharing instead of already committing resources for HIPC or for reducing charges.

The Chairman asked Mr. Giustiniani whether an early repurchase expectation after six months would be realistic.

Mr. Giustiniani responded that, as other Directors had noted, the current crisis was essentially a crisis of confidence, which should be restored rather quickly. Also, very strong conditionality and prior actions should be attached to the use of the SRF, which would enhance the restoration of confidence.

Mr. Morais made the following statement:

The facility that is being proposed reflects the new reality facing the Fund, one in which increased global financial integration has created this situation where emerging market economies are more vulnerable to changes in the behavior of international investors. If the Mexican case were considered an isolated incident, the recent crisis in economies with enviable records of growth and development leaves no doubt that the global financial system has entered a fundamentally new era. The response of the Fund has entailed a strategy based on two pillars: encouraging strong adjustment, and the timely commitment of a large volume of financial support aimed at restoring confidence. The new facility must remain wedded to this approach in order to be effective.

In establishing this facility, it must be clear that the first line of defense against such problems is improved surveillance and the willingness of a member country to implement the required reform. The cooperation of major market participants seems to me an important element in an effort to prevent macroeconomic and structural imbalances from erupting into a full blown crisis. It is less difficult for a country to implement far-reaching reform in a relatively stable environment than when the authorities have to deal with crises of confidence at the same time. Besides, given the morphous nature of market confidence, it is difficult to predict when it will be regained once a crisis has emerged. It is also difficult to predict the recessionary impact of adjustment policies, and much less so what it would mean for future developments in the real sector of the economy.

The staff proposal appears to be a reasonable attempt to prepare the Fund for the challenges of integrated capital markets and free capital movements, and we are prepared to go along with the consensus to establish the new facility. We can also go along with a higher rate of charge. We do not think, however, that a one-year period for repurchase is long enough.

On the use of proceeds accruing from the use of the facility, we are prepared to consider some addition to the Fund's precautionary balances. As other Directors, we also agree that a greater part of the proceeds be used to meet shortfalls in the ESAF-HIPC Trust.

Mr. Fernandez made the following statement:

First, it will be no surprise that I support the proposal and the general features of this new facility. The case for an adaptation of Fund instruments has been made before by several speakers, so I will not come back on this.

As a consequence, although I share the very legitimate concerns of Mr. Kiekens regarding the risk of setting up what could be read as a bailout facility, I do not think the alternative proposal would change anything of the problem. I would therefore rather call for early discussions on topics suggested by Mr. Kiekens and Mr. Esdar, and look for safeguards. I support, in principle, Mr. Esdar's proposal to associate private sector creditors to negotiations in their very early stages in a way to be clarified soon. In fact, in doing so, we would basically resort to the procedures which were called for by the summing up of a Board meeting, putting in place the Emergency Financing Mechanism in September 1995, which stated that, "consultations with key creditors would be initiated at the onset of the emergency."

Regarding eligibility, I also share the view that we should clarify the circumstances in which the facility is activated, and I find the proposed formulations of Ms. Lissakers and Mr. O'Donnell well crafted; this is the proposal related to the threat to the monetary system and the serious risks of contagion. Obviously, the institution of such a facility raises numerous questions. We could debate at length some points made in the paper. For example, the thought that the SRF is put in place only when there is a good chance of a rapid turnaround in confidence, or the thought that the SRF not be used as a means of bailing out private creditors, or many others. More thorough and relaxed discussions will be necessary, and reviewing the facility will be a necessary and crucial exercise. But I agree with Mr. Bernes that this review will be a better means of achieving our goals than to establish such a facility only for two years, as suggested by Mr. Esdar.

Turning now to the specific characteristics of the SRF, I find Mr. O'Donnell's suggestions convincing and I can support them. First, I agree with the staff that this facility should be linked to a Stand-By or Extended Agreement, which should be the anchor of conditionality, and conditionality will have to be all the more strong in such cases. But I am not sure at all it should be granted that the SRF features would only kick in above the access limit. I would favor, like other speakers, flexibility on this matter.

Second, I support the idea of a progressive surcharge. Although I find Ms. Lissakers's second idea interesting—this was the idea of connecting the charge to the size of tranches being drawn; I guess I still have to think a bit about this. The point, I am sure, is that I can support Mr. O'Donnell's proposal, which is illustrated in the chart. This clearly would provide a strong incentive for members to treat access as precautionary and to make early repurchases.

Third, I could go along with a starting point at 400 basis points, which is in fact quite low, and only as far as it is a starting point. I can also support an increase, for instance, of 50 basis points every six months.

Fourth, I can support the availability for one year, a repayment obligation after 18 months, and installments due in the next six months, although this seems to be on the longer end.

Fifth, turning to the issue of the use of the income deriving from the SRF, I agree with the staff that it is desirable to strengthen the prudential stance of the Fund. For this highest priority, the establishment of an additional contingent account could be warranted. Nevertheless, I could also agree that some of the overall increase in revenue deriving from these programs could be used to reduce the basic rate of charge. These two points are perfectly in line with the facility. But I have also some sympathy for the proposal related to the ESAF-HIPC Trust.

Lastly, I would like to state that in our minds an early implementation of this new facility is an integral part of the Korean program.

Mr. Zhang made the following statement:

First, I would like to thank the staff for preparing a paper on the Supplemental Reserve Facility so quickly after the Manila meeting in November. My authorities, in principle, support the Fund in establishing the proposed Facility to provide short-term and large funding to members with the intention of restoring market confidence and stopping further capital outflows. This should also strengthen the Fund's capacity to play a central role in responding to financial crises.

I agree with the staff analysis and assessment on the rationale and necessity for establishing the Facility. The crisis in Mexico in late 1994 and in Asia since August this year have clearly demonstrated both how vulnerabilities can increase so rapidly in the financial sector, and how large, sudden, and disruptive the turnarounds in investor confidence can be. They have indeed created a new kind of problem for the Fund; that is how to help members contain sharp reversals in private capital flows and bring about an early return to normal market conditions.

The Facility is but one of the three pillars mentioned in the Manila Framework to address the currency turmoil problem and restore macroeconomic stability. The first pillar is surveillance. Indeed the Manila meeting explicitly pointed out that surveillance needs to be addressed effectively as soon as possible. Surveillance is a very crucial preventive measure which should help lay a solid foundation for monitoring capital flows and put all of us on the alert with necessary transparency.

The second pillar involves the enhancement of the regulatory capacity and the strengthening of the financial infrastructure. There are already initiatives in the region, and collaborative efforts with the Fund, the World Bank, and other multilateral institutions would certainly be useful and more productive.

The third pillar is the financing arrangement. This pillar is of a remedial nature and, for it to be successful, we must have a good grip on the vexing question of moral hazard.

This is a difficult issue and we cannot avoid the question of how the funds provided would not be used to fund capital outflows or repayments to private sector lenders. If official funds continue to be poured in that allow private sector creditors to exist, there will never be enough official funds. How do we ensure that there is a private sector "standstill" is the key question. For the Fund, and for economies providing supplemental financing, this is a question that would constrain their ability to take part and effectively support the programs. The answer lies in the need for the Fund and other relevant institutions to help coordinate the standstill or rescheduling of debts with private sector creditors of the borrowing member. I agree with Mr. Esdar that the private sector should be included in the package.

Coming back to the staff paper, I concur with the staff that the purpose of the Facility is not to finance such outflows but rather to stop them. The Facility is not intended to intervene with the normal process of bankruptcy and investor losses if banks and enterprises were insolvent. It is indeed important that creditors would have to bear the credit risks rather than relying on bail-out by the official sector. We emphasize that the design of conditionalities should stress improving the soundness of the banking sector, particularly the intermediate role of the banks and strengthening of the legal system, especially the legalities relating to bankruptcies and prudential supervision, to minimize the risks of moral hazard. The importance is not only to help members overcome their current difficulties, but also to build up their capacity to resist attacks in the future.

We can go along with the staff recommendation that conditionality under this Facility would be linked to the conditionality of the associated stand-by or Extended Arrangement. The suggestion in the staff paper of a tight program and additional reviews is a sound one if we want to ensure the success of the program. However, I would caution that we have all learned from the recent Asian experience and the program should take full account of the local situation and the ramifications for other economies. It should avoid an over-kill which would fail to achieve the objective of the program. We would like to urge the staff to work out an optimal level of adjustment and indeed this question has already been discussed in recent revisions of emergency cases.

As the supplemental reserve facility could call for more resources from the Fund and in fact the liquidity ratio has lowered rapidly, we urge an early completion of the eleventh review of Fund quotas. We are pleased that bilateral support has played an important role in dealing with the crisis situation in Asia. However, with the establishment of the Facility it is desirable to have permanent and accountable additional funding. In this context, it is ideal to consider making use of the GAB. In addition, we also urge the faster establishment of the New Arrangements to Borrow.

The paper has argued well on the need for a high rate of charge to provide the right incentive. To facilitate the implementation of the Facility, it might be useful to have unified, standardized, and concrete guidelines on how the actual spread within the range of 200 to 400 basis points above the basic rate of charge would be determined. We believe this could improve the transparency of running this Facility and increase objectivity in determining the charge. It seems appropriate to me that different rates of surcharge should be decided according to the different levels of access in terms of their quota. The staff's elaboration is appreciated.

With regard to the timing of repurchasing as described in No. 6 of the draft decision, we believe that it is advisable to provide a longer duration for program members from what was proposed by the staff which would give a better leeway for the members concerned to effectively adjust their economies. And we believe that the members would certainly lose no time in making advance repurchase when conditions permit, since restoration of market confidence is of the greatest importance to themselves.

On the issue of the impact of additional large income from the Facility on the Fund income position, we would like to underscore the risks involved in this new Facility due to its underlying feature of large amounts of credit and front loading. Therefore, it is imperative to maintain a precautionary stance on the possible large income derived from implementation of the Facility. However, we have also noticed that negotiation of the programs and extension of credits under the Supplemental Reserve Facility-like circumstances added to administrative expenses. It seems to me appropriate and reasonable to conceive that a part of the additional income would accrue to the Fund and would enter into the calculation of the basic rate of charge to achieve the Fund's net income target. The rest would be kept in a contingency manner. We can go along with establishment of SCA-3 if consensus can be reached to that effect. As the staff paper on this issue was made available to us only last Friday, we should give our authorities sufficient time on this important issue and we should avoid making hasty decisions. However, I believe that this would certainly not negatively affect the establishment of the Facility.

Mr. Rouai made the following statement:

The proposal to create a Supplemental Reserve Facility is built, among other things, on two ideas that are previously discussed by the Board, namely the short-term financing facility and the application of higher charges on large-scale use of Fund resources. Our chair supported the former and expressed misgivings about the latter. I view today's discussions from two angles. On the one hand and under the fast track angle, I support the establishment of the SRF to deal with the present case. On the other hand, major issues, including the moral hazard aspect associated with this facility and the role of creditors in similar support operations, remain unresolved and need to be addressed urgently.

Two characteristics differentiate between regular Fund facilities and the SRF, namely, the repurchase period and the applicable rate of charge on which I shall concentrate my comments.

On the repurchase period, while I can support the shortening proposed by the staff, I recommend an element of flexibility in the application of the expectation/obligation nature of repurchases. While one would expect a financial crisis to end after two years, I would like to point out that most, if not all, the recent programs approved by the Board were designed with the expectation that a large part of the initial stock of short-term external debt will be rolled over. A bunching of external debt obligations could therefore occur if Fund repurchases and repayments of short term-debt overlap. This could be amplified if the repurchase period is further reduced as some Directors are proposing, which could add another element of unpredictability and nervousness not helpful to restoring market confidence. For these considerations, I expect that program reviews pay particular attention to the issue of short- term debt with regard to its level, the conditions associated with its rollover, and the need to reduce altogether the reliance on short-term financing.

With regard to the rate of charge to be applied to the SRF, this chair had the opportunity to express misgivings about higher charges for large use of Fund resources. In addition, with the inclusion into the SRF of shorter repayments maturities, the main incentive behind the idea of higher charges, namely early repurchases, has been eliminated. Nevertheless, I agree that large and front-loaded resources create additional Fund exposure to risk. It is with this consideration in mind that I propose the following :

The surcharge, which should be equivalent to 200 basic points, should be calculated over the adjusted rate of charge and not on the basic rate of charge. Borrowings under the SRF will therefore be subject to contributions to SCA_1 and to adjustments for deferred charges. This will allow a substantial increase in the net income target of the Fund and a constitution of added precautionary balances, and will take care of the issue of additional risk to the Fund.

The added resources generated by the surcharge should be deposited in a new Special Contingency Account. Since the reasoning behind the surcharge is to encourage countries to make early repurchases, these contributions should be refunded at the time of the repurchase when the covered risk is no longer there. I cannot support any other use of income derived from the surcharge because the SRF and its income are of a temporary nature and should not be considered as a permanent source of financing for the Fund. This is particularly true with regard to the use of the added income for the ESAF-HIPC financing.

Such decision will certainly further discourage bilateral contributions. In addition, the experience of SCA_1 and SCA_2 shows that it is rather difficult to reach a conclusion that the resources in these accounts are no longer needed in order to be used for other purposes. Mrs. Lissakers's and Mr. O'Donnell's proposals regarding the rate of charge and the structure of the SRF are risky. Let me take the case of a country with an SRF, combined with an Stand-By Arrangement or an EFF, and suppose that six months later market confidence and access are restored. Under normal circumstances, like in the Mexico case, the country will refrain from further purchases. However, if we apply a gradual structure of changes to the SRF, we may encourage the country to continue its purchases under the Stand-By Arrangement/EFF in order to repay the more expensive purchases under the SRF. On the issue of a separate facility versus a window within an arrangement, I would like the staff to confirm my reading of footnote 17, which covers Mr. Kiekens's proposal of not to have a separate facility, but a window within a Fund arrangement. If I am correct, higher charges, except in a refundable form, would not be available.

On other technical aspects of the SRF, this facility is built on the assumption that financial crisis include two elements: an underlying BOP need, which should be financed by regular Stand-By Arrangement or EFF; and a short-term financing need resulting from the loss of market confidence to be financed by the SRF. However, the staff report is not clear on the phasing of the financing between the two elements. There is a concern that there will be a tendency to reduce the regular Fund financing and to augment financing under the SRF since the latter is more advantageous to the Fund with regard to higher charges and short repurchase period. In order to introduce an element of objectivity, the underlying BOP need should be fixed at the level of the annual access under the access limits policy. This level is now 100 percent of quota. All other resources provided by the Fund beyond 100 percent of quota will be financed under the SRF.

Although it appears that the SRF is not designed to include ESAF-eligible countries, there are clearly some ESAF-eligible countries who share the characteristics of SRF-eligible countries.

Turning now to the remaining unresolved issues, the application of higher charges and shorter repurchase periods constitute only an added cost for the eligible countries, but it is not clear that they constitute a strong enough insurance against moral hazards risk. It is important to reduce the risks for countries confronted with problems associated with shifts in market confidence. In this context, there are two steps the Fund could take. One, since short-term external debt seems to be the one common element at the origin of the crisis and for the determination of the access under the SRF, the amounts to be used should be those communicated to the staff at the occasion of the latest Article IV consultation. This will encourage countries to pay close attention to the evolution of this aggregate. Once transparency is assured, the Board will have the opportunity to better assess the risks associated with short-term debt and recommend appropriate actions. The second common characteristic to the recent country crises is the rapid loss of market confidence, in particular when the real extent of the crises is exposed. One remedy is to urgently strengthen the work on adherence to the SDDS by emerging economies and to strongly encourage the publication of PINs.

Mr. Cippa made the following statement:

We consider the proposed new short-term financing facility a potentially effective way to respond to crisis situations characterized by liquidity shortages due to capital outflow and loss in market confidence. As the financing need of emerging countries facing a crisis is mainly short term in nature, the argument goes that in such circumstances the Fund should not extend credit under stand-by or Extended Arrangements since their terms and access limits were not designed for that purpose. In our view, this argument needs to be judged against equally well-founded concerns about market incentives and, in particular, about the signaling effect of formalizing the extensions of credit in situations which, until not so far ago, were deemed exceptional. With Mr. Kiekens's word, we must avoid that access to the new facility becomes routine.

Events are pressing for a swift decision. We fully understand this, and in accepting to decide today, like Mr. Esdar, we are willing to take considerable risks. But we must also be aware that there are fundamental issues involved which would have required further considerations. Moral hazard and the role of the Fund as lender of last resort are among these issues that would have required a more detailed discussion prior to the establishment of the facility. For these reasons, we think that the new facility should be created for a limited period of two years, after which a review should take place. A continuation of the facility should be made subject to the assessment made at the time of the review.

Furthermore, I fully share the urgency of exploring ways to involve more actively private sector operations in this kind of exercise. If very high access is warranted to counter a systemic risk, it should be coupled with the appropriate stringent conditionality and payment modalities. There must be a strong adjustment program combined with an exceptionally high rate of charge.

We are in favor of a substantial interest premium with a rate of charge of at least 4 percent above the SDR basic rate of charge. Even though this might still be rather low under the circumstances, the incentives are thus set for early corrections of misguided policies and for the intended early repurchases. As regards Ms. Lissakers's proposal to link the rate of charge with the size of the loan, I think we could go along with that. I see Mr. O'Donnell's proposal more difficult to implement.

Concerning the size of purchases under the new facility, we agree that setting specific access limits linked to quotas may not be appropriate in dealing with confidence crises. However, it is also clear that the Fund's involvement cannot be without limits. The protection of Fund resources is crucial to us and we would expect that no decision will be taken that would put at risk the financial solidity of the institution. A point we would like to stress is that the Fund should not be obliged to finance a large and sustained capital outflow. If market confidence cannot be restored within a short period of time and outflows cannot be reversed, other measures perhaps consistent with Article VI of the Articles may have to be envisaged.

On maturity, we do not see why repayment of credit within a shorter time frame than two years cannot be envisaged. Essentially for the same reason expressed by Mr. Giustiniani, we are in favor of repurchases beginning after one year with the maturity of the outstanding loans shortened accordingly. There should also be a well-defined deadline by which purchases are expected to have been made. The proposed mechanism of initially formulating an expectation is not appropriate for the intended short-term purpose of the facility. We also support the fact that the new facility is envisaged to be available only for one year following the approval.

The use of the new facility will undoubtedly contribute considerably to the net income of the Fund. In this respect, we do not think it to be wise to lower the rate of charge on the use of other Fund resources. This compensation for additional income would amount to cheaper Fund support for other, more traditional debtors. It is not clear what the incentive effect of such a constellation would be. Using the additional income to help finance the costs from persistent overdue obligations amounts to using highly variable income for special use. Alleviating the burden on both creditors and debtors who up to now shared in financing the cost of overdue obligations will also take some peer pressure from those members in arrears toward the Fund. For these two reasons, we can support this option.

In discussing the status report on the options for financing the ESAF and the HIPC Initiative last November, we have already made clear that we oppose financing the administrative cost of conducting the ESAF-HIPC Trust with the Fund's net income. Using the additional income from the Supplemental Reserve Facility for this purpose would again amount to exactly the same. There is no evident connection between the SRF and the ESAF-HIPC Trust. Furthermore, such financing would not contribute to transparency of the cost of the ESAF and HIPC Initiative, either.

Since the Fund evidently incurs additional risk in extending large-scale support, there is an evident need to bolster precautionary balances. Therefore, we consider it natural to use the additional income of such risky arrangements for the accumulation of necessary additional reserves. We do not see, however, why the additional income should be paid into a special contingency account. As long as the SRF remains established, additional reserves will remain necessary to cover additional risks. The balance of such a special account could therefore never be reimbursed. For this reason, we would not support holding such additional reserves in a special contingency account.

Mr. Shaalan made the following statement:

In accordance with your wishes I shall put aside my prepared statement and concentrate on the various practical issues before us.

First, we support the proposed new facility which aims at larger access and a shorter period of repayment and higher charges. This appears to be an appropriate response to the new environment we find ourselves in.

On eligibility, of course the facility should be open to all members , while in practice it will be used mainly by emerging market countries. We would not, like Ms. Lissakers, link it only to situations where there is a threat to the monetary system or the risk of contagion. In addition to the reservations expressed by Mr. Kiekens in this regard, this will just add a new operationally difficult dimension. Here, we would appreciate staff confirmation that establishment of this facility will in no way jeopardize the existence of the exceptional circumstances clause.

On access limits, we agree that there should be no access limits. The facility would be make resources available for one year, but we can be pragmatic about that.

On conditionality, we agree that it should be based on the conditionality of the accompanying Stand-By or EFF arrangement.

On the repurchase period, we have no problem with the staff proposal. That is, repurchases are to begin after two years and should be completed in four quarters thereafter. We would have no difficulties with Mr. O' Donnell's proposal of graduated charges related to the period the credit is outstanding, provided that they would start at the lower end of the 200 to 400 basis points range. We also could support Ms. Lissakers' proposal relating the charges to the size of the drawings, depending on the position of the legal counsel on its feasibility.

On the rate of charge, for the variety of reasons cited by many speakers and in the interest of promoting the revolving nature of the Fund's resources, we would be inclined to favor the higher end of the proposed range , only as an outer limit.

Finally, we thank the Treasurer and his staff for the excellent paper they have provided us, on such short notice, on the possible treatment of the income to be generated by the new facility. Clearly there are a number of important issues involved here. We would, however, suggest that for today's discussion we limit our consideration to the issue of what to do with the income to be generated from the surcharge to be added to the basic rate of charge, since this is the only new dimension that arises out of the establishment of this new facility. Doing so would, in effect, mean the adoption of staff's alternative (ii) in Table 2 on page 6 of EBS/97/234. Thus we are of the view that we should include the proceeds of the service charge and of the margin between the rate of remuneration and the basic rate of charge when estimating net income and when determining what the rate of charge coefficient should be. In the usual manner, at the end of the year any excess income should be used to reduce the rate of charge coefficient.

The question that would then remain for consideration today is what to do with the proceeds from the surcharge. In our view, we should discard the third and fourth options presented by staff which have to do with reducing burden sharing and with ESAF/HIPC, simply because it would be very much a case of mixing apples and oranges, and would further complicate Fund finances and make them even less transparent than they are at present. We can see merit in using the proceeds to enhance the Fund's precautionary balances and remain open to either placing them in a separate contingent account or adding them to the Fund's General and Special Reserves. We would appreciate further clarification by staff on the advantages and disadvantages of each of these two alternatives.

To conclude I would like to support Mr. Kiekens' statement on the need to get back to emphasizing the prevention of crises. As the major international financial institution entrusted with safeguarding the stability of the world's financial system, it is incumbent on the Fund to focus its attention at this stage on the increasingly evident dangers of premature capital account liberalization not only to the domestic economies in question, but to the global economy as a whole. So far we have given increasing prominence to the potential gains of capital account liberalization. We must now place increased emphasis on identifying the preconditions for safe liberalization, as well as on the conditions that would help minimize the risks of contagion when crises do erupt, as they inevitably will. We therefore look forward to more work by staff in this direction. Such work is the necessary complement to the initiative before us today. Today's proposal is aimed at containing the damage of crises after they occur. We must simultaneously seek to improve the global financial system to minimize the incidence of such crises.

Ms. Lissakers considered that, with regard to the pace of capital account opening, if one looked at the concentration of financial flows to Korea in the interbank market and other short-term flows, one could see an example of the dangers of tardy capital market opening, not of premature opening. That was further underscored by the fact that the Korean authorities themselves recognized that accelerating capital account liberalization was part of the solution.

The Chairman considered that both Mr. Shaalan and Ms. Lissakers would agree that an orderly capital account liberalization was desirable.

Mr. Shaalan said that he did not fully agree with the Chairman's characterization of his position. It was important not to lose sight of the fact that hasty capital liberalization, without a highly developed and regulated financial market, could be a danger. He said that he would return to the matter later in the current discussion.

The Chairman considered that Mr. Shaalan would agree with the assertion that, in the case of Korea, at least two things had been at the root of the problems: insufficient and inappropriately sequenced capital account liberalization, and an extremely weak financial system. Those two elements of the current problems had to be corrected.

Mr. Zamani added that the reputable foreign banks that had become engaged in Korea should have been able to ascertain the full extent of the emerging problems; the blame for the current crisis could be spread more widely than just the Korean authorities.

Ms. Lissakers said that she agreed with Mr. Zamani's comments; the home country regulatory authorities of the banks that had provided the financing flows also had to improve their operations.

The Chairman said that he also agreed, and that not enough attention had been paid to the work of such regulatory authorities in the recent past.

Mr. Wijnholds made the following statement:

Before turning to the features of the new facility, I would like to take a step back and look at the Fund's approach to crises. In my view, it takes three things to be an effective crisis manager: strong prevention mechanisms, mechanisms to rapidly mobilize large-scale resources, and mechanisms to limit moral hazard by ensuring appropriate burden sharing. These three parts need to be balanced. We have to ensure that the Fund is taking a balanced approach in this respect. I would have therefore strongly preferred to discuss the issue of a new facility in the context of a more fundamental analysis of our approach to crises.

I am concerned that markets could interpret the proposed decision as a signal that the Fund now has a special 'bail out facility', and that the Fund is letting investors off the hook. The Thai program did discuss a lot of burden sharing issues, but it is much less emphasized in the Korean program. Let me stress that when I talk about burden sharing, it is not only the effectiveness of bankruptcy laws and the design of financial restructuring that I have in mind. Moral suasion with respect to continued participation of banks in extending credits, which could well be in their own interest, is another element. Also, a general standstill on certain payments, followed by negotiations with foreign creditors, is an option under certain circumstances. Indeed, this is an option that deserves serious consideration, as was stressed in the 1995 G-10 report. In this light my Dutch authorities and I are very disappointed about the time it is taking for us to discuss the recommendation from the same G-10 report to extend our lending into arrears policy. I hope this discussion will not be postponed any longer. In addition, it would be useful to have a discussion exclusively on the issue of moral hazard and burden sharing. This should include a discussion on the effectiveness of bankruptcy laws, burden sharing in financial sector restructuring, how to orchestrate a standstill and the use of moral suasion to ensure roll-overs.

The staff paper before us mentions that an adequate burden sharing will be a point of attention in requests for support under the new facility. However, staff suggests that the possibility of a debt restructuring will only be considered at a later stage, if the large financing package fails to placate the markets. To ensure fair burden sharing, the SRF document should have contained a complete description of how private creditors will be treated. I would also leave the option open to use moral suasion or a standstill from the start of the program. The argument that we should not interfere in commercial decisions strikes me as rather awkward. If this really would be our philosophy, it seems to me that we should not provide any assistance.

There are obviously attractive elements in this new facility. There is no doubt in my mind that it is appropriate to put a higher charge on these large packages, and to shorten the repayment period. However, I wonder whether there really is a need for a new facility. As Mr. Kiekens argued, higher charges and shorter repayment purchases seem also legally possible under our current facilities. I would be interested to hear the Legal Department's views on this. Footnote 17 on p. 11 does not seem to tell the whole story. My preference is for a solution as proposed by Mr. Kiekens, i.e., a system of differentiated charges, say beyond the ceilings under our present access policy. Nevertheless, I would like to express my views on the features of the SRF proposal.

First, I would favor a surcharge of 400 basis points. Many emerging markets already pay such spreads in normal times. If the idea of the surcharge is to induce countries to return to the markets as soon as possible, anything below this level will be ineffective. I am also attracted by the suggestions of some Board members to increase the rate of charge as the time outstanding rises.

Second, I am presuming that the establishment of the new facility does not mean that the Fund no longer has a catalytic role. The lack of clear access limits under the SRF could give the wrong impression here. I wonder whether some check could be built in that precludes unlimited use of Fund resources. Fund participation should be part of a concerted effort to address a crisis, with support from other sources and appropriate burden sharing. I therefore strongly support the addition of most of the language proposed by Mr. Esdar to be added to the decision. Here I would propose to use the language utilized in the summing up by the Chairman on the Emergency Financing Mechanism: "to contain significant damage to the country itself or to the international monetary system ..."

Third, given the special circumstances under which this facility will be used, perhaps we should look at some special conditions, as well. One condition could be that the Letter of Intent is published. This would allow for maximum transparency and accountability. Another condition could be that there is a minimum period for the negotiation of an SRF-supported program. This could deter countries from waiting until the last moment, and guarantees the staff some time to put a program together. As we saw in Korea, the marginal return of an additional day in terms of the quality of the program can be quite high in the initial one or two weeks.

Fourth, I have a real concern about the implementation of a program when we frontload money and backload the implementation. This is partly inevitable in these operations, but we should use our financial leverage to the maximum extent. Therefore, I would prefer to have a staggered approach to the first tranche, as we are doing in Korea—rather than only one or two tranches.

Fifth, I would prefer to have a repurchase obligation rather than an expectation which can be changed into an obligation by the Board. In addition, the proposed two-year grace period seems to be more than adequate—and as others, I would prefer a shorter repayment period.

Sixth, I would favor that the bulk of additional income of the SRF purchases goes to precautionary balances, reflecting the risks that accompany very large access to our reserves.

Seventh, I support the German proposal for limiting the validity of the decision to a two-year period.

Finally, if there is to be a press release after this discussion, I would find it very important that we stress that the Fund will also pay attention to issues of burden sharing and moral hazard when applying this facility.

The Chairman said that he agreed in particular with Mr. Wijnholds's point on encouraging countries not to wait until they were in the midst of a crisis to come to the Fund for assistance. It would be useful to hear Directors' views on how to make such a procedure operational.

After adjourning at 1:10 p.m, the meeting reconvened at 2:30 p.m.

Mr. Guzmán-Calafell made the following statement:

Against the backdrop of an increasing integration of capital markets worldwide, and the dominance of capital movements in balance of payments transactions, the economic crisis that emerged in Mexico in 1994 and several Asian countries in 1997 has posed new challenges to the Fund. A number of adjustments have been introduced to Fund policies and procedures to enhance the ability of the institution to meet these challenges. These adjustments have gone a long way toward achieving the intended results, as evidenced by the impressive speed with which the recent Stand-By Arrangement with Korea was concluded. Nevertheless, it is clear that we must continue to look for further improvements in the operative framework of the Fund to allow the institution the capacity of response which is needed under the present conditions of the world economy. In this context, today's discussion is welcome. Let me say at the outset that I agree that there are grounds to support the creation of a special facility aimed at dealing with short-term financing needs resulting from sudden shifts in market confidence and reflected in pressures on the capital account. The recent experience suggestions that these may be frequent features of economic crises under among the Fund's member countries in the coming years. Therefore, we have to equip the Fund with the tools needed to react very rapidly in response to external problems originating the capital account, and be ready to accept that in the future, the provision of financial support beyond current access limits will tend to lose its existing exceptional character.

As evidenced by the comments of previous speakers, it is far easier to agree with the overall idea of a facility of this nature than with its specific features. Obviously, in delineating the latter, we must be guided by the need to ensure that the creation of a new facility represents an improvement over existing policies. With this in mind, I would like to concentrate my remarks on three issues. The financing of underlying versus short-term financing needs, the repurchase periods and the use of a short charge on the rate of charge on the financing for the under the new facility.

The staff notes that financial crisis may comprise two components, an underlying balance of payments need and an additional and often larger short-term need in that in view of the different characteristics, it is appropriate to separate their financing while keeping both in a common adjustment program. I agree with the rationale that supports this idea, but it is not very difficult to see that in practice it would be very difficult to calculate with certainty the specific amount of financing that would need to be devoted to either of these components. Furthermore, an attempt to make calculations of this nature is likely to raise issues of uniformity of treatment given the different costs involved in the use of one sort of financing or another. For these reasons, support under the supplemental reserve facility must always be accompanied by the maximum financing available for the member country under Stand-By or Extended Arrangements in accordance with the annual or cumulative limits.

According to the staff, the new facility would be used only in circumstances where there is a good chance of a rapid turnaround of confidence. Therefore, it makes sense to think about somehow short repurchase periods. However, I have some concerns. As noted in the report, the exact timing of the return of confidence is uncertain, and may vary substantially from one country to another. Furthermore, a significant portion of the external financing obtained by the member country from other sources to face the crisis will normally mature in the short term and may coincide with repurchases to the Fund, thus raising the danger have a concentration of amortizations and renewed payments problems. If this is the case, shortening the repurchase period would be self-defeating. Two recommendations emerge with these elements in mind. First, heeding the staff's call for flexibility in deciding the timing of repurchases is essential and this flexibility should also apply to the availability of access under the supplemental reserve facility.

Prudence suggests the adoption of a repurchase period of three years with quarterly installments commencing two years from the date of each purchase. As proposed by the staff, the latter should initially comprise an expectation which the Board could extend before being replaced by an obligation.

Let me turn now to the proposal to set the rate of charge 200 to 400 basis points above the rate of charge applicable to the use of general resources account resources. The staff argue that the higher rate of charge is justified by, one, the incentive it creates for the member to treat available resources as precautionary; two, to make early repurchases when conditions warrant; and three, as a means to compensate the Fund for the additional exposure to risk resulting from these operations. I understand the concerns behind these arguments, but the use of a higher rate of charge to face them raises a number of question marks. Let me mention a few.

This measure magnifies the external burden and therefore complicates economic adjustment for those countries facing the most serious payments problems. It is fair to ask if this is consistent with the cooperative nature of this institution. Moreover, many of these countries will either face extreme difficulties to obtain external financing or simply lose access to private capital markets for some time. Under these circumstances, they will tend to use financing available at any cost, and therefore they will not there will not be main many incentives to treat Fund resources as precautionary even under a higher rate of charge.

The measure is intended to compensate the Fund for the additional exposure to risk, but in fact by complicating the member country's payments problems, it increases risks to the Fund. There is also an inconsistency in arguing a higher risk to the Fund and simultaneously expressing the expectation of a rapid turnaround of confidence in these cases. It is true that a higher rate of charge may provide incentives for early repurchases. Nevertheless, given its other adverse effects, it is far from clear that this is the best way to achieve this objective. We have an early repurchase policy and we are going to discuss it at the Board in the short term. If we have reasons to believe this policy is not working adequately, we should search the means to enhance its effectiveness. In addition, if the higher rate of charge is going to encourage early repurchases, I wonder why do we need to shorten the repurchase period and conversely, if we introduce shorter repurchase periods, why do we want to encourage early repurchases? There is also a danger that the introduction of higher charges will encourage other creditors to increase interest rates on financing granted to the affect the member country. Notwithstanding these shortcomings the Board decides to introduce higher charges for financial support provided under the SRF, we should seek to inflict the least possible damage to the borrowing member countries and therefore set the rate of charge at most at 200 basis points above the basic rate of charge applicable to the use of general resources account resources under other facilities and policies. I agree that the working of these and other features of the supplemental reserve facility should be subject to periodic review by the Board.

I do not support the introduction of a graduated charges. I may be wrong, but I believe that there is a direct relationship between the amount of resources a country is using and the magnitude of its economic problems. I am also tempted to think that if a country extends the use of Fund resources over time, this will be because its economic situation is worse than anticipated. I fail to see the logic for adopting a policy that increases the costs of adjustment in parallel with the seriousness of the economic situation, particularly considering that our early repurchase policy should provide margins of safety against possible abuses.

Let me now say a few words on the use of income deriving from credit under the new facility. I believe that we cannot be but consistent with the principles leading to the introduction of a higher charges for the SRF in the first place. According to the proponents of the higher charges, one of its main merits is that it compensates the Fund for the higher exposure to risk. It is only logical, therefore, to allocate income derived from the surcharge to the Fund's precautionary balances. Since this is a cooperative institution, the best way to accomplish this objective is by holding these precautionary balances in a new, special contingent account and once the risk for which the contingent ESAF was established disappears, any balances in the account should be returned to the members who paid the surcharge. In addition, since as explained by the staff the operation of the SRF adds to administrative expenses, a part of the additional income generated by the new facility must enter into the calculation of the basic rate of charge. Any remaining amounts could be used either to reduce further the rate of charge, or to help finance the present burden sharing arrangements.

Mr. Vernikov made the following statement:

The new facility is needed to deal with rapid and significant swings in market sentiments. I tend to agree with the staff that it is imperative that the Fund itself is able to provide not only its expertise and opinion on the market developments, but necessary sizable assistance as well. I see merit in separating medium- to long-term assistance provided through EFF and/or Stand-by arrangements from essentially short-term funds needed to deal with overreaction of the markets. At the same time, I should note that it would be preferable to have in the staff's paper a menu of options. The staff could pay more attention to alternative solutions and, in particular, to the windows approach.

As for the timing of purchases and repurchases, front loading of disbursements is probably inevitable. Otherwise, the facility can not be operational. One year is sufficient time to access the new facility. Although all of us would prefer to ensure early repurchases, I do not see an adequate mechanism to enforce them. We probably need to limit the time of the use of resources under the new facility. Concentration of repurchases in the third year seems to be appropriate.

The level of interest rate to be used in a new facility is obviously a matter of disagreement.

I would like to point your attention to what the staff says in section II, paragraph 6 of the paper on charges, on "the progression of charges both with increasing access and over time ... the Fund's charges not only were difficult to understand and lacked transparency, but also did not appear to contribute to avoidance of prolonged use of Fund credit as had been intended." In light of this previous experience, the Fund should not be overly optimistic regarding the stimulating power of the higher rates of charge.

Overall, I share the reasoning presented by Mr. Guzmán against the high rates of charge.

There is also a trade off between the shortening of the time for the use of resources, on one side, and the rate of charge, on the other. A shorter time limit decreases the need for surcharges.

Like many of my colleagues, I favor a lower and nongraduated rate of charge. As a compromise, why don't we start with a zero surcharge for six months and then use graduation as proposed by Mr. O'Donnell?

In any situation, there will be significant income generated by the new facility.

I support the staff's proposal to use such income for a reduction in the general rate of charge and for the changes in the burden sharing mechanism.

I do not favor the establishment of the SCA-3 account since such accounts are hard to deal with. Our experience with the SCA-2 shows that the process of liquidation is lengthy and cumbersome.

I consider it inappropriate to use the additional income for financing of ESAF-HIPC.

Finally, I think we should respect our decision to dispose extra Fund income retroactively at the end of 1998 financial year.

Mr. Yoshimura made the following statement:

In response to the new types of economic problems that we have faced in Mexico and Asian countries, the Fund should be well equipped with appropriate tools to effectively discharge its duty. In this respect, in recognition that the Fund has been faced with difficulties to cope with the new type of problems that are mainly caused by the loss of market confidence, the paper presents a useful basis for creating a new facility for the Fund to fulfill this task. I appreciate the staff's effort to present before us the well-documented paper so swiftly on the possible framework of the new facility which the staff calls the supplementary reserve facility. I broadly agree with the framework of the Supplemental Reserve Facility proposed in the paper, but let me add a few words on the framework of the SRF.

On the rate of charge under this facility, the paper proposes that it be set 200 to 400 basis points higher than the adjusted basic rate of charge. Within this range, while it is a reasonable argument that higher charges will provide more incentive to repurchase earlier than scheduled, our position is more inclined to the lower end of the range as we believe that the lower end number could do the job and facilitate the early repurchase. However, considering that it is most of the important for us to reach a common understanding as to the appropriate structural charge, I can be flexible on this point and hope the reasonable solution that could be supported by a wide range of chairs will emerge as a result of our discussion today.

On the threshold that the SRF will kick in, I can go along with the staff's proposal. However, I would like to refer to the fact that in the case of Korea, the reason why the access was exceptionally high was partly due to the fact that there was considerable divergence between the calculated and the present quota shares. If the present quota of Korea had been along the lines with its calculated quota, the access of 500 percent of quota, as was the case of the Indonesian program, would have resulted in the financing of $16 billion.

As many Directors already mentioned, it is very important for us to make utmost efforts to minimize the problem of moral hazard. In this respect, it is also important to find out appropriate solution in the question of the proper burden sharing among creditors, including private creditors. Since I understand Mr. Esdar's proposal to include some sentences in the first part of the decision is based on the consideration to this effect, I support the most of the sentences proposed by Mr. Esdar, but I am a bit skeptical in the appropriateness of including in them specific references such as standstill or limiting the financing to be provided the Fund to the member's short-term interest liabilities because these specific references might lead to a negative response from market participants if our position is known to them.

On the capital account convertibility discussion, as this chair has emphasized in previous discussions, I also feel that the pace and the sequence of liberalization must be carefully examined, learning the lesson from the recent experience in Asian countries.

On the question of how to deal with additional income deriving from the extension of the credit under the SRF from FY 1999, I think we should not rush to the conclusion considering that the wide range of issues are involved in finding the answer to this question. Moreover, I understand that there are strong assumptions that the credit under the SRF should be repurchased very early and Korea as a possible first beneficiary of the SRF has a good chance to actually repurchase very early, which will have a large impact on the income from the use of the SRF. It would take some time for us to have a good understanding on how the purchase and repurchase under the SRF will be made. Thus, I am of the view that we should revisit this question at a later stage. In the same token, I think the staff's proposition to reserve judgment on the use of income from the SRF in fiscal year 1998 is a sensible one, and support the idea that income deriving from the SRF for the time being should be kept in the new contingent account.

Having said this, I just mention the one option which was referred to in the staff paper. The option to use the additional income from the SRF to cover the ESAF-related administrative costs does not appear appropriate for the same reason stated by Mr. Cippa.

Mr. Zamani made the following statement:

I do welcome the staff paper on the Supplemental Reserve Facility (SRF), and wish to thank the staff and management for the very adequate treatment in response. To a great extent I do believe that the facility meets the request of the meeting of ASEAN or Asian finance and central bank deputies in Manila. The SRF has been designed as short-term and quick-disbursing financing facility to augment an exceptional Stand-By or Extended Arrangement. This new facility is required in the light of the globalization of financial markets and increased scale of private capital flows. It was proposed in the paper that the Fund would provide resources to such a facility only in the context of an overall financial package involving other lenders. In this connection, my authorities believe that the Fund and other multilateral institutions should provide the first line of defense while other bilateral or any other lenders could still provide the second line.

The authorities also emphasized that the importance of ensuring that this facility is not a substitute for any regional facilities which could play an active role in augmenting the Fund's resources. This is with a view that the delayed stability of the New Arrangements to Borrow, as well as the implementation on the latest quota increase.

On the activation, we recognize the importance of an appropriate adjustment program to restore confidence while the country in need of large short-term financing to forestall capital outflows may not have balance of payments problems that require more medium-term credit tranche resources. However, we are not certain if this facility should replace the exceptional circumstances clause. This clause would, in effect, subject the country with large financing of balance of payments need to access limits while access to this new facility is subject to a penalty rate of charges, thus making use of member countries worse off. Though there can be a penalty rate, we agree with the suggestion that the Fund lower the proposed interest charges of 200 to 400 basis points above the basic rate, and then apply a graduating rate to encourage early repurchase or discourage longer use. We are prepared to quickly look at the detailed suggestions on charges and repurchase schedules.

On conditionality, we are of the view that for the country already under the Stand-By Arrangements, no additional conditionality should be imposed, although drawings may be subject to more reviews and higher intensity of data provision. Our rational is that the facility is meant to serve as a lender-of-last-resort, and thus is subject to a penalty rate of charges. Moreover, the present Stand-By Arrangement conditionalities are already stringent and comprehensive, more than those in the past.

At this juncture, I would like to touch on something more general. In the past, perhaps prior to the Mexican crisis, the Fund was mainly preoccupied with problems associated with the external current account and public finance. Since the Mexican crisis, though, the Fund had been faced with more and more problems associated with capital flows, mainly generated by the private sector. At the request of several member countries, the Fund is also currently looking into hedge fund activities as well as excess market dynamics. What all this entails is that the Fund is involving itself more in addressing problems generated by the private sector. It is timely, therefore, for the Fund to look carefully at its programs and create the current costs as to their appropriateness and their adequateness, as well.

On the treatment of income generated from the facility, our preliminary view is that the additional income should be first channeled into a new contingent account. We have noted the various suggestions on the use of the additional income arising from this facility. I believe, however, that there is less urgency to resolve this matter at present. I would suggest that the appropriate usage of the cumulative income should be discussed and decided a bit later on.

Mr. Al-Tuwaijri made the following statement:

Let me start by thanking the staff for this informative and timely paper. With increased globalization of financial markets and the major role of capital flows in today's economy, the Fund needs to put in place a specific facility to address crises initiating from shifts in such flows. Therefore, I can support the proposed supplemental reserve facility which is designed with this in mind.

The higher access to resources and the front-loading of disbursements under the facility are more suited to addressing crises of confidence and associated capital outflows. The specific feature proposed for the facility are also acceptable. The staff makes a strong case for shortening the repurchase period and for raising the rate of charge above the basic rate applicable under Fund facilities. As for the level of the surcharge, I believe that 200 basis points are sufficient to achieve the desired results. I could also support a graded approach similar to the one suggested by Mr. Sivaraman this morning. As for the repurchase period, as described in the decision, the shorter period for repurchases appears to be more in line with the purpose of the facility.

In view of the importance of maintaining the catalytic role of the Fund's financing and its revolving nature, provision of resources under this facility should only be undertaken in the context of an overall financial package where resources from the Fund are substitute but not the major share. Private investors should be expected to participate in those financial packages, as mentioned by Mr. Esdar this morning. Otherwise, the establishment of this facility could signal to the market that provides private investors will be bailed out in the future.

On the use of income from credit extended under the facility, I will make two very preliminary remarks.

First, the proceeds of the service charge and the regular income on credit extended should be treated like proceeds from any other facility, and therefore enter in the calculation of the basic rate of charge to achieve the Fund's net income target.

Second, the proceeds from the surcharge could go, first, to strengthen the reserve position of the Fund, and second to augment the financing of the ESAF and HIPC trust through the payment of the general resources account fees fronting the trust, and third to defray part or all of the costs of burden sharing.

Ms. Srejber made the following statement:

The recent financial crisis in Asia has demonstrated that there is a case for setting up a supplemental reserve facility in order to strengthen our response to such crisis situations. While one could argue that a supplemental facility is not really needed because Article V, Section 4, allows the Fund, at its discretion in cases of very high access, to set any terms and conditions under existing facilities in order to safeguard its interests, there may also be a case for establishing a standardized instrument which can be implemented swiftly and effectively in response to adverse market developments. On balance, a standardized instrument, whose terms and conditions are clear and transparent, may be the best solution. Nonetheless, moral hazard might also emerge as market participants might start pricing potential rescue operations into their risk profiles. Policymakers might also start developing complacency toward risk if they can count on rescue operations. I think the only reasonable way to deal with this problem is to set tough terms and conditions, particularly short duration, high interest rate margins and frontloaded conditionality, to encourage an early return to market financing.

The explicit objective of the SRF should be to provide exceptional financing with tough conditionality in order to restore market confidence, based on the view that strong policy implementation is a necessary companion of exceptional financing. The staff proposes that conditionality be limited to the underlying Stand-By or Extended Arrangement, but I am not sure why we cannot allow conditionality to be linked to the SRF at least in the form of prior actions. I can accept that the Stand-By and the Extended Arrangement are needed in order to continue policy implementation after the immediate crisis have been resolved. But I would like the Legal Department's opinion as to whether it would be possible to link conditionality also to the supplemental facility, as I believe that it is the policy implementation that restores confidence.

With regard to the Fund's catalytic role, as mentioned by some other speakers, I am concerned that the SRF would move us away from the basic concept of the Fund's catalytic role. I think we must be very careful to ensure that the Fund or other multilateral institutions do not end up financing all outflows from these countries in distress. Markets must not get the idea that the facility is designed to entertain bailouts of other creditors. Moreover, even if the authorities take action to limit systemic risk and restore the domestic financial system, they should not attempt to rescue insolvent domestic banks and their shareholders. Individual banks and creditors have to pay a price for making poor investments decisions. The same principles should also apply to international banks. However, it is much less clear how to deal with such situations, because there may be implications for external arrears, particularly if sovereign borrowers are involved. Thus, I support some formulation in our decision today along the lines suggested by Mr. Esdar, but as we have not yet discussed "lending into arrears and orderly workout," I would favor a formulation that would make it possible to later incorporate the conclusions of those forthcoming discussions.

I also think that we should clearly phrase the objective of this facility in today's decision, including the need for conditionality. The use of the SRF should be very restricted. Thus I would favor a formulation in the decision that limits the objective to systemic risk at the global level and contagion that can lead to such systemic risk. I also support Mr. Esdar's proposal to institute the facility for two years. I am also positive to the review idea but I would not like to wait one year for the first review. As we are in such a hurry to establish this facility we should be open for changes more frequently.

Some Directors have raised the issue whether the SRF should start after a flexible access to the Stand-By or Extended Arrangement or after the access limits of 100 and 300 percent respectively have been reached. I think on balance it would be more practical to initiate the SRF once the other access limits have been reached.

With regard to safeguarding the Fund's resources, I would prefer a more frequent series of disbursements and reviews than the two or more suggested in the paper to secure that policies are implemented as intended. In addition I think that the duration of the facility suggested in the paper is too long. I would much rather support resources being available for a shorter time frame of 6 months, and if legally possible with 3 months' roll over periods and escalating charges, in order to encourage an early return to markets, and minimize moral hazard. However, I can go along with resources being available one year but if confidence has not returned after one year we would need to consider other measures like a stand still.

Turning to the repurchase period I believe it would be appropriate that countries were "expected to repurchase" after 6 months or if the Board would decide to hold resources available for one year, expectation to repay would start after one year. The obligation to repurchase would start after 12 months (or 18 depending on the decision on availability of resources). Hence I am also not in favor of staff's proposal to institute a possibility to extend each repurchase by as much as one year. While the staff proposal would allow for some flexibility, it would not encourage early repurchases as soon as market access has been regained. At the same time, I find the proposed 200-400 basis point margin on the rate of charge on the low side, because the starting point, the basic rate of charge, is a risk free short term rate, which is well below what markets would charge in emergency situations. The rate should be high enough to encourage an early payback. As mentioned earlier, I favor a progressive rate.

Turning then to the issue of first and second line of defense raised by Mr. Zamani, bilateral funds provided by the so called "second line of defense" which will presumably accompany the supplemental facility in the future, at least in some cases, should not alter the Fund's preferred creditor status.

Finally, the increased income generated from the use of the facility should be placed in a new reserve account—SCA-3—to guard against outstanding risk, and it should not be used to lower future charges across the board. Instead, at some point int he future, when the reserves are no longer needed, the funds could be distributed to all member for example according to quota.

The Chairman asked Ms. Srejber to elaborate on her point on the objective of the SRF.

Ms. Srejber responded that Mr. Esdar had proposed involving private creditors in debt work-outs, including—if she had understood him correctly—that the Fund would guarantee interest payments for private creditors. She was not prepared to agree today to such a formulation, preferring a Board discussion at a later date on orderly work-outs and lending into arrears.

The Chairman noted that the more he listened to Directors' interventions, the more he was convinced that a review of the facility would be useful after one or two years, in order to incorporate the conclusions of upcoming related Board discussions.

Ms. Srejber said that she agreed with the need for an early review, so that the conclusions of discussions on such issues as Fund lending into arrears and orderly debt work-out mechanisms could be incorporated into the design of the SRF—perhaps in less than a year.

The Chairman pointed out that, because the issues involved were quite complex, it might take more than a year for all the pertinent discussions to be completed. For example, the issue of mechanisms for orderly debt work-outs might touch upon the Fund's Articles or on national legislation and international agreements, which might take some time to address.

Ms. Srejber said that she agreed that many of the related issues were quite complex, but as time had been short for the consideration of the SRF, provision should be made for revisions as necessary.

Mr. Taylor made the following statement:

> We support a facility of this nature; its time has come. We would support a facility, broadly speaking, along the lines as proposed by the staff. The first of the three key characteristics that were identified in Manila was that the facility should be large enough. We should not lose sight of this. Having a facility that is half big enough is not going to get half the benefit. Arguably, it might get none of the benefit. So there is some passing concern about available liquidity in the paper—none in the decision, I do not think—and this underlines the importance of getting on with the quota increase and the NAB ratification. That is obviously made much more urgent if we approve this facility. Until we get at least those increments to our potential capacity to fund this facility, we are living somewhat dangerously, because, as several people have said, we are establishing, in effect, something very close to a new entitlement unless we are very careful about this.
>
> On how to contain a new entitlement, this certainly needs very careful thought. One suggestion has been to restrict eligibility by size of country. I can see some of the arguments on that side, but I agree very much with speakers such as Mr. Kiekens, Mr. Shaalan, Mr. Yao, and Mr. Wijnholds. In practice, to try to distinguish between members in this way will be very difficult and very divisive. I think the formulation that Mr. Wijnholds most recently read out would be a reasonable way to come out on this. That is to say, point to systemic risk and contagion, but not try to exclude access to countries which may be experiencing in their own system pretty much exactly the same problem, but are not perhaps quite big enough to count as a systemic risk. We should put the emphasis more on conditionality and on charges in containing access.
>
> On conditionality, I suppose it is sensible not to seek separate conditionality for this facility, but the conditionality definitely needs to have a different focus. We know what the focus has to be on. It cannot exclude macroeconomic measures, but it has to focus, as other people have said, on reform of the financial sector and its supervision. That involves for some members fundamental cultural change. That may be easy to do. It is easy to say, it may be easy to do, for countries that do not need to do it, but it is not easy to do for countries whose culture has been different.
>
> We continue to see—and you yourself, Managing Director, continue to see—a reluctance or incapacity of neighbors to learn from each other in this respect. I think what we need to try to do, as far as we can, is to give fair warning to potential candidates for access to this facility. Just because it is difficult to do, it does not mean

we should not try. We could, for example, develop a kind of primer that would give fair warning to what will be required in the unfortunate case where another member might have to come to us to use this facility. Mr. O'Donnell referred to the yellow card. I think that is a very good idea, if we could find a way of making something of that nature operational. Mr. Wijnholds referred to a minimum time for the Fund to sort out what the program should consist of. That might be difficult in practice. Why not write some of these things down in advance and give fair warning? That would improve the position of yourself and of the staff when it goes out on mission, to underline the importance of opening up to the Fund and coming to the Fund earlier than at the absolute last minute. So perhaps you could give some more thought to what you might call the infrastructure that might surround the operational aspects of this facility.

Coming to repurchases and charges, I should say from the outset that until further notice I feel obliged to reserve the position of my Korean authorities, because I am not sure that they have the same understanding of what is to happen in relation to their position as may be intended here. I may not be right about that, but it is very important that we get that sorted out, perhaps over the next couple of days.

More generally, in principle we need to get both the repurchase period and the charge to work for us, but there are some problems with being too quick in requiring repurchase. It was the Director of the Policy Development and Review Department, I think, who first pointed out to me that we need to have a facility that goes somewhat beyond what the market is willing to do in a crisis situation. I think that is an entirely sensible position. So in principle it should be 60-90-day rollover, but I do not think that actually meets the practical situation.

There are a couple of other considerations. If we have a repayment period that is as short as some colleagues have proposed, what happens if there is a second wave, as I understood happened in Mexico? What is the position of the member? Can it draw again? If so, at what rate? We would at least have to sort that out, because the principal case that we have experience with so far did have this second-wave effect.

Furthermore, coming specifically to Korea. The current arrangement with Korea runs over three years. If repayment is required earlier than that, Korea will be paying and repaying at the same time, which might be thought to be rather bizarre. On the face of it, to me, if there are to be higher charges imposed on the balance of the Korean drawing, it logically must be brought forward.

On charges, I would be on the high side of this debate, but it is difficult to pick a number, as it were, referring to Mr. O'Donnell's graph. It is difficult to know what X is unless you know what the other parameters on both the X and Y axes actually are. I do not know how sophisticated you can get this, but I think a bit of a sag in the graph, perhaps finishing higher right out on the far side of the axis, might be a better design. In any event, all of the parameters, I think, need to be known before you can confidently answer what X should be.

Finally, on three other points. On the use of funds, I think the best thing is to park them in an SCA account for the time being. On the question of whether there should be a sunset clause or not, I think I agree with exactly where you are on that. I do not think we should have a sunset, but we should have an early review. I think 12 months might be the outer limit for a review. Maybe we should decide to have a review within 12 months and see how far we can get on improving the design or the relationship with the private sector and a range of other matters that we know we should have thrashed out before we approved this facility, and to agree to a review within 12 months, in the light of experience, would be my preference.

Finally, a question for the staff. On the second line of defense, as Mr. Zamani referred to it a moment ago, what is in the staff's mind if this facility is in place? Is there a second line of defense? If so, what is its nature?

The Chairman reiterated that he was interested in the idea of the issuance of a "yellow card" for recalcitrant countries, as well as in Mr. Wijnholds's suggestion that countries needed to be encouraged to request Fund assistance at an early stage of an emerging crisis. He considered that, four months ago, Korea could have been a first credit tranche client, which could have facilitated the progressive resolution of their problems. Therefore, it was important to attempt to make such incentives operational.

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

I would like to begin by making a basic point. Perhaps we did not explain sufficiently the motivation for the staff's choice of the design of the mechanism. There were three possibilities for achieving what I think the international community was calling for in a facility such as this. One was to create a new facility and to specify the terms and conditions for that facility, such as higher, and perhaps graduated, charges and shorter maturities. A second possibility was the use Article V, section 4. When the Fund's holdings of a member's currency go above 200 percent of quota, the Fund establishes, as a condition for waiver, certain terms and conditions for use of those resources, which could include shorter maturities and higher charges. The problem is, as the General Counsel would describe, this has to be a collateral-like mechanism, which means that, upon satisfaction of the country's obligations, those surcharges would need to be refunded. There was a question—in the staff's mind at least—about the incentive effect, and the effectiveness of the incentive effect, that would be created by a refundable set of charges. The third possibility was to establish a general policy by which all members using resources above certain thresholds would be charged a higher rate of charge, which was mentioned by a number of Directors. However, if one is going to capture the use of most resources that countries might access under this facility, one would have to set that threshold quite low. Moreover, that threshold would have to apply to the entire membership, which means that countries using resources under an Extended Fund Facility to deal with problems that require long-term measures and that may have only long-term gestation periods, in terms of turning the balance of payments around and so forth, would also have to pay those higher charges. On the other hand, if one wanted to exempt those countries, one would have to set the threshold so high that it may not capture the resources used by countries under this facility. Regarding the other two options—the use of Article V, Section 4 and the idea of establishing a common policy across all members—they are not sufficiently powerful to achieve the specific and targeted aims that the Board seemed to be seeking in the context of this kind of an arrangement.

On the difficult issue of how to include the private sector, the first point I would make is that it is important for all of us that are involved in this to insist to people outside the Fund that there are any number of parties in the private sector suffering and taking very substantial losses under all of these programs. Equity holders in some of these markets have lost very large amounts and proportions of their investments. In each of the cases, institutions have been closed in which equity holders—and creditors in certain instances—have lost their capital as well. This is not, in any of these cases, a bail-out in the sense that that word is being used in the popular press.

That being said, there are problems, because in these cases we have arrived after some kind of guarantee was issued by the respective government—both in the case of Thailand on the 58 suspended institutions and in the case of Korea, although in Korea we are not sure about the nature of the guarantee that has been offered by the authorities. The very offer of the guarantee, on the one hand, has complicated the matter of seeing ways in which the private sector could be made to take the appropriate losses—if there are to be losses—that are involved. Also, it calls into question the use of bankruptcy proceedings. In all countries, one of the best ways of ensuring losses in the private sector would be to appeal to a robust, effective bankruptcy process. This is more so the case where we are dealing, as we are in Korea, with basically private debtors and creditors. But there is a certain element of sovereignty that has not been injected into this equation because of the guarantee that has been offered by the Korean authorities.

Along with bankruptcy procedures, we have raised other issues, like more effective regulation and supervision, that are very important as mechanisms to deal with private creditors in such circumstances. Each of these cases, and presumably cases that we will face in the future, differs dramatically one from another—how much of the debt is private-private; how much of it is sovereign-private; how much of it may be sovereign-sovereign, and so forth. Also, the terms and conditions under each one of those structures of debt differ. If it is medium to long term, it may be with banks, or it may be securitized. In those two cases, also, there will be a difference between what may be possible from a legal point of view and from a policy point of view. In the event that a lot of the debt is short term—which is the situation that we are confronting in these cases—there is the issue that, even if you do want to find a mechanism to try to make the private sector incur appropriate losses, you also want to make sure that the country's trade is not disrupted. How do you separate trade credits from some of these other credit lines? How do you make a clear enough distinction so that you know that in going after one of those aspects of the debt you are not going to complicate unduly the life of the country by interfering with other aspects of the credit? Some of these issues are in a staff paper which will be coming to the Board for discussion in January 1998. There will have to be a separate discussion and a separate paper on the specific private-to-private debt issue, which is not fully addressed in the paper that will be coming out in January.

Mr. Giustiniani made a point about the threshold, but we need to distinguish between different thresholds. The threshold in the staff proposal is not the 200 percent that is defined as holdings of the country's currency in Article V, section 4; rather, the staff is referring to the threshold on the use of Fund credit. What the staff is suggesting as the threshold is basically the access limits under Stand-By and Extended Arrangements; that is, if a country's access to resources under this facility goes above either the annual or the cumulative limit—and in Korea's case it has gone above both—the SRF terms and conditions would be applied to the remaining resources provided to the country above those limits.

In response to Mr. Taylor, the logic of the proposal in the staff paper as applied to Korea would suggest that Korea, in drawing the first purchase under the Stand-By Arrangement in excess of 500 percent of quota, is above both the annual and the cumulative access limits. If we are to see a one-year SRF basically laid on top of the three-year Stand-By Arrangement, then all of the resources that are provided in subsequent tranches for the remainder of the year come under the SRF and would be subject to the terms and conditions to be decided by the Board for that facility. That facility, and the availability of resources under the facility, would then cease for Korea a year from now; basically, that meant that the resources that remain available to Korea under the Stand-By Arrangement in 1999 and in 2000 would revert to the terms and conditions of regular general resources under the Stand-By Arrangement. All purchases from December 18, 1997, if the facility is in place by that date, up through purchases to the end of November 1998 would be under the terms and conditions of this facility, and then there are eight quarterly disbursements, I think, phased under the arrangement in 1999 and 2000 which would come under the Stand-By Arrangement's terms and conditions.

Mr. Esdar asked whether, if the SRF had been in place when the Korean program had been negotiated, all the purchases of the first year would have been under the SRF conditions and the remaining 200 percent of quota purchased under the Extended Fund Facility would have been under normal Extended Fund Facility conditionality.

The Director of the Policy Development and Review Department responded that, for the first purchase under the SRF, up to 100 percent of quota would have been under the terms and conditions of the Stand-By Arrangement. The amount in excess of that for the first year of the arrangement would have been under the SRF, and then the purchases in the second and third years of the Stand-By Arrangement would have reverted to Stand-By Arrangement conditions. The first threshold was 100 percent of quota; once the country exceeded that level, additional resources provided to the country in the context of that combined Stand-By Arrangement-cum-SRF facility, would be at the terms and conditions of the SRF for that period of one year during which those resources were available to the member.

Mr. Esdar said that he was not referring to the drawings, but whether, if the extended funds were distributed equally over three years, everything above 300 percent of quota would be subject to SRF conditions, with the somewhat modified time schedule.

The Director of the Policy Development and Review Department responded that everything disbursed in the first year of the arrangement above 100 percent of quota would be on SRF terms. Drawings in the second and third year would be under the Stand-By Arrangement terms.

The Chairman pointed out that there might drawings of less than 200 percent of quota in two years.

The Director of the Policy Development and Review Department agreed that that might be possible.

Mr. Rouai asked whether, if after the one-year period Korea regained access to capital markets, it could continue to draw on the EFF and repay the SRF.

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

The Chairman considered that the scenario described by Mr. Rouai was possible, and perhaps desirable.

Mr. Rouai asked whether the proposed graduated rate of charge would have no effect in the event that Korea regained access to capital markets and began to repay the loans made under the SRF.

The Director of the Policy Development and Review Department responded that that would depend on how the SRF were structured. It was possible that, if the graduated increases began after only one year, a member could make a first purchase under the SRF and make a repurchase after six months. In that case, the member would pay only the initial surcharge, because the resources would not remain outstanding long enough for the graduation of charges to be activated. Indeed, that had been the apparent aim of Mr. O'Donnell's proposal: to encourage the member to repay the loan under the SRF as soon as possible and avoid the graduation.

The Chairman noted that, in that case, the threat of graduation would have served its purpose.

Mr. O'Donnell asked why there would be a reversion to the terms and conditions of the original Stand-By Arrangement after the one-year SRF period.

The Director of the Policy Development and Review Department explained that, in almost all of the SRF-eligible cases, there would be a dual problem that would need to be addressed: the sudden loss of market confidence and the more traditional problems associated with standard multiyear programs. In most cases, there would likely be a need for ongoing Fund support of the usual nature in the context of a Stand-By or Extended Arrangement; the SRF would be laid on top of that arrangement for just the first year. The presumption was that the large amount of resources that could potentially be made available under the SRF, together with the policy reforms, would restore confidence; however, it was also recognized that there might be a need for the country, supported by the Fund, to press ahead with other necessary reforms and measures. Indeed, in the current cases of Thailand, Indonesia, and Korea, it was unlikely that financial sector problems could be resolved in one year—the building of the supervisory and regulatory institutions, and other measures, would need some time to bear fruit. However, in such cases, there would be a question whether, if confidence had been restored, the country had a balance of payments need; if such a need did not exist, then it might be possible to continue that arrangement on a precautionary basis.

Mr. O'Donnell noted that, in effect, there would be a substantial reduction in the rate of charge after the first year, which was not preferable. He expressed the hope that the World Bank would become fully engaged in the second and third years of the programs to deal more fully with the longer-term structural issues. Having the Fund remain focused on the shorter-term issues relating to the SRF would clarify the division of labor. As the Fund's involvement would be associated with higher-risk issues, a higher rate of charge was justifiable.

The Chairman said that he agreed with Mr. O'Donnell that, at times, the Fund was involved in relatively high-risk programs, but it was also charged with defining macroeconomic conditionality and setting a program's framework, which included contributing to structural reforms. That was why, in part, a multiyear Stand-By or Extended Arrangement made sense—even after the intense confidence crisis had passed, as had been the case in Mexico in the mid-1990s. If the SRF had been in place at the time of the Mexican crisis, the Fund would have had in place a system of repayment more similar to the arrangement that the U.S. Treasury had had; in any event, the Fund would have remained committed to the Mexican authorities' reform efforts for the entire time of the program supported by the EFF arrangement. The proposed design of the SRF might not be exactly what would be needed in the near future, which was one of the reasons that make an early review of the experience with the SRF desirable; nevertheless, the current design represented a good start.

Ms. Lissakers noted that the Director of the Policy Development and Review Department had referred to having the SRF in place only over the first year of a possible three-year Stand-By or Extended Arrangement. She asked whether financing under the SRF would be available potentially in the second year of an arrangement as well, if there were a sudden eruption of loss of market confidence; for example, would Russia be eligible to activate the SRF if it were to face a sudden loss of market confidence at the current juncture—that is, after the first year of its Extended Arrangement.

The Director of the Policy Development and Review Department responded that the SRF could be available to countries after the first year of a Stand-By or Extended Arrangement. For example, if the SRF had been in place in mid-1997 and if the resources required by the Philippines had been larger, it would have been possible to lay SRF financing on top of the existing Extended Arrangement. It was important to clarify that the use of the SRF might not necessarily be confined to cases in the context of a three-year Stand-By or Extended Arrangement. While the recent Asian experience suggested that a Stand-By or Extended Arrangement would be required, if the nature of a country's problems indicated that extended Fund involvement might not be necessary, then a shorter Stand-By Arrangement might be sufficient. Indeed, the Mexican Stand-By Arrangement had not been for three years initially.

Ms. Srejber asked whether, in the event that a country had an existing Stand-By or Extended Arrangement, the more demanding conditionality associated with the SRF would replace the prevailing conditions.

The Director of the Policy Development and Review Department responded that the existing arrangement would be modified to the extent warranted by the prevailing circumstances; the terms and conditions of the existing arrangement would be renegotiated in light of the fact that the additional SRF resources were made available.

Mr. Giustiniani said that he understood that a country requesting access to SRF resources in conjunction with a Stand-By or Extended Arrangement would draw resources up to 100 percent of its quota under the arrangement, and the remaining resources would be drawn under the SRF during the first year. He asked whether, after that first year, the regular access limit of 200 percent of quota would apply for the rest of the arrangement or whether the exceptional circumstances clause would be prolonged.

The Director of the Policy Development and Review Department responded that, in the normal course of events, the regular access limits would apply. For example, a country could start a three-year Stand-By Arrangement and, in addition, use resources under the SRF because it was confronting the kind of crisis similar to the current Korean situation. If market problems were resolved reasonably quickly, confidence could be restored, but the country would continue with its adjustment program under the Stand-By Arrangement. If something then happened to the country midway through the second year—a very severe terms of trade deterioration, for example, caused by a change in the situation of some of its export markets or any fact that would under normal circumstances warrant consideration as to whether exceptional access should be provided under the Stand-By or Extended Arrangement for the adjustment problems that the country then faced—there was nothing in the current proposal that would deny the country the opportunity to request those resources.

The Chairman added that, in the situation described by the Director of the Policy Development and Review Department, the special definition of the exceptional circumstances clause would not be altered by the creation of the SRF.

Mr. Esdar considered that there remained a logical problem. Although he agreed that there should be a relatively brief repayment period, he wondered whether it would be possible for a country to draw on resources under the Extended Fund Facility because of a balance of payments need that, while there was a simultaneous repurchase under the SRF.

The Director of the Policy Development and Review Department responded that that had been the situation that Mexico had potentially faced. Even though there had not been a shortening of maturities, there could have been a possible overlap in the repurchase obligations of Mexico under the 1995 arrangement. If it had continued under the arrangement with the Fund, there would have been the possibility that resources would be provided at the same time that very large repurchases were coming due. That had been the case in a number of countries that had used Fund resources.

Mr. Sivaraman asked whether, if a country's need was determined at 700 percent of its quota, the first year's drawings would be equivalent to 500 percent of its quota—100 percent of quota under the Stand-By or Extended Arrangement and 400 percent of quota under the SRF—while the country would draw 200 percent of its quota in the second year. If that were the case, then the program's access under the SRF would be front-loaded.

The Director of the Policy Development and Review Department explained that, in the circumstances of the countries that the Fund had been assisting in the context of the Asian crisis, the need for resources, in the short term, was to bolster reserves to provide confidence to the markets. That confidence would help to convince private financiers to maintain their resources in the countries; the official resources did not aim to substitute for the departing private sector resources. However, it was important to note that, in each of those cases, given the expected profile of recovery of the country, there was not expected to be a large balance of payments need for those countries after the first year. In each case, the current account deficit—which had been small in the case of Korea and relatively small in the case of Indonesia, but large in the case of Thailand—would likely diminish; some countries might record surpluses in the near future. Beyond the immediate adjustment, it was not expected that there would be a large balance of payments need. As a result, there was not a commitment to large resources under the arrangements to those countries in the second and third year.

Mr. Wijnholds noted that there were now on record three possibilities for dealing with the question of meeting exceptional financing needs: a new facility like the SRF; the use of Article V, Section 4, as explained in footnote 17 of the staff paper; and, through a general policy regarding charges, which had not been made clear in the staff paper. It would have been useful if the staff paper had explained the options clearly.

Mr. Kiekens said that he disagreed with the interpretation of the limits of Article V, Section 4, explained in footnote 17 of the staff paper and confirmed by the Director of the Policy Development and Review Department; the interpretation of a waiver possibility for the Board in the sense that additional charges can only be requested as collateral was too narrow.

The Fund may, in its discretion, ask whatever terms and conditions that safeguards its interests. Directors had agreed that higher charges—not as collateral but higher charges in order to strengthen the precautionary balances of the Fund—were an effective and desirable way of protecting the Fund's interest; the same goal could be achieved through the use of Article V, Section 4.

The Director of the Policy Development and Review Department said that, further to Ms. Srejber's question, conditionality under the SRF would be tailored to the reality of resources being provided to the country, whether in the context of a new or already existing arrangement; such conditionality would likely involve prior actions.

The review of the SRF could take place after one to two years of experience, the Director continued. Also, implications for the facility might arise out of the capital account amendment discussions, as well as discussions on mechanisms to encourage private sector orderly debt work-outs; however, those discussions might take some time to complete.

In response to Mr. Taylor's question, the Director confirmed that the second line of defense financing would remain an option in conjunction with the SRF. However, the precise structure of available financing options in such situations was not yet clear; consideration would need to be given to official financing—such as from the Fund and other international financial institutions—for bilateral creditors, and to involving private creditors—not only through incurring losses, but also through some kind of voluntary extension and restructuring of debt instrument maturities.

There seemed to be a center of gravity emerging among Directors' positions on a number of issues, the Director noted. On charges, several Directors preferred to begin at the top end of the range proposed by the staff, and to proceed progressively higher through graduation. Other Directors had expressed a preference for charges at the lower end or in the middle of the staff proposed range. The staff would attempt to craft a compromise proposal that balanced the various preferences. Similarly, a center of gravity between various positions on the maturity in the new facility was emerging around a one year grace period, although a number of Directors had expressed a preference for a shorter period. Nevertheless, it was recognized that it was undesirable to add to any market uncertainty by unduly shortening the availability of resources under the SRF. With respect to the repurchase structure, there appeared to be support for first having an expectation, which then could be converted into an obligation a year later. On balance, there appeared to be support for having two repurchases after the first year grace period—perhaps three months and six months after the grace period or perhaps at the end of the first year grace period and six months later.

Mr. Esdar asked whether there would be an obligation to repurchase one year after a purchase under the SRF.

The Director of the Policy Development and Review Department responded that he had detected support among Board members for an expectation to repurchase after one year, which could be converted to an obligation at the request of the Board.

Ms. Lissakers considered that an obligation to repurchase should begin earlier than had been proposed by the staff. The repurchase obligation should be one year after a purchase; however, an additional six months could be granted.

The Director of the Policy Development and Review Department explained that, if a member was not able to satisfy the expectation to repurchase after one year, then it would need to inform the Board. The Board could then agree to terms and conditions—including additional policy actions—before granting an extension of the repurchase period. The staff was suggesting that such an extension be for a one-year period, after which it would become an obligation.

The Chairman pointed out that the distinction between expectation and obligation was necessary to provide the Board with some flexibility. As Directors were aware, an obligation to repay the Fund was binding, and the alternative would be for the member to lapse into arrears to the Fund, which would trigger the established remedial procedures. As a result, it was considered useful to provide the Board with some flexibility in the event of very exceptional circumstances.

Ms. Lissakers cautioned that maturities as long as one or two years might be difficult for a number of Directors to accept. In fact, she had initially considered that the facility should provide very short-term financing—closer to a short-term swap facility—with the possibility of one rollover. The staff proposal was pushing the facility into the territory of medium-term financing. While she had been convinced by the staff about the desirability of not having too short a trigger on the repayment obligation, extending the repurchase obligation to two years would not be acceptable; she would consider supporting an expectation after one year of a purchase and an obligation six months later.

The Director of the Policy Development and Review Department considered that the positions of the staff and Ms. Lissakers did not differ. He had suggested that one year from the date of purchase—not one year from the end of the availability of resources—a first repurchase expectation would come due, and perhaps six months later a second repurchase expectation would come due, if the repurchases were to be phased semi-annually. If the member were not able to meet that expectation, it would appeal to the Board for some additional period—subject to the Board's discretion, but up to one year—at which point the repurchase would become an obligation.

Ms. Lissakers believed that, if the situation facing the member was that of a short-term loss of confidence, there should be every expectation of an early repurchase. An obligation to repurchase within 18 months would create a strong incentive for both the member and the Fund to operate within that time frame. She said that she recognized the risks outlined by the Chairman regarding the ramifications of imposing rigid, early obligations to repay the Fund, but those were risks that would need to be taken in exchange for her support of the facility. Otherwise, if a longer obligation period were implemented, substantially higher surcharges than proposed by the staff would need to be imposed.

The Chairman pointed out that the proposed graduated structure of charges would address, in part, Ms. Lissakers's concerns. Also, it was important to underline that the Fund and the international community did not have much experience with crises of confidence, such as the current crisis in Asia.

The Board might wish to retain a certain amount of flexibility, in order to be able to address exceptional and unexpected circumstances that occurred from time to time, the Chairman continued. For example, in Argentina during the administration previous to Mr. Menem's, the Fund and the international community had attempted, without success, for over two years to persuade the authorities to respond to the country's problems. The current political situation in Korea was improving, and a new president would be elected within two days; however, it was possible that, some time in the future, unexpected, disruptive developments might threaten the country's reform efforts. In such cases, it would be most helpful to provide the Board—not the staff or management—the degree of flexibility offered by the distinction between expectation and obligation.

Ms. Srejber said that her authorities had been reluctant to support the proposed short term facility; if it were proposed to transform it into a medium-term facility, then she could not support the proposal.

The Chairman asked Ms. Srejber what she would consider as "medium term."

Ms. Srejber responded that anything over one year could be considered as medium term. She said that she agreed with Ms. Lissakers on the design of the proposed facility. Her own authorities had accepted the proposed facility on the condition that it would be short-term in nature, with very high conditionality, many prior actions, and an obligation for an early repurchase.

The situation described by the Chairman could not be described as stemming from a temporary loss of market confidence, but from more protracted problems, for which the Fund's standard arrangements were appropriate, Ms. Srejber continued. She noted that countries within her own constituency had experienced a wide loss of market confidence, and they had learned that what was necessary was an early return to the markets to borrow—even at much higher rates than before the start of a crisis. The Fund should not be expected to finance members in such circumstances at subsidized rates.

The Chairman considered that the Fund was not subsidizing countries facing a sudden, massive loss of market confidence.

Ms. Srejber stated that, if the Fund was providing long-term resources at very low rates, that would constitute a subsidy.

The Chairman said that he disagreed with Ms. Srejber. In cases in which it was known ex ante that problems were of a protracted nature, he agreed that other Fund instruments were available. However, in cases where there were unexpected developments, it would be prudent for the Board to maintain a certain degree of flexibility. It was important to note that the decision establishing the SRF could provide for a suspension of access to Fund resources in the event that an expectation were not met.

Mr. Taylor said that, on the matter of the design of the facility, he had received different instructions from various members within his constituency. As a result, he said that he would support the Chairman's position, which he considered as a practical and commonsense approach. He believed that the Chairman's example of Argentina was instructive; it could also be pointed out that the incoming Korean president would not take office until three months after the upcoming election, which would leave a very short time before a mandatory repurchase obligation, as suggested by some Directors, would be confronted. It was true that, as the international community had not had much experience with such situations, it would be reasonable to provide the Board with an element of flexibility. If circumstances were clear that repayment was feasible, presumably the expectation for repurchase would be met and there would be significant international pressure to do so.

Mr. Guzmán-Calafell said that he supported the Chairman's view that the Board needed to retain flexibility in the matter. While the facility was designed to address cases of temporary loss of confidence, it would not be certain ex ante when that confidence would return. Also, in such crises, financing that a country could be expected to obtain from financial markets would be of a short-term nature, and amortizations might be concentrated in a short period of time. If the Board were not to allow itself the flexibility to extend repayments to the Fund, that might give rise to additional market instability, which would defeat the intent of Fund assistance. As a result, it was important to retain the flexibility to extend repayments, if the Board decided that that was appropriate. The concerns of some Directors were difficult to understand, as the facility would carry a higher rate of charge than normal and as the Board would retain full discretion over the decisions involved.

The Chairman recalled that, in the case of the Fund-supported program adopted in December 1995 to assist the Mexican authorities to respond to the financial crisis at the time, it would have been difficult for the authorities to have met a one-year repayment obligation, as the Mexican economy had remained relatively weak. He urged the Board to be considerate of the possible difficulties that could befall members in crisis, recalling that the Fund did not possess the same flexibility that national central banks and treasuries had in handling their financing.

Mr. Fernandez asked whether, if the expectation period began one year after a purchase and if there were multiple tranche drawings, the starting level of the surcharge could begin six months after each purchase. He noted that he would prefer such a time schedule.

The Director of the Policy Development and Review Department clarified that the expectation to repurchase would be exactly one year after the purchase. There would then be a period, if the member requested and if the Board accepted, during which those resources could remain outstanding, but at the end of which an obligation would be created. That period, as the staff paper noted, could be up to one year following the date of expectation. With respect to Mr. Fernandez's question, it was for the Board to decide on the structure and timing of the purchases and repurchases.

Mr. Giustiniani asked whether repurchases of drawings would be phased in four equal, quarterly installments.

The Director of the Policy Development and Review Department recalled that that had been the original proposal outlined in the staff paper. The revised proposal—which he considered reflected the center of gravity among Directors' positions—was that an expectation to repurchase would exist one year after a purchase; at the request of the member, the Board could then consider whether to extend further the period before an obligation was created, after which the Board would retain the discretion to act as it wished—for example, it could impose an obligation to repurchase the following day (that is, one year and one day after the purchase) or it could impose an obligation six months or one year later. Under that scheme, the maximum outstanding maturity period would be two years—one year to the expectation, with a further one-year period granted by the Board until that became an obligation.

Mr. Giustiniani asked whether the time limits applied for all purchases or for each purchase.

The Director of the Policy Development and Review Department responded that repurchase timing would be based on the date of each purchase.

Mr. Giustiniani noted that several Directors had stressed the importance of maintaining flexibility through longer expectation and obligation periods. However, he considered that the Board already had a significant amount of flexibility to determine not only when an expectation should be converted into an obligation, but also to extend the obligation period.

The Chairman pointed out that that was not the case, which was the reason for the Board's current discussion of the matter.

The Director of the Policy Development and Review Department added that once an obligation had been scheduled, the Board did not have the authority to grant an extension.

Mr. Rouai stated that he strongly supported the flexibility with regard to the expectation obligation of the repurchase; however, if the member regained access to capital markets and there was an improvement in reserves, the member would remain under the guidelines for early repurchase and the staff could oblige the member to make the repurchase.

Messrs. Cippa and Esdar asked what the Board majority requirement was for converting an expectation into an obligation.

The General Counsel responded that a majority of the votes cast would be required to convert an expectation into an obligation.

Ms. Lissakers asked the General Counsel to explain the meaning of Section 7, paragraph (g), of Article V.

The Chairman asked the General Counsel to read the passage in question.

The General Counsel stated that the passage read:

> The Fund, on the request of a member, may postpone the date of discharge of a repurchase obligation, but not beyond the maximum period under (c) or (d) above or under policies adopted by the Fund under (e) above, unless the Fund determines, by a 70 percent majority of the total voting power, that a longer period for repurchase which is consistent with the temporary use of the general resources of Fund is justified because discharge on the due date would result in exceptional hardship for the member.

The staff had prepared a paper on the issue several years ago (SM/87/226, 8/25/87), the General Counsel continued. While it was the policy of the Fund not to extend the date of a repurchase obligation, the Fund did have the legal authority to do so under the Articles. The Executive Board had taken the position that, as a general matter, it would not extend the maturity of outstanding purchases in order to avoid discharging members from meeting their obligations when they fell due. If consideration was given to a postponement of repurchase obligations, two different cases in Article V, Section 7(g) would have to be envisaged. First, there was the case of an obligation that became due and for which the Board would be prepared to extend the maturity, but without exceeding the maximum period, prescribed under the relevant policy. For example, assuming that the relevant policy prescribes a maximum period of two years, the Board could extend a repurchase date within that period by a majority of the votes cast. If it was intended to extend a repurchase date beyond that period, the Board would need to adopt a decision by a 70 percent majority of the total voting power, based on a determination that the extension beyond the maximum period would not undermine the revolving character of the Fund's resources and that the discharge of the obligation on the original due date would result in exceptional hardship for the member. Those rules were intended to avoid an unduly long extension beyond the maximum maturity.

Ms. Lissakers asked whether the reference to "not beyond the maximum period under (c)"was three to five years; if that were the case, then a simple majority would allow an extension of the obligation.

The General Counsel responded that the extension had to be understood in the light of the facility under which the purchase had been made. Therefore, in the case of a purchase in the credit tranches, the period would be three to five years; in the case of a purchase under a special policy, the period would be that provided for in that special policy, which was why there was a reference to subsections (c) and (d) in the Article.

Ms. Lissakers asked whether, under paragraph (g), a 70 percent majority could go beyond the maximum maturity outlined in the facility if the Fund deemed that discharge on the due date would result in exceptional hardship for the member.

The General Counsel answered in the affirmative.

The Chairman asked the General Counsel to explain what the definition of "exceptional hardship for a member" would entail.

The General Counsel pointed out that there had not been an activation of that provision, so it would be difficult to speculate what the Board would consider as exceptional hardship. Presumably, the Board would review, inter alia, the balance of payments and reserve position of the member.

The Chairman pointed out that the traditional Fund definition of exceptional was quite demanding.

The General Counsel said that he agreed with the Chairman.

Ms. Srejber asked whether the maturity of the facility would be determined from the date of the last payment, after an obligation to repurchase was activated.

The General Counsel considered that, in the context of the current discussion, the maturity of the facility would be two years.

Ms. Srejber asked whether the full amount of the loan would not be repaid within two years of the first purchase, because there would be multiple, phased repurchases.

The General Counsel answered in the affirmative.

The Director of the Policy Development and Review Department noted that the period of repurchase in the Articles and the credit tranches was three-and-a-half to five years for each purchase. In the current case, that term was being used consistently; thus for each purchase the maturity would be essentially from one to two years.

The General Counsel said that it was important to note that the maturity of each purchase under the facility needed to be considered. For example, in a Stand-By Arrangement where purchases were phased over two years, the first purchase must be repurchased in the following three- to five-year period. However, if the whole spectrum were considered, it might reach seven years.

Mr. Esdar asked whether each purchase would be repurchased in a lump sum after a maximum period of two years, rather than in tranches.

The General Counsel answered in the affirmative.

The Director of the Policy Development and Review Department pointed out that that had not been the original staff proposal. Moreover, what seemed to be emerging from the current Board discussion was support for two repurchases or semiannual repurchases, rather than four quarterly repurchases. However, that remained a point to be decided by Directors.

The Treasurer made the following statement:

> Mr. Zoccali asked about the commitment fee which we had not specifically mentioned in the staff paper as a source of income. The commitment fee is one quarter of 1 percent of the arrangement, but it is refunded as members make purchases and they pay the half percent service charge. The commitment fee is not usually brought into income. However, the Fund earns income on the portion of the arrangement represented by undrawn balances at the end of the period and because the member had not canceled the arrangement. This is normally a very small portion of the Fund's income, but it should have been included in the staff paper for completeness.
>
> Mr. Shaalan and a number of other Directors raised the issue of the difference between the general reserve and a possible SCA-3. The SCA-3 would be a contingent account, and conditions would need to be agreed as regards the refund of resources placed in such an account. Therefore, one should be very careful on a SCA-3 as a residual source of any excess of the Fund's income. As regards the general reserve, balances from the reserve could be distributed to all members in proportion to quotas. Such a distribution would be largely in favor of the creditors.
>
> Because of the difficulties of distributing the SCA-3, which would normally have a mechanism to refund balances to the contributors, and because of the virtual impossibility of getting the money out of the general reserve except as a distribution of net income, the staff has suggested that a certain proportion of the income from the SRF would not be regarded as income for FY 1998, pending a review of what the Board would want to do with that income. The staff's approach would give maximum flexibility for the Board to deal with that issue in the coming weeks. While it is important to deal with the issue fairly soon, it is crucial to do so before the end of the financial year or excess income will end up in reserves, ipso facto.

Ms. Srejber pointed out that, as special contingent accounts were created on the basis of Board decisions, the Board could determine the precise structure of such accounts.

The Treasurer said that he agreed with Ms. Srejber, but noted that the Board would need to determine the circumstances under which the refunds would be distributed from a new SCA-3; a number of Directors expressed their preference to return to consider the matter at a later date. At present, the Board must decide whether to keep the resources out of the Fund's income for FY 1998; the staff had proposed keeping it out of income and giving the Board the flexibility to return to the matter soon but when it had more time.

The Chairman considered that the Board would need to consider the matter at a very early date.

The Treasurer said that he agreed with the Chairman.

Mr. O'Donnell asked how some of the income from the SRF could be used for ESAF-HIPC purposes.

The Treasurer explained that, under the Articles—by an 85-percent majority—and as suggested in the staff report on the status of the financing of the ESAF-HIPC options, part of the Special Disbursement Account (SDA) money that was used to reimburse annually the General Resources Account for the expenses of running the ESAF could be discontinued for 1998. Also, the subsequent deficit in the Administrative Budget would be compensated by the use of income from the SRF; the SDA could transfer the amount that would otherwise have been transferred to the GRA to the ESAF-HIPC Trust. According to the latest estimates, the amount would be about SDR 40 million in the current year.

Executive Directors agreed to continue their discussion.

Mr. Cippa asked whether the rate of charge would be retroactively reduced if the Board decided to put the extra income into the precautionary balances before the end of the year.

The Chairman suggested that, in order to save time, the Board return to issues related to the SRF income at the following Board meeting.

Mr. Sivaraman proposed that, in order to find a possible compromise position, the expectation period could begin six months after the first purchase; if the member was not able to make a repurchase after the six months, then the Board could choose to extend the period by one year, so that the obligation fell due one-and-a-half years after the first purchase.

The General Counsel made the following statement:

> The question raised by Mr. Wijnholds concerning footnote 17 in the staff paper has been answered. The purpose of the footnote was not to hide information from the Board, but rather to address what the staff regarded as a specific issue in the paper. The understanding was that there had to be a special rate of charge that would apply only to the facility, and therefore different approaches could be considered. Under the solution that was put forward by Mr. Kiekens, the system is different. It would be possible to have, by a 70-percent majority of the total voting power, a rate of charge that would not require the establishment of a new facility, but in that case it would apply to all holdings within the credit tranches or under the Extended Fund Facility up to a certain level. This would be different from the purpose of the exercise we are confronted with today.
>
> I think also the question raised by Ms. Srejber has been answered at this point. It is possible for the Fund to have two levels of conditionality under the Stand-By Arrangement with a higher conditionality to release the disbursements under the facility. For these disbursements, special performance criteria would have to be met. It would mean that, under the same Stand-By Arrangement, certain purchases could be met—say, in the credit tranches—but other purchases, which would be under the facility, could not be made by the member. Legally, this is possible. The question for

the Board will be to determine whether it is desirable to have these two types of conditionality side by side. This is a policy issue, not a legal issue.

On the possible use of Article V, Section 4, we have in the paper identified two possibilities. The first one would be to have a shorter repurchase period. The second one would be to have a refundable rate of charge. I understand that Mr. Kiekens, perhaps other Directors, take a broader view of what the Fund could do under Article V, Section 4, and in particular feel that the Fund should be able to impose a nonrefundable rate of charge. This is not our reading of the provision. I will try briefly to explain why.

First of all, the provision of Article V, Section 4 only has been used effectively in one case, so we do not have much practice on the implementation of that provision. Moreover, that case—the case of the gold collateral of Egypt in 1958—was not a good precedent, and apparently it was felt that it should not be repeated. There were a number of legal and policy problems with this gold collateral.

In any event, at the time of the Second Amendment, it was considered useful to keep the provision without amending its language. I would like to draw the attention of the Board to the language of this provision, Article V, Section 4:

The Fund may in its discretion, and on terms which safeguard its interest, waive any of the conditions prescribed in Section 3(b)(iii) and (iv) of this Article, especially in the case of members with a record of avoiding large or continuous use of the Fund's general resources. In making a waiver, it shall take into consideration periodic or exceptional requirements of the member requesting the waiver. The Fund shall also take into consideration a member's willingness to pledge as collateral security acceptable assets having a value sufficient in the opinion of the Fund to protect its interests, and may require as a condition of the waiver the pledge of such collateral security." The key word in this provision is the word "safeguard.

Throughout the various instances in which the application of the provision has been envisaged, there has always been a reference to the use of Article V, Section 4 to ensure the repayment of the resources provided by the Fund. Hence, the use of the word collateral. That is the typical type of guarantee—for example, the Egyptian gold pledge I mentioned a moment ago. About ten years ago, the question was raised whether the Fund could not only require collateral, but also require a shorter repurchase period. A shorter repurchase period could also be regarded as a safeguard of Fund resources, at least in some cases, because the Fund would ensure the revolving character of its assets. The term "safeguard" is essential to the understanding of the provision and it is almost a coded word. It appears already in Article I(v): "The purpose of the Fund to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards."

At the time of the Second Amendment, the word "safeguard" was added to Article V, Section 3(a): the Fund's policies had to establish adequate safeguards for the use of its resources. The meaning of the word was queried at that time by some Executive Directors. The then General Counsel answered that there was no intention to go beyond what was the practice of the Fund in ensuring the repayment of Fund resources. It has now been recognized that both the provision of collateral and, more recently, the adoption of a shorter repurchase period constitute safeguards within the meaning of Article V, Section 4. Therefore the question now is whether a higher rate of charge could also be a safeguard. If the rate of charge is refundable upon repayment of the principal, it is a form collateral; there is no problem. If, however, the rate of charge is not refundable and, therefore, becomes part of the Fund's income, it does not by itself ensure the repayment but serves a different purpose. It may be used by the Fund to reduce other charges, or for distribution of income.

Therefore, should one read the provision narrowly or broadly? We read the provision narrowly, because if it were read broadly, it would mean that under Article V, Section 4 the Fund has unlimited powers not only in terms of repurchases, but in terms of charges to determine whatever terms and conditions it wants to impose on a member above 200 percent of quota. That is neither the practice of the Fund nor the description of the meaning of "safeguard" that was provided at the time the Second Amendment. Of course, the Board is always free to interpret a different interpretation of the Articles of Agreement, but as far as we are concerned, we believe there is no evidence that there was any intention to give the Fund a power that goes beyond what is strictly necessary to safeguard its resources.

On the text that has been circulated by Mr. Esdar, some remarks may be made but they could be discussed at some other time. In particular, the question of limiting access to this facility to cases of possible contagion that could threaten the international monetary system. Very briefly I would like to say that again this is not the first time that there is reference to the systemic effect as a condition of access to Fund resources. In this respect, the distinction is made between two types of decisions of the Fund. There are decisions which do not affect the access of the member to the Fund's resources—for example, the Emergency Financing Mechanism, which is not a decision on substantive access, but it is a procedural decision. Similarly, the reference to systemic problems in the General Arrangements to Borrow (GAB) does not relate to the member's access to the Fund's resources but only to the willingness of GAB participants to make their resources available to the Fund. The two issues are totally separate. For instance, there are differences in the GAB between loans for participants in the GAB and loans for nonparticipants, while under its Articles the Fund is bound to observe the principle of nondiscrimination. Therefore, the question really is whether, when it comes to using the Fund's resources, injecting that condition that the problem has to somehow affect the international monetary system would be consistent with the nondiscriminatory or uniform use of Fund resources. This question has not come up in many contexts, but, for instance when the Board adopted the exceptional circumstances clause for higher access to Fund resources, it was proposed by some Directors at that time to limit the availability of the exceptional circumstances clause to cases involving a systemic problem affecting the international monetary system. That was resisted by a large number of Directors on the grounds that it would be contrary to the principle of uniform treatment.

The problem is serious because if higher access is reserved for cases creating a systemic problem, the criterion for access is no longer the member's own balance of payments problem, which is the criterion referred to in the Articles. If a facility is not available unless the member's problem has an impact on other countries, the consequence is that the Fund will not assist the country unless other countries are affected, while the use of Fund resources should be determined by the member's problem. Moreover, if that condition is inserted countries that do not meet that condition—systemic effect—will not be eligible under the facility. What happens to them? If they are not eligible under the facility, normally they will have access to the Fund's resources under the normal credit tranches. Therefore, they will have access to the Fund resources under different terms and conditions, which seem, on balance, to be more favorable: exceptional circumstances clause, longer repurchase periods, and lower rates of charge.

Mr. Esdar considered that the General Counsel's interpretation was too narrow. It was clear in the Articles that the Fund had to protect the international monetary system, and it would be inconceivable that the Board could not establish facilities to serve that particular purpose. Therefore, it must be possible to have some objectives in the new facility that directly addressed those problems reflected in the general objective of the Fund. It might be possible to propose a formulation that would state that, in general, the facility was open to every member, but it was intended particularly for those countries whose balance of payments problems had a particular effect on the international monetary system and that might generate a contagion effect.

The Chairman pointed out that the language that Mr. Esdar had quoted from the Chairman's concluding remarks at the conclusion of the Board meeting on the Emergency Financing Mechanism was responding more or less to the concern raised by Mr. Esdar.

Mr. Esdar said that he agreed with the Chairman, but the General Counsel had said that the same goal could be achieved through the use of procedures, rather than facilities; he was not convinced by the General Counsel's argument.

The Chairman said that, legally, the point was very important. It was true that, on the one hand, there were procedures, and, on the other hand, there were facilities. He asked the staff of the Legal Department to present options at the following Board meeting that attempted to resolve the matter.

The General Counsel noted that, if the new facility were described as purporting to remedy situations that in many cases were expected to affect the international monetary system, then it would be only an explanation rather than a condition, and the problem would disappear. There would be an issue, however, if the reference to systemic effects were made a strict condition. Also, it was important to note that the language in the decision establishing the Emergency Financing Mechanism was much more nuanced, not making the systemic effect a precise condition but an important element in the Board's final judgment. He said that alternative formulations would be submitted.

Mr. Wijnholds recalled that the word "or" appeared in the language of the Emergency Financing Mechanism and should be included in the decision establishing the SRF.

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

The General Counsel noted that a number of Directors had raised the issue of how the Fund should treat private creditors. In that regard, there was no problem about addressing moral hazard concerns and looking at what creditors were prepared to do. The question whether the Fund could single out private creditors and make that a condition of the use of the facility was a much more fundamental issue. It was not obvious that private creditors would be the only concern. Moreover, the distinction between public and private creditors might be somewhat arbitrary. For example, pension funds were normally private, but there were also public pension funds.

Ms. Lissakers stated that the staff had not addressed the question of attaching the surcharge to the size of the purchases, rather than to the maturity, or to both.

The Chairman pointed out that Ms. Lissakers had suggested attaching a graduation to the two variables of the amount and of the length of time. Mr. O'Donnell had proposed concentrating more on the passing of time, rather than the amount. However, no one had proposed a way of combining the two approaches.

Mr. O'Donnell said that the two proposals could be combined by levying the charge on the outstanding balance.

Mr. Bernes stated that he agreed with Mr. O'Donnell; in fact, his own earlier presentation had proposed a similar combination.

The Treasurer pointed out that, in fact, charges were levied on outstanding balances.

The Chairman noted that Ms. Lissakers had preferred a kind of progressivity according to the amount of the loan; the concept of outstanding balances incorporated the notion of proportionality more than progressivity.

The Director of the Policy Development and Review Department considered that Ms. Lissakers's proposal could be achieved by differentiating by either the length of time outstanding or by the size of the purchases outstanding; also, they could be combined in some way, with the only caveat being that it had to be by quota. It could not be one third of the absolute amount, for example, as had been suggested.

The Chairman said that there might be a difficulty when the situation involved a country with an artificially low quota.

There was broad agreement on the establishment of a facility and on higher charges on the use of resources under the facility, the Chairman noted. The issues raised by Mr. Esdar, especially those suggesting a more precise language for the objectives of the facility and the eligibility in light of the comments made at the current meeting, could be addressed properly, utilizing, as needed, the language of the Emergency Financing Mechanism procedures, while recognizing that in those cases, there were procedures and in the other cases there was a facility. Directors had discussed the duration of the facility, and an equilibrium point between the various positions would be identified. On the availability of financing, a period of one year received most support.

Directors had recognized that the use of resources under the facility should be subject to strong conditionality and, preferably, with a high volume of prior actions, the Chairman observed.

On higher charges, the Director of the Policy Development and Review Department had described possible equilibrium points among Directors' positions, the Chairman stated.

On the disposition of income from the proposed SRF, there was unanimous support to postpone to an early date a decision on that matter, as proposed by the staff, the Chairman noted. On the disposition itself, the Board would meet soon to discuss the matter. There was a variety of preferences, but the spectrum of proposals defined in the staff paper provided a good basis for a decision; he preferred the tripartite solution suggested by Mr. O'Donnell. While the three amounts could not be equal—in particular regarding the part committed to the ESAF—various possibilities would be considered.

The staff would consider carefully all the views expressed by Directors, and proposals would be presented to Directors for their consideration at the following Board meeting, the Chairman concluded.

Mr. Esdar said that it was important to present proposals that addressed the issue of including private sector creditors in any orderly debt work-out scheme; there had been broad support among Directors. He suggested that, as the staff proposals would take a day to prepare, and since Directors' national authorities would need to be consulted, the Board should meet in two days, on December 17, to conclude the discussion on the establishment of the SRF.

The Chairman stated that he agreed with Mr. Esdar's proposal to conclude the discussion on the SRF on December 17.

Mr. Fernandez said that he would agree to conclude the SRF discussion on December 17, on the condition that the proposed disbursement for Korea, scheduled for December 18, would be made under the new SRF terms.

Ms. Lissakers stated that she agreed with Mr. Fernandez; the establishment of the SRF should be given a high priority.

The Chairman suggested that Directors consider the staff proposals at an informal luncheon the following day, December 16, and the Board could conclude the SRF discussion on December 17.

3. RUSSIAN FEDERATION—REPORT BY STAFF

The staff representative from the European II Department made the following statement:

> Directors will recall that the previous mission returned to headquarters in early November with the recommendation that the review not be completed because the fiscal situation was deemed to be off–track. Not only had cash revenue failed to reach the program floor set for September 1997, but the cash deficit ceiling had also been met through the emergence of new arrears, and the prospects for the remainder of the year were not favorable. Another important consideration in the mission's decision not to seek a completion of the review was that the 1998 budget did not offer a firm enough assurance that the fiscal situation was being set right. The revenue projections in the budget were, in our view, a substantial overestimation, while the spending pressure, in terms of the underlying trend of the government's consumption of goods and services, appeared even higher than the budget. Thus, actual cuts would have to take place first to bring spending down to the budgeted levels, and then further down to levels consistent with available resources. The mission left behind proposals for revenue and spending measures for the consideration of the authorities, proposals that were partly based on the recommendations for tax

administration and expenditure control prepared by technical assistance missions fielded by the Fiscal Affairs Department.

By the time of the First Deputy Managing Director's visit to Moscow in the second week of November, the authorities had proceeded to formulate a fiscal action plan, and it was agreed that this plan would be further fleshed out and major parts implemented during the first half of December. Accordingly, the current mission reviewed the progress in the implementation and further development of the plan. We also reviewed 1998 fiscal policy, and reached firm understandings on 1998 federal budget targets, which in the mission's view offers the prospect of a substantial correction of the fiscal situation. Further refinement of these understandings in early 1998, together with a formulation of the monetary and structural policy guidelines for 1998, will permit the staff to present to the Board the full 1998 EFF program around March 1998.

Originally, the staff had intended to wait until that Board meeting to propose the next disbursement under the program. However, the progress made at this point and the actions executed are significant enough that the mission's recommendation is that the sixth quarterly review, which was left uncompleted at the end of the last mission, be now completed. Following management approval, we would circulate the letter of intent and the supporting staff report by the middle of next week, with a view to holding the Board discussion around January 5.

I will now describe the nature of the action plan, and the further understandings reached. I will also describe recent financial developments, including monetary policy actions.

Revenue performance improved somewhat in October and November over the levels registered in the third quarter, and a further improvement is expected in December. Even so, our projection is that federal cash revenue will amount to around Rub 245 trillion in 1997, compared with the program floor of Rub 283 trillion (see table). An additional Rub 45 trillion may be raised as counterpart to offset operations. The cash deficit is expected to be well within the program ceiling. However, counting the accumulation of arrears to enterprises, the overall deficit could reach more than 8 percent of GDP.

The 1998 budget, as approved by the Duma at the first reading, calls for revenue of Rub 353 trillion (in the Fund definition) or a little less than 12 percent of GDP. Since it is expected that there will be no more offset operations to clear spending arrears against overdue taxes after January 1, this represents a substantial jump in cash receipts over 1997, which the mission does not think can be achieved. Spending in the budget is set at Rub 493 trillion, of which debt service is projected at Rub 120 trillion. The budget thus envisages a small primary deficit and an overall deficit of Rub 141 trillion (or 4.7 percent of GDP).

By contrast, the baseline projections of the mission were for substantially lower cash revenues and substantially higher noninterest spending. Together with an increase in debt servicing stemming from recent increases in interest rates, the deficit would reach, in the absence of measures, almost

Rub 230 trillion (7½ percent of GDP). Thus, the gap between the budget and the mission's projections of the underlying deficit was nearly Rub 90 trillion or 3 percent of GDP. This was the gap that was to be filled with measures, unless the cash deficit could be allowed to go higher. Needless to say, particularly because of recent developments in financial markets, a sizable increase in borrowing requirements was an avenue that did not seem viable.

The authorities are indeed moving to fill this gap with spending and revenue measures. On the spending side, the authorities' fiscal action plan includes the preparation of an inventory of personnel and programs, following which the spending ministries are to propose cuts in both that will enable them to function within the constraints set by the government. At the same time, the government is putting in force physical ceilings on the consumption of energy and heat by spending units. The goals set for these cuts are Rub 45 trillion (or 1.5 percent of GDP) in 1998, and these cuts would be enforced through a strengthened Treasury system, in line with the recommendations made by a recent technical mission from the Fiscal Affairs Department.

On the revenue side, the authorities have agreed to put in place measures to improve tax administration and raise revenue, with the aim of attaining a revenue target of Rub 330 trillion in 1998 (or 11 percent of GDP), or about Rub 30 trillion above the baseline projection of the staff. This additional 1 percent of GDP would be sought partly through the measures in the fiscal action plan and also through additional measures discussed in the mission. Some of these new steps will be implemented in the next several weeks. Further measures will also need to be specified, which would be in place by the March Board meeting.

The revenue and spending measures would virtually close the gap referred to earlier, except for a small amount that could constitute an additional deficit, possibly to be financed through extra privatization receipts. Accordingly, the 1998 deficit would amount to about Rub 150 trillion or 5 percent of GDP. This would be a substantial adjustment from the expected 1997 outcome, and would help put the fiscal situation on a path of recovery.

Before the Board meeting, the authorities will need to put in place a large number of actions constituting the measures already agreed on. Some steps have already been taken, in particular a presidential decree ordering the collection of information and presentation of proposals for cuts, ministry by ministry. Also, the Emergency Commission met on December 8 and ordered that action be taken against a number of enterprises, including the seizure of two oil refineries owned by tax delinquents. The resolution putting into effect these Emergency Commission orders is in the process of being signed, and we will be looking carefully at its finalization and implementation, which also is of great importance for the World Bank in moving forward with its own Board meeting on Thursday this week. Other fiscal prior actions include the creation of a spending reserve in the budget that could only be released if revenue exceeded a set limit. The bulk of these measures are not only essential for the 1998 budget, but will also have a lasting effect on how fiscal policy is formulated and implemented, on how information is gathered, how spending decisions are made, and how spending is controlled. In short, they would be a great step forward in modernizing the fiscal policy apparatus of the Russian government.

On the side of monetary policy, it is well known that Russian financial markets have been buffeted by the shifts in investor sentiment that has affected other countries. Clearly, Russia was particularly vulnerable because of the large weight of foreign investors in its Treasury bill market and the justified perception that fiscal policy was off–track. The authorities responded by speeding up the depreciation of the ruble within their corridor, but making large sales of foreign exchange to absorb the brunt of the pressures on the exchange rate, while intervening in domestic credit markets to limit the increase in interest rates. International reserves fell by about $6 billion during the month of November, and this intervention was almost fully sterilized, partly through purchases in the treasury bill market, and partly through additional lending to banks on the security of government paper. In fact, net domestic assets increased sharply, well above the December program ceiling, while reserve money fell very little. In our discussions with the authorities, we argued that full sterilization of the intervention in foreign exchange markets was in fact feeding a continuation of the attack on the currency, and that treasury bill yields and other market interest rates had to be allowed to find their level independently if the exchange rate regime was to be maintained. Indeed, in early December the central bank withdrew from the treasury bill market and allowed interest rates to rise sharply. Since the early days of December, investor sentiment has improved and interest rates have eased, although they rose in the past few days reflecting some concerns about the health of President Yeltsin.

During the mission, we also held discussions with Russian officials, jointly with the World Bank staff, to begin to elaborate the structural program for 1998. We made good progress, and plan to complete discussions in this area during the next mission in early 1998.

Mr. Melese d'Hospital asked what revenue measures would not be in place by the time of the Board's forthcoming review of the Extended Arrangement (planned for January 5, 1998). Furthermore, he wondered whether the staff believed that Russia's international reserves had stabilized.

The staff representative from the European II Department commented that, as agreed between First Deputy Finance Minister Kudrin and the First Deputy Managing Director, the authorities' fiscal action plan should yield Rub 5-10 billion, approximately. The revenue yield from that plan was extremely difficult to estimate because several different revenue measures would be implemented under the plan. First, the state tax service had proposed creating a national tax inspectorate to improve tax collection from major enterprises throughout the Russian Federation. As Directors might have recalled, an important element of earlier taxation plans had been the establishment of large taxpayer units to collect revenues from major taxpayers in every region of the Federation (previously, large enterprises had tended to co-opt regional authorities, who were not effective in collecting taxes). The new national tax inspectorate would focus on the measurement of tax obligations throughout the Federation, regardless of where enterprises were located. While the inspectorate would be established in the first half of 1998, it was difficult to quantify its likely impact on fiscal revenues. Second, the likely impact of other measures to collect revenues from large taxpayers was also hard to estimate. The staff had estimated that those measures would increase revenues by about

Rub 5–10 billion, but had used the lower estimate of Rub 5 billion in its projections. Third, the authorities had undertaken to implement other revenue measures that would yield Rub 25 billion in revenues. Of those measures, four would be implemented shortly, three of which would be taken before the planned January 5 Board meeting on the sixth quarterly review of the Extended Arrangement. Most of the other measures agreed between First Deputy Finance Minister Kudrin and the First Deputy Managing Director would be in place before the Board meeting.

As for the March 1998 Board meeting on the newly agreed program under the Extended Arrangement, the authorities and staff still needed to agree on about Rub 15–20 billion in additional revenue measures, the staff representative noted. Thus, while substantial progress had been made—in which the staff had used highly conservative estimates—substantial work still needed to be done in identifying further revenue measures. The authorities and the staff would begin to do so over the next few weeks, including not only tax administration measures but also longer-term measures that might require approval by the Duma.

Foreign exchange reserves had currently stabilized, and might even have increased somewhat over the previous week, the staff representative stated. Nonetheless, the situation remained highly sensitive to developments in international financial markets and to speculation about, for example, President Yeltsin's health. The authorities were on course toward eliminating by end-1997 restrictions on foreign investment in the GKO market (which might be followed by some further pressures on reserves). It was vital that they continue their practice of not fully sterilizing capital outflows and allowing interest rates to rise in response to speculative attacks; otherwise the authorities would effectively be prompting such attacks.

Ms. Cilento commented that it had been her impression—from a recent informal country matters session on Russia—that the measures currently under discussion would not have a major impact on fiscal revenues until mid-1998. Moreover, the January/February period was typically a difficult one in the Russian Federation, because of seasonal factors. She therefore wondered if most of the expected progress would take place in the second half of 1998.

The staff representative from the European II Department responded that, although some revenue measures would only be in place by mid-1998, others would be in place by the start of the year—three out of the ten measures in the fiscal action plan would be implemented by the start of 1998. Indeed, it was possible that fiscal revenues might increase substantially in early 1998, though that was not certain. An important element of the fiscal action plan was the elimination of offset operations as of January 1, 1998—a decree had been passed to that effect, which the staff proposed monitoring via a continuing performance criterion. According to the head of tax administration, continuing offset operations were one reason revenues had increased slowly in the third and fourth quarters. Until those operations were ended, companies would continue to be reluctant to pay their taxes in cash. The decree to eliminate those operations was being taken seriously, as illustrated by the fact that, on the last day of the its mission in Moscow, the staff had almost not been able to enter the finance ministry because the ministry's entrances had been blocked by crowds of people trying to obtain applications before January 1.

Mr. Donecker, noting that the Board had discussed the need for comprehensive tax reform during recent informal country matters discussion on Russia, wondered about the status of comprehensive tax reform. The finance minister might only be able to present the reform to parliament by mid-1998.

Another staff representative from the European II Department responded that the new finance minister was working on a revised version of the tax code, and, to the best of the staff's knowledge, intended to submit it to the Duma by mid-January 1998. Some parts of the revised tax code would not become fully effective until mid-1998, and the bulk of it perhaps not until the January 1, 1999.

Mr. Zoccali wondered whether the staff would provide more information on developments in prudential indicators. In particular, given shifts in market sentiments and tightened financial market conditions, he wondered whether the authorities were taking pre-emptive measures to strengthen prudential regulations.

The staff representative from the European II Department noted that the recent mission had included a staff representative from the Monetary and Exchange Affairs Department to examine the position of the banking system in the recent crisis. Since the start of the crisis, the authorities had strengthened their monitoring of banks, especially the 20 major banks, via the government's special review unit. On the basis of the information received to date, the prudential position of banks had not changed substantially during the crisis. Although the market had feared for some time that Russian commercial banks would have insufficient foreign exchange to meet their obligations, the banks had dealt with liquidity needs and their capital ratios had remained sufficient. While banks might have suffered some accounting losses—mainly in their holdings of short-term treasury bills—those would not have to be realized as long as banks did not have to liquidate their positions before the debt instruments matured. The banks had not had to report losses and suffer a deterioration in their capital adequacy, because the central bank had allowed them to continue to carry forward losses into 1998.

Nonetheless, there were continuing medium-term concerns predating the recent mission, the staff representative said. The financial position of the banking system as a whole remained difficult to assess, particularly as the figures provided by banks were of doubtful reliability; supervision was not fully consolidated; and there was anecdotal evidence indicating that banks might be hiding nonperforming assets in the form of off-balance sheet items of related companies. While those medium-term problems might become more pressing, the banks had thus far been able to weather the immediate crisis.

The mission had discussed with the management of the central bank the latter's position vis-à-vis bailing out banks, the staff representative added. The central bank would provide assistance to solvent banks and would act, in good faith, as a lender of last resort. However, the central bank would not seek to protect commercial banks from incorrect decisions taken in the middle of the crisis.

4. BULGARIA—REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the second review under the 14-month Stand-By Arrangement for Bulgaria approved on April 11, 1997, together with the authorities' letter of intent (EBS/97/218, 12/1/97; and Sup. 1, 12/2/97).

The staff representative from the European I Department made the following statement:

> Since the staff report for the second review under the Stand-By Arrangement (EBS/97/218, Supplement 1) was issued, the authorities have fully met most of the prior actions and have made sufficient progress on the

remaining ones to ensure satisfactory implementation of the program (Appendix I). Information received over the past two weeks indicates that economic developments have been consistent with the program and in some cases even more favorable than expected. The legislation underlying the 1998 budget is proceeding through Parliament without major difficulties and the laws on the value-added tax (value-added tax), corporate tax, personal income tax, local taxes, and the customs code have passed in line with understandings under the program. Policies and prospects remain as indicated in the staff appraisal, and the staff continues to support the authorities request for completion of the second review.

On the remaining prior actions, owing to the heavy legislative agenda in the context of the adoption of the 1998 budget and the need to consult with all institutions involved, a new law on the State Savings Bank (SSB) has not yet been passed, but the draft is fully consistent with converting the SSB into a regular commercial bank as discussed in the staff report. Regulations for foreign exchange positions and liquidity were adopted by the board of the Bulgarian National Bank and the regulation for lender of last resort is in the process of being finalized. Decrees on incomes policy and external debt management in line with the memorandum of economic policies are expected to be adopted by the Council of Ministers on Monday, December 15.

The tax preferences extended under the Foreign Investment Act appear to be circumscribed more narrowly than reported in the staff report. In addition to meeting the conditions mentioned in the report, firms must be set up specifically for the purpose of undertaking priority investment projects. As such the tax preferences do not apply to the acquisition of existing assets, including in the context of privatization. Nevertheless, the wording of the law is vague and its implications are difficult to assess. In these circumstances, it has been agreed with the authorities to set up a working group, with participation by the Fund and the World Bank, which will report by end-January on the implications of the law and propose amendments to it to reduce the scope of the concessions as needed. The authorities will take necessary steps to amend the law, if warranted, before the third review under the arrangement.

Recent data on economic developments are encouraging. Consumer price inflation remained stable at 0.5 percent in November, well below the expected range of 1-2 percent. Preliminary data on the external account show a larger than expected trade surplus for the first nine months of 1997. So far, the turmoil in international financial markets affecting emerging market economies has had limited impact on Bulgaria: yields on 3-month treasury bills rose by 140 basis points to 7 percent per year in late November where they appear to have stabilized while money demand continues its rise with monetary liabilities of the issue department increasing by DM 110 million during November 1997. As a result, gross official reserves reached DM 4.2 billion compared to DM 2.8 billion at end-June.

The staff representative added that the Council of Ministers had just adopted the decrees on incomes policy and external debt management, in line with the agreed understandings in the memorandum of economic policies. The decree on incomes policy had been adopted in principle, and would be issued following formal consultations with the social partners on December 18—informal consultations had been held already, and the government did not expect that the decree would need to be amended as a result of the formal consultations. Furthermore, the parliament had approved the budget on December 12, consistent with the program's budget, and had ratified the World Bank's Financial and Enterprise Sector Adjustment Loan and the European Union's balance of payments loan, which should both be disbursed over the next few weeks.

Mr. Wijnholds made the following statement:

Implementation of the comprehensive program for macroeconomic stabilization and structural reforms has proceeded broadly as expected. Indeed, only five months after the establishment of the currency board arrangement, Bulgaria is already reaping the fruits of its disciplined monetary regime, the appropriately supportive financial policies and wide-ranging structural reforms. Performance under the present Fund-supported program has also been successful as all quantitative performance criteria for end-September were met and those for end-December 1997 appear to be well within reach.

The economy has been recovering steadily since mid-1997 as confidence in the authorities' economic policies and the health of the financial system returned. Output recovery has been gaining momentum, with inflation and interest rates falling rapidly. The consumer price index recorded a modest increase of 0.5 percent both in October and November, and interest rates are converging to comparable yields on Deutsche mark assets. Monetary developments, together with strengthened fiscal and external account positions, have made necessary an early update of the economic indicators for this year. Indeed, with more efficient tax administration, strong budget revenue collection and lower-than-programmed interest payments, the general government budget is likely to outperform the initial program targets. The overall deficit for 1997 is now expected to be in the range of 4.4 percent of GDP rather than the program forecast of 6.2 percent, and the primary surplus is expected to improve to 4.6 percent of GDP. The external position has also been stronger than earlier projected as Bulgaria posted a trade surplus of $300 million in the first half of 1997. Moreover, the current account is projected to record a surplus of 1.8 percent of GDP for 1997 as a whole. This performance, together with the rebound in domestic money demand, has brought about further accumulation of international reserves and as of end-November the reserves of the Issue Department of the Bulgarian National Bank amounted to deutsche mark 4.2 billion. Reserves are expected to increase to deutsche mark 4.4 billion ($2.5 billion), or 4.3 months of imports, by the end of the year.

In addition to the appropriately tight financial policies, the authorities have vigorously pursued implementation of the envisaged structural reforms. The process of privatization has been substantially accelerated in 1997 with the completion of the first wave of voucher privatization and the sale of a number of large enterprises. Privatization receipts reached over US $400 million through September, exceeding initial expectations. Satisfactory progress was also made in the process of financial rehabilitation of the major public utilities, as well as in isolation and liquidation of loss-making enterprises. To this end, the authorities' letter of intent and the staff report give ample information. Last, but not least, the systemic bank restructuring undertaken in the midst of the financial crisis, has contributed to the overall success of the program. The closure of 17 banks and strengthened bank supervision have helped in restoring confidence in the financial system. Simultaneously, with the increasing money demand the remaining banks have strengthened their positions, and maintained solvency and relatively strong capital adequacy ratios.

To take into account recent economic developments and expected legislative changes the authorities, with the assistance of Fund staff, have updated the macroeconomic and budget frameworks for 1998. The economy is expected to grow 4 percent over 1997 and the monthly average inflation is projected at about 1 percent, down from a rate of 17.5 percent in 1997. The 1998 draft budget envisages an overall deficit of 2.0 percent of GDP compared to an expected deficit of 4.4 percent in 1997, while the primary surplus will decrease to 2.5 percent of GDP. Finally, the foreign exchange reserves would rise to deutsche mark 5.2 billion ($2.9 billion), equal to 4.5 months of imports, by end-1998.

The program of the Bulgarian authorities for the period ahead focuses on the achievement of a strong fiscal position, and on the challenges facing the country on the structural front. As regards fiscal policy, the authorities intend to maintain a tight policy stance to underpin the currency board arrangement and ensure medium-term fiscal sustainability. The Bulgarian authorities believe that the proposed fiscal stance is sufficiently tight, especially given an expenditure contingency of 1.3 percent of GDP. The contingency expenditures would cover the costs of the restructuring and privatization of the national airline and a number of major public utilities. Concerning the 1999 fiscal target, the authorities are fully committed to achieving a balanced budget with a primary surplus of 4.5 percent of GDP.

Fiscal targets for both 1998 and 1999 will be achieved in the context of a comprehensive tax reform, measures to improve social expenditures, and further tightening of discretionary spending. At present the government is in the process of implementing a tax reform package aiming at enhancing efficiency and equity, and strengthening tax administration. The authorities' intentions have already been announced and some of the key steps are: a reduction in the corporate profit tax from 40.2 percent to 37 percent; revaluation of the long-term fixed assets and acceleration of depreciation for machinery and equipment; as well as amendments to the personal income tax, including a reduction in the number of income brackets. The Bulgarian authorities are cognizant of the fact that the envisaged amendments could adversely affect revenue performance and they intend to achieve a trade-off between reducing tax rates, and broadening the tax base, tightening loopholes and exemptions. In addition, the authorities agreed with staff's advice to keep expenditures in line with revenue performance in order to address any downside risk to the budget.

The incomes policy envisaged for the period ahead will continue to contribute to the achievement of the fiscal targets and to financial discipline in the state-owned enterprises state-owned enterprises. As in the past, incomes policy will be guided by the principle that wages should develop in line with the financial performance of enterprises.

As regards structural reforms, the authorities' strategy focuses on deepening the privatization process, achieving further progress on financial isolation and restructuring of the loss-making state-owned enterprises, energy and agricultural sector restructuring, and strengthening and privatization of the remaining state-owned commercial banks. The Bulgarian government has recently announced a broad strategy for acceleration of the privatization process with the aim of divesting 38 percent of the state-owned enterprises measured in terms of long-term fixed assets in 1998, and a further 15 percent in 1999. The strategy envisages utilization of a broad menu of privatization options, such as voucher and cash privatization, management buy-outs, and sell-offs of pools of large enterprises through investment banks and foreign consultants. Indeed, the second wave of voucher privatization is already scheduled to take place in the spring of 1998 and contracts were signed with a number of investment banks and foreign consultants for the privatization of a group of 30 large enterprises. Concerning the banking system, the government is fully committed to privatize the remaining five state-owned commercial banks by the end of next year.

On Bulgaria's external outlook and policies for 1998, both exports and imports are expected to show continued strong growth. The current account is expected to shift into a small deficit in the face of strengthening in domestic incomes and continuing strong inward foreign direct investment. As regards debt management policies, the Bulgarian government is fully committed to work toward normalizing its relations with a number of official creditors. To this end, discussions were already held both with bilateral and multilateral creditors aimed at resolving common disputes.

Finally, I would like, on behalf of the Bulgarian authorities, to thank staff for their efforts to assist Bulgaria in its transformation to a market economy.

Mr. Vernikov made the following statement:

In view of the late hour, I will try to be quite brief and summarize my comments.

Overall, I am very happy to see that the program is working. Indeed, Bulgaria's performance under the arrangement is even better than expected, due both to natural economic developments and to conscious and brave efforts by the authorities. Hopefully, the country's economy already hit bottom earlier this year, and next year we might see a recovery.

Fiscal policy keeps posing hard challenges, but they are much more manageable now than before. I noted that the substantial primary budget surplus in 1997 will decline next year, more or less in parallel with a reduction in interest payments. It is especially welcome that interest rates have come down rather fast, thus providing a post-factum confirmation of the correctness of the policy choice made. The staff expressed some concerns about the ways in which the authorities intend to use the additional funds available to them. I believe that, on balance, the authorities' stance remains solid and responsible.

With regard to income policies, I think the authorities have done right to retain administrative controls over wages in the public sector, especially on yet unprivatized state-owned enterprises. Empirical evidence shows that in countries without such controls, the enterprises have tended to act counterproductively to macroeconomic stability.

The staff, apparently, has some reservations about fiscal measures that might reduce the revenue side, and suggest that those measures be phased in over time. One of such measures is the revaluation of assets. I noted, however, that long-term fixed assets are valued at 1992 prices. That leads to overtaxation of capital and decapitalization of industries. In my opinion, there is simply no alternative to the measure the authorities are poised to undertake, and, after the one-time shock, means will need to be found to offset the impact on the budget revenues.

There is not much to say concerning monetary and foreign exchange rate policy, in view of the operation of the currency board. I am glad that Bulgaria has been building up foreign exchange reserves at a higher pace than envisaged.

I have a small factual question pertaining to the external sector: have the Bulgarian authorities eliminated the export tax as they were planning to do by the end of this year? And, secondly, does the staff agree with the authorities on the rationale for maintaining this and other similar trade restrictions?

The ultimate success of the Bulgarian program will, of course, depend on the course of structural reforms. In this regard, while I welcome the progress already achieved and the policy intentions for the next year, I would like to make two comments.

Firstly, I wonder whether having exact numeric targets for privatization (which are very ambitious, maybe even too ambitious) is the most credible and productive way to address the issue. Market participants aware of the authorities' policy commitments may contribute considerably less revenue to the budget, and this is particularly true for those privatizations scheduled for the end of the year.

Secondly, I noted Bulgaria's plans to privatize very expeditiously five leading banks, and I would like to know a little more about the authorities' current thinking—namely, who are the potential buyers? Is there any foreign investor interested? It seems to me that there is a danger that overly hasty divestiture of the state will not lead to an effective ownership structure, thus leading to a continuation of past practices with insider or related lending, asset-stripping, etc.

In conclusion, I agree with the main conclusions of the report and support the proposed decision. I wonder why we could not have completed this review on a lapse of time basis, given that the Bulgarian authorities have complied with all performance criteria? I wish Bulgaria further success.

Mr. Tilyayev made the following statement:

After a severe setback in the transition process at the beginning of the year, Bulgaria is at last making tangible progress toward putting into place a stable macroeconomic environment. Although output will continue to fall at a somewhat slower pace of close to 8 percent for 1997, there are good reasons to assume that this decline can be halted and even reversed in 1998. The staff is projecting an increase of real GDP of 4 percent for the coming year. Indicators on inflation, foreign reserves accumulation and interest rates show impressive improvements and give rise to a much positive medium-term outlook for the Bulgarian economy.

I commend the Bulgarian authorities for maintaining the political momentum in favor of the difficult stabilization measures backed by the Stand-By Arrangement which have brought impressive results. All performance criteria of the arrangement for end-September have been met and almost all prior actions for completion of the second review were implemented. I therefore support the proposed decision of the staff. Given the above positive assessment, I will limit my comments to the following points:

In the monetary area, the currency board arrangement tying the lev to the deutsche mark has been highly successful in restoring confidence in the Bulgarian currency. By taming hyperinflation, it has proved to be a fitting solution to the crisis at hand. Although yearly inflation for 1997 will still reach 600 percent, a rapid decrease closer to the level of the peg currency is under way. Capital inflows are keeping short-term interest rates at the relatively low level of around 6 percent, limiting the contraction in economic activity usually experienced in the initial context of a currency board arrangement. Although the discipline of the currency board is being felt, it has thus not led to extreme pressures for private debtors and the government resulting from their exposure to interest rates.

In the fiscal area, I agree with the staff that adherence to the budget is of paramount importance to lend credibility to the government's economic policy strategy. Such credibility and stability together with other factors such as an appropriate legal framework are important to attract foreign businesses and thus further private capital inflows. Should foreign investment gain further momentum, the government's room of maneuver for fiscal policy will therefore increase.

I also welcome the government's plans for tax reform with the aim of improving the revenue side of the budget and eliminating distortions and disincentives. However, as the staff rightly points out, this may initially result in a larger than expected shortfall of revenues threatening the fiscal target for 1998 and endangering hard won stability gains.

On the structural front, the authorities' strong commitment to reforms and privatization are commendable. Being fully aware of the difficult political choices this process involves, it comes as no surprise that the state continues to play a major role in the industrial and agricultural sectors. Capacity for implementing the ambitious structural reform targets also seems to be limited. Thus actual structural reforms have not entirely kept up with initial intentions.

However, the bankruptcy procedures involving a number of banks are being carried through and the liquidation of enterprises is well under way. Such signals of commitment by the regulatory authorities are bound to contribute to the emergence of a sound banking system and a competitive private enterprise sector. I encourage the government to continue its efforts to put in place a clear regulatory and legal framework for economic activity and build up its own resources for managing the necessary market-oriented reforms.

Lastly, let me emphasize that underpinning the structural reform process with measures of well-targeted social support is an important element for securing the continued backing of the sweeping systemic changes under way. If this can be reconciled with the medium-term fiscal framework, the credibility and sustainability of the macro-economic regime in place will be enhanced further.

With these remarks I would like to wish the Bulgarian authorities all the best in the challenges ahead.

Ms. Abdelati made the following statement:

The economic reforms under the currency board arrangement continue to serve Bulgaria well. The recovery in output is well under way and inflation continues to decline. Economic performance surpassed expectations in a number of important areas, including foreign reserve accumulation, the speed of monetization, the declining yields on securities, the number of privatized enterprises, and privatization proceeds. These developments were underpinned by generally prudent fiscal and monetary policies.

The success achieved over the past few months should not give rise to complacency. Bulgaria is still in the early stages of stabilizing the economy, correcting imbalances, and achieving a sustainable growth path. In order to consolidate the gains achieved to date, continued fiscal discipline is absolutely necessary, as well as further steps to strengthen the banking sector. An acceleration of structural reforms—which are slowing—particularly banking privatization, agricultural sector reforms, and reform of some trade and foreign investment regulations are also necessary.

Looking forward to the 1998 targets, the fiscal stance targeting an overall deficit of 1.6 percent of GDP, even if it is slightly less ambitious than had been originally envisaged under the program, represents a significant improvement over the 1997 outcome. Although the planned tax reforms could jeopardize achievement of the projected revenue levels, we are reassured by the existence of expenditure contingency measures equivalent to 1.3 percent of GDP, and by the authorities' announced commitment to keep expenditures in line with revenues. We echo the staff's concerns regarding the importance of safeguarding fiscal outcomes, and endorse its advice to increase social expenditures when fiscal pressures ease. Recent tax performance seems to support the authorities' expectation of higher collections from value-added tax, excises, and personal income tax. Because of its concern that revenues may fall short of budget projections, the staff has called for the phasing-in of needed asset revaluation and related depreciation allowances, instead of implementing them in tandem with the other elements of the tax package. That measure alone would account for a reduction in tax revenues in the order of about 3 percent of GDP.

From Supplement 1, we understand that the 1998 budget has recently been approved, incorporating the complete tax package, and, by implication, the full impact of asset revaluation on revenues. The supplement did not indicate if the staff was still concerned about revenue prospects. Could the staff provide an updated assessment of its revenue projections for 1998?

Strengthening the banking sector, particularly banking supervision, remains a key element of the structural reform agenda, especially in the context of lower bank profitability and continued high loan concentration. Supervision could be further strengthened with speedy implementation of the early warning system. Progress on this front would ensure that the improvements achieved in the functioning of financial markets over the past month are preserved. In this regard, it is critical that the law on the State Savings Bank, whose passage has been delayed, be passed expeditiously.

The accelerated rates of enterprise privatization in 1997 are commendable. The targets for 1998 and 1999 appear to be overly ambitious and could be problematic if some of the program assumptions are based on these targets. The share of total fixed assets that have been privatized increased in 1997 from 5 percent to nearly 20 percent. The authorities expect to reach 58 percent by end-1998 and 75 percent by 1999. These targets assume that all commercial companies and half of all utilities will be privatized by the end of 1999. But the neglect of the privatization pipeline in the past year, as noted in paragraph 14 of the staff report, does not augur well for achieving these targets. It is also essential that the authorities undertake further legal and procedural changes to facilitate further privatization. In light of the uncertainty regarding the achievement of the privatization targets, we wonder what assumptions the staff used in projecting privatization proceeds of 2.8 percent of GDP in 1998. Failure to reach this level of privatization proceeds could jeopardize the financing of the overall fiscal deficit, as noted in paragraph 22.

The staff points to the prevalence of a number of impediments to private sector initiative in the agricultural sector and to foreign investment in general. We share these concerns, and urge the authorities to take measures to improve institutional capacity and the judicial and legal systems so as to capitalize on the positive trend in investment sentiment. At the same time, we would caution against granting excessive incentives and tax breaks to foreign investors, which can discriminate against domestic investors and encourage rent-seeking activities. I therefore welcome the information provided in Supplement 1 pointing to the somewhat more limited scope of these tax incentives. It is important that the analysis and recommendations of the working group that will review tax incentives for foreign investment be completed and implemented without delay so as to avoid the need to later amend the Foreign Investment Act again. Frequent changes to regulations governing foreign investments can have a damaging effect on investment sentiment. With these remarks, we wish to support the proposed decision and wish the Bulgarian authorities continued progress in achieving sustainable and strong growth.

Mr. O'Loghlin made the following statement:

This chair is encouraged by the fact that the authorities have met all end-September performance criteria, and the prospect that those for end-December seem well within reach. We welcome the broad implementation of the range of prior actions as outlined in the staff statement, and also the commitment of the authorities in their letter of intent to continue their hitherto strong fiscal stance, to press appropriate structural reforms further forward, and to significantly intensify the pace of privatization.

The turnaround which the economy has experienced in recent months also reassures us about the likelihood of continued adherence to the course of reform on which Bulgaria has embarked. The substantial decline in interest rates and the strong pick-up in foreign direct investment must encourage this while, if economic activity expands as projected next year, it will become even more clear that the economic reorientation now under way can pay off for Bulgarians generally, bolstering public support.

We are happy, therefore, to support the completion of the present review. But we have no illusions about the challenges still ahead.

On the fiscal front, we are acutely conscious that the lower-than-anticipated deficit now in prospect for 1997 is somewhat flattering. Revenues will surpass original expectations only because the tax system is interacting with inflation in a way which imposes a burden on business inconsistent with sustained business expansion. And savings on budgeted noninterest spending are coming from an unsustainable compression of social outlays on the one hand, but above-budget noninterest spending otherwise. Looking ahead, we consider that the authorities' fiscal goals for 1998 and beyond are appropriately ambitious but note that they are contingent , in particular, on substantial further interest savings and significant increases in revenue apart from profits taxes. Should either of these expectations appear at risk, the authorities should stand ready to take further measures to ensure that their budgetary goals are realized—as a necessary element in preserving the confidence and stability flowing from the adoption of the currency board arrangement. Mr. Wijnholds's assurances in this regard are most welcome.

Looking to the external accounts, we note that the better-than-anticipated surplus on the current account this year is entirely a function of a decline in imports. Indeed, at least in dollar terms, exports are running a little below original expectations—even if somewhat above 1996 levels. Bearing in mind that domestic inflation remains well above that obtaining in its major markets, and thus that the effective exchange rate is set to rise further assuming broad constancy of the lev, strong growth in productivity is critical if there are to be adequate exports to avoid a steeper deterioration in the balance of payments than now envisaged.

In these circumstances, it is vital that wage developments in the business sector, and the evolution of business costs more generally, reflect the realities of the market-place. Privatization is one avenue to assuring this—by imposing market discipline across an ever-wider range of economic activity. The faster pace of privatization which the authorities envisage for 1998 and

1999 is welcome in this context. While the goals adopted seem quite ambitious, and will certainly test the capacities of all involved, their achievement would bring Bulgaria a major part of the way toward the ultimate objective of a market economy.

The growth of private sector activity which this implies, however, emphasizes the need to carefully monitor the banking sector. Profitability there has been declining. Lending seems still to be concentrated in a few sectors of the economy. Experience of risk evaluation in the context of a free market presumably remains limited. While the growth of resident deposits in domestic banks is an encouraging sign of returning confidence, the resulting high liquidity of the banking system, against this background, poses its own risks. We would encourage the authorities, therefore, to step up their efforts to strengthen bank supervision and, in particular as a means to enhancing expertise in banking, to press forward with the privatization of the five remaining state-owned commercial banks.

With these remarks, we wish Bulgaria every success in the period ahead.

Mr. Palmason made the following statement:

The staff report on Bulgaria made a rather joyous reading in the run-up to Christmas. Unlike much less festive papers that have landed on my desk recently, this one could put an overworked Assistant in the holiday spirit. I can highly recommend it, and agree with most of the analysis and recommendations. Against a background of much less encouraging news from Bulgaria in the last two years, it is delightful to learn that there is finally light at the end of the tunnel. A successful introduction of the currency board arrangement has set the stage for lasting stabilization, although that side of the story hardly gets told in the report, hopefully due to the currency board arrangement's smooth performance.

On fiscal policy, it is apparent that the authorities made progress in 1997, helped by relatively favorable economic conditions, and windfall gains of lower interest rates. I remain hopeful that any additional windfall gains be used to further reduce the deficit, because a prolonged deficit in 1998, albeit lower than this year's deficit, may serve to undermine confidence in the currency board arrangement. While I can sympathize with the authorities' desire to increase social spending and, at the same time, implement overdue changes to the tax system, I fear that this may create bigger problems than it can solve at this juncture. I would tend to agree with staff that a consumption-driven recovery, at the expense of a larger fiscal deficit, could bring the currency board arrangement under pressure.

Turning to the structural issues, we should not forget that lasting stability, sustainable high growth, and higher living standards, are not attainable without even more progress on the structural side. In spite of the most recent efforts to change it for the better, the Bulgarian economy is still in a relatively poor structural shape. I note that a significant portion of economic activity is still in the hands of the public sector, in spite of substantial privatization efforts. Land and agriculture still seem more or less untouched by the hand of reform, and progress is slow with regard to the utilities. Moreover, I have little evidence that corruption and rent seeking activities have been effectively outlawed. Hence structural issues should remain high on the agenda in consultations with the authorities.

With regard to land reform and agricultural reforms, I detect some forthcoming improvements in the letter of intent. Conditions for completion of the third review may improve the situation: first, the abolition of 25 state trading companies and privatization of 9 state mills; and second, issuance of ownership certificates for 90 percent of restituted land. While it has taken the authorities a long time to get to this point, and much remains to be done, those reform efforts constitute a good beginning on the long road to improved efficiency. Here swift implementation is crucial.

The discussion on privatization in the report was a little puzzling. It appears that the authorities have resorted to a menu of privatization methods, having sought advice from privatization consultants, among other things. I welcome the rather ambitious privatization agenda ahead, which will return a substantial part of long-term assets to the private sector by 1999. The sooner the private sector gets the chance to run the engines of the economy, the better. In that regard, I wonder if staff is reading too much into problems with existing consultants' contracts. Perhaps they could elaborate a little on the significance of those contracts in the privatization process.

Having said that, this chair would like to lend its support to the proposed decision.

Mr. Barro Chambrier made the following statement:

It is encouraging to note that the recent implementation of the macroeconomic and structural reform policies and the establishment of the currency board arrangement supported by the Stand-By Arrangement have produced remarkable results, in the aftermath of financial crisis in late 1996 and early 1997. The Bulgarian economy has now begun to recover, as confidence in economic policies and the banking system has improved. The efforts made by the authorities have also enabled them to meet broadly the performance targets for September 1997.

Notwithstanding these encouraging outcomes, the Bulgarian economy remains fragile and the strengthening of macroeconomic policies and of structural reforms must be pursued vigorously in the near term , as well as over the medium term. In this connection, I welcome the authorities' strong commitment to continue to establish a market-based system centered on the disciplined framework of a currency board arrangement and to implement rapid privatization, so as to foster economic growth.

Since I am in broad agreement with the staff recommendations, I will limit my statement to a few specific comments for emphasis.

To secure the success of the currency board strategy and of the program, the fiscal policy should continue to play a major role in enhancing confidence in the economy. Therefore, the achievement of the projected overall deficit of 1.6 percent of GDP in 1998 calls for further tightening of the fiscal policy. In order to consolidate the gains already achieved so far, the authorities should continue to implement revenue-increasing and expenditure-containing measures. On the revenue side, the authorities should strengthen further tax administration and broaden the tax base. The authorities' intention to use revenue in excess of programmed amount to reduce further the fiscal deficit is welcome. However, I also share the staff concern regarding the risk of revenue shortfall in the implementation of the proposed tax reform, in particular as regards the area of profit taxes.

On the expenditure side, it will be imperative to strictly control expenditure, while securing the necessary amount for the social sectors. As regards the incomes policy, it is encouraging to note that it will remain tight in order to preserve competitiveness. However, the weaknesses related to the incomes policy mechanism call for the need to keep under close review the performance of state-owned enterprises that are free to determine wage increases and to ensure that wages are kept in line with productivity.

Overall, the authorities should stand ready to implement additional measures if needed. To reduce the burden on the budget, not only the government should be encouraged to reduce its involvement in the economy, but the privatization of the public enterprises should also be accelerated.

Regarding the banking system, the return of confidence in the banking system since the recent crisis has been instrumental in strengthening this sector, in particular as regards the solvency and liquidity of the banks. However, additional efforts are needed to improve the supervision of the existing banks. In this regard, the Banking Supervision Department (BSD) should accomplish its functions forcefully, given the potential for rapid credit expansion. Moreover, as far as the currency board arrangement is concerned, the authorities are encouraged to continue to enhance the transparency in the banking operations. Progress in bank privatization, which has been slower than envisaged, should be accelerated. While the return of confidence and the improvement in the business environment are taking place, could the staff indicate whether new banks, domestic or foreign, are entering the market and on what conditions?

With regards to structural reforms, the authorities have made significant progress in restructuring and transforming their economy toward a market-oriented system. In particular, privatization continues to be the cornerstone of the program. It appears that structural reforms envisaged in the program are ambitious and are not without risks, given that some delays were already registered in the area of bank privatization and further liberalization of some sectors of the economy in the recent past. It will be critical for the success of the program that any delay be avoided. Another issue that merits some attention, as suggested by the staff, is the need to accelerate the implementation of a targeted social safety net as part of the strategy, in order to reduce the need for subsidies to some sectors of the economy.

With these remarks, I support the proposed decision and wish the Bulgarian authorities all the best in their endeavors.

Mr. Merino made the following statement:

It is encouraging to learn from Mr. Wijnholds's helpful statement that only five months after the establishment of its currency board arrangement Bulgaria is already reaping the fruits of its disciplined monetary regime, accompanied by appropriate supportive financial policies and wide-ranging structural reforms. It is also reassuring to note that all performance criteria for end-September 1997 under the Stand-By arrangement have been met and that those for end-December are well within reach. As we agree with the thrust of the staff appraisal, and support the proposed decision, I will confine my comments to three issues: fiscal sustainability, external vulnerability, and structural reforms.

Clearly, one of the main strengths of a currency board arrangement is the credibility that it accrues to the formulation of sound monetary and fiscal policies, necessary to re-establish confidence and to lower interest rates rapidly. This factor has played a critical role in Bulgaria, where the overall deficit of the general government is now projected to be 4.4 percent of GDP compared with the programed 6.3 percent of GDP, reflecting mainly lower interest payments. Although there is no room for complacency given the still high ratio of public debt to GDP, financing the overall deficit of 1.6 percent of GDP as proposed in the 1998 budget would not seem to pose difficulties, given the expected privatization proceeds of 2.8 percent of GDP and the new external financing that will meet the program's external amortization requirements. In addition to overall control of noninterest expenditures, improvements in the functioning of the tax system and its administration will also be required to achieve fiscal soundness. In this regard, we commend the authorities for their comprehensive tax reform, entailing a broadening of the tax base, a tightening of the tax code, and a strengthening of tax administration. However, considering the institutional and cultural constraints impeding rapid revenue increases—present in many other transition economies as well—the authorities would be well advised to execute the 1998 budget conservatively, and to be ready to keep expenditures in line with revenues. The restoration of confidence in the authorities' policies was reflected in the large overall external surplus and the rapid increase in official reserves. However, in 1998 exports will be adversely affected by ongoing enterprise restructuring, and imports will show continued strong growth in response to improving domestic conditions and vigorous inward foreign direct investment. The authorities will need to consider complementary measures to ensure the consistency of the macroeconomic policy mix and incomes policy. In the context of sustained structural reforms, such policies are likely to stimulate investment and a significant rise in imports, before the enterprise sector can serve as the basis for sustained growth. Measures to stimulate aggregate demand should be avoided, given the pressures that a consumption-driven recovery would, in time, exert on the currency board arrangement. In this regard, although the new incomes policy linking wage and sales per worker in state-owned enterprises is a step in the right direction, market discipline could be more effective in containing nominal wage increases.

The success or failure of a currency board arrangement rests crucially on the successful implementation of structural reforms, in particular the government's ability to advance deregulation and the ambitious privatization drive. Given the dramatic success of initial stabilization, there may be a temptation for the government to delay addressing the more difficult structural issues. Thus far, performance with structural reform has been mixed. It will be crucial, therefore, for the authorities to show well paced and tangible progress with their privatization drive to secure their credibility in this field— while focusing on needed improvements in the institutional capacity of the public sector, strengthening of the judicial and legal systems, and fighting against crime.

The favorable macroeconomic situation and increasing confidence in the economy was reflected in the partial return of savings to the domestic banking system and a sharp increase in foreign direct and portfolio investment inflows. It is necessary, therefore, to use the current period to complete the needed strengthening of banking supervision and prudential regulation, and to accelerate the privatization of the state banks. The elimination of deficiencies in the legal framework for loan collection, collateral requirements, rights to seize collateral, and bankruptcy proceedings will contribute to more efficient domestic credit intermediation while helping to improve the balance sheet of financial institutions.

Finally, the existence of a Fund-supported program and strict compliance with it is critical at present if the authorities are to reap maximum credibility gains from their new institutional framework. In this light, we would fully support their request for continued assistance from the Fund via an Extended Arrangement when the current Stand-By arrangement runs its course.

Ms. Mercusa made the following statement:

Looking at the past few months, the improvement in Bulgaria's economic situation and increased market confidence are very encouraging. In some respects, the success of the stabilization plan has exceeded expectations. The results achieved in terms of foreign and domestic confidence, falling lev interest rates, and rapid accumulation of international reserves all stem from the authorities' commitment to a well-designed program. We join other speakers in supporting the completion of the review and encourage the authorities to persist with their difficult, yet rewarding, adjustment effort.

We wish to stress the importance of maintaining the momentum of structural reforms, which is currently crucial, given that the earlier economic crisis had ended and that the time for longer-term measures has arrived. It is important at this stage for the government to resist the temptation to defer dealing with longer-term structural problems. Indeed, overconfidence has played a disruptive in Bulgaria on more than one occasion.

On macroeconomic policy, I will highlight some points that require further thought and perhaps further policy decisions by the authorities, as in other transition economies. While some aspects of macroeconomic performance have been impressive, I am puzzled by 1998 and 1999 projections for inflation and interest rates. Inflation is expected to exceed 16 percent in 1998, and to decline to 10 percent in 1999, and thus will be higher than in neighboring countries and will result in negative real interest rates. My first question is, are these levels compatible or sustainable in a currency board agreement? The staff paper attributes the resurgence in inflation to three causes: inertia, administrative price increases, and other transition-related factors. As for inertia, we understand that a realignment of relative prices may be necessary after the turbulence of the past year. As this appears to be a consequence of an undervalued initial exchange rate peg, we wonder if and how this realignment of prices can be absorbed smoothly over time. What will the consequences be for capital inflows and investment; how will inflows be affected by negative real interest rates; and how will this affect the quality and quantity of credit available for investment?

Increased inflation will also threaten competitiveness in the traded goods sector. In fact, the spread between the lev's fixed exchange rate and its long-term purchasing power parity has been widening rapidly—even before Bulgaria had managed to achieve positive real growth. As competitiveness can be eroded quickly, we would appreciate comments by the staff on the effects of inflation on the traded goods sector.

We also wonder if there is some room in Bulgaria's currency board arrangement for discretion with respect to the mechanism that converts foreign currency into domestic currency, and whether some flexibility could help to control inflation.

Mr. Melese-d'Hospital made the following statement:

I would like to thank the staff for their hard work and for a transparent and concise paper. The paper makes clear that the cautiously optimistic point of view we adopted in our last statement was fully warranted. The authorities have fulfilled and, in some cases, over fulfilled the strong commitments taken five months ago under this program, and we see the results: low inflation, low real interest rates, rebounding money demand, and strong reserves in the context of a credible CBA, significant downward revisions of the fiscal deficit and upward revisions in the current account surplus, and upward revisions of 1998 growth estimates (now 4 percent). If the authorities stay the course, the program will bring significant benefits to the vast majority of Bulgarians in terms of economic tranquility and higher standards of living. As I am in broad agreement with staff's views and recommendations, I will focus my comments on a few key areas which I feel deserve emphasis.

At this juncture and in light of the favorable outcome over the past five months, relaxation of efforts on the part of the authorities represents the single greatest risk to the program. Such relaxation could occur in two ways: a proclivity to spend the proceeds of reforms before the financial environment is fully stabilized, or growing lethargy on key reforms as the apparent urgency of reform fades. As regards the former, I would urge the authorities to carefully pace the introduction of measures likely to result in increased expenditures or reduced revenues in light of financing constraints, and to regularly take stock of the effects of measures already taken so as to avoid any overshooting of budgetary constraints. Some of the structural reform measures the authorities will be implementing over the coming months, while important, can be expected to result in a short term loss of revenue (example: privatization), and it is vital that the authorities fully appreciate the fluid and dynamic nature of the Bulgarian economy at this stage in the reform process. If overshooting occurs, it will be incumbent on the authorities to rectify the situation through immediate fiscal measures to preserve the all-important credibility of the CBA. Finally, privatization revenues will likely prove a very tempting target to politicians facing strong spending demands from their constituencies, but this temptation must be resisted, with such revenues going instead to pay down debt or finance needed infrastructure.

Regarding the threat of a slackening of efforts on structural reform, let me be clear that I view this as the most important part of the reform effort going forward, as it will determine in large part the long run productivity of the Bulgarian economy. In this light, I would note that some delays in the reform agenda have already occurred, notably in the area of bank privatization, and the government remains dominant in certain sectors such as agriculture. District heating subsidies continue to be a not-insignificant part of the budget, although I note that prices have been raised to 70 percent of cost and are projected to hit 85 percent by 1998/99.

Progress should be accelerated where possible in all these areas, with a view to creating a supple and dynamic private sector which will put a minimum of strain on the still-fragile debt situation and still-new CBA. Banking supervision should be strengthened to reduce the perceived risks of the Bulgarian banking system and, not incidentally, increase the salability of banking assets. If bank privatization remains sluggish, alternative methods of disposal should be considered.

Agriculture seems to be the one area of the economy in which the authorities have yet to be convinced that markets work. While recognizing that it takes a large leap of faith to give up the tools of command and control in such a vital area as foodstuffs, I would remind the authorities that they will have to take this leap sooner or later, and that they will be better off the sooner they do so.

Regarding still-substantial energy subsidies to households, Bulgaria would be better served by crafting a targeted social safety net to take care of those in genuine need and eliminating subsidies. In addition to delivering more social service for fewer lev, such a strategy would at a stroke eliminate a major set of economic distortions and resource misallocations and also open the sector to future privatization and private investment. Coordination with the World Bank will be crucial in this area.

On banking privatization, I understood that there had been concerns over the type of contract ("success fee") being offered by the authorities to private parties who undertake to find purchasers fir state-owned banks, and I would like to query staff whether this problem has been resolved. I would also be particularly interested in hearing staff's views on potential risks to the banking system under the CBA stemming from volatility in emerging markets interest rates and capital flows, and whether the recent pressures on various emerging markets; currencies have had any effect.

Finally, I would like to ask staff if they would comment briefly on the status of efforts to strengthen the intellectual property rights regime.

The staff representative from the European I Department commented that the projected rise in inflation relative to partner countries in 1998/99 reflected mainly the expected real appreciation of the lev, resulting from ongoing economic restructuring and productivity increases. The staff did not expect the rise in inflation to have detrimental effects on competitiveness; however, competitiveness would deteriorate if productivity gains did not materialize because structural reforms slowed. Capital inflows would not be affected by the negative real interest rates, as the attractiveness of lev assets under a fixed exchange rate depended on the nominal rate of return of those assets relative to alternatives, such as deutsche mark- or dollar-based assets, which remained positive. Furthermore, the main inflows consisted of foreign direct investment, which sought high rates of returns on real economic assets, and those should greatly exceed the short-term returns on government securities.

There was little room for discretion under the currency board arrangement as it was currently designed, and the staff saw no reason to modify it at present, the staff representative indicated. Moreover, Bulgaria was weathering the pressures from the turbulence among some emerging market economies well, partly because there was little scope for further capital outflows, as the country had been subject to such outflows previously. In fact, Bulgaria was benefiting from significant capital reflows—although total estimated short-term foreign capital amounted to only about $300 million at present.

The privatization targets were specified in terms of long-term fixed assets, valued at either 1992 prices or more recent prices, depending on when those assets were acquired, the staff representative explained. Fixed assets were simply used as a measure of the size of the assets being privatized, and were more akin to policy goals than definite targets. By end-1997, the authorities had privatized about 19 percent of total fixed assets, compared with the goal of about 25 percent.

The authorities were proceeding with bank privatization in a number of ways, the staff representative continued. Of the five banks being privatized, two were being tendered—one of which would likely end up being sold—and one large bank would be sold through an investment advisor. The remaining two banks would be difficult to sell. About three or four foreign banks had entered Bulgaria's commercial bank market in 1996/97, including two that had taken over banks placed under conservatorship. To the staff's knowledge, only one domestic bank had been licensed, namely, the Sofia Municipality Bank. To expedite their privatization program, the authorities had introduced a limited moratorium on licensing for one year, which would be in effect in 1998.

The staff had estimated that privatization receipts would amount to about $350 million under the 1998 budget, compared with about $450 million in 1997, the staff representative added. The estimate was a highly conservative one, as it did not include the possible proceeds from the sale of the Bulgarian telecom company, and, in fact, was far below the authorities' estimate of about $600 million.

The staff's essential point about the privatization contracts based on success-fees was that the length of those contracts (18–22 months) might make it difficult for the authorities to achieve their stated privatization goals, particularly as the enterprises involved were large, the staff representative clarified. Nevertheless, it was a positive step to use consultants on a success-fee basis to market state-owned enterprises, because the authorities' capacity to market the enterprises was limited; the consultants increased the transparency of the privatization process; and the contracts included a clause stipulating that the relevant enterprises would be liquidated after the contracts ended—if they had not been privatized by then. While the consultants had some incentive to proceed speedily with the privatization process, because they were paid on a success-fee basis, the staff hoped that the new contracts would have a shorter time horizon than 18-22 months.

The staff had been monitoring fiscal revenues closely over the previous few months and, on that basis, did not think that the revenue projections should be revised, the staff representative stated. As for the export tax, it would likely be eliminated as part of the package of trade measures to be implemented in 1998. The status of the export tax would be considered at the next program review. Regarding the phasing of the revaluation of fixed assets, the staff had proposed phasing in some portion—not all—of the revaluation, as was the case in Brazil and Chile. In the final analysis, the staff had agreed that the full revaluation of assets, with an adverse revenue impact of about 3 percent of GDP, would come into effect in January 1998. While the staff had hoped to limit the revenue effect of the revaluation to about 2.5 percent of GDP, the 0.5 percentage point difference between the staff and the authorities had been relatively minor. There was no major difference of view on the approach to the revaluation of fixed assets.

Mr. Erasmus made the following statement:

> I want to join other Directors in commending the Bulgarian authorities on the progress they have made with the implementation of this program. Their commitment to the program that was agreed with the Fund is illustrated by the fact that all performance criteria for end-September were observed, some by a considerable margin, and by indications that those for end-December will also be observed. The reaction of the economy to the program has been impressive—within a short period of time, monthly inflation has declined substantially to less than 1 percent, interest rates have converged quickly toward benchmark DM securities, the volume of manufacturing production has recovered sharply, and the current account has improved substantially. It is, however, evident that much remains to be done to place the economy on a path of high and sustainable growth.
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> For the purpose of today's discussion, I would like to focus my comments on three areas of policy implementation. In the area of fiscal policy, the negative impact of the profit tax on economic performance and fiscal consolidation raises some concern. Firstly, as noted, the postponement of the revaluation of fixed assets has inflated revenue from this source and affected private sector investment adversely. Secondly, perceptions of an unfair tax system could lower tax compliance, and thus undermine revenue. I therefore join Mr. Vernikov in supporting the authorities' decision to proceed with the revaluation of fixed assets to eliminate the bias against fixed investment. The adverse impact of this on the budget should be countered by the authorities' commitment to keep expenditure in line with revenue and a further decline in interest payments. Also, and as noted by staff, the authorities' budget projections are based on a conservative growth estimate.
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> Recent events have once again illustrated the risks posed by a weak banking system to continued macroeconomic stability and growth. Although the capital adequacy ratio of Bulgarian banks is in line with international

standards, the large uncovered foreign exchange position and high degree of loan concentration has increased the vulnerability of the banking system at a time when the profitability of banks has been under pressure. It is therefore important that the authorities proceed with the planned reforms in this sector, including the strengthening of the supervisory capacity of the central bank and the privatization of the five remaining state-owned banks.

As acknowledged by the authorities, the large current account surplus in 1997 was exceptional, and due largely to the sharp fall in imports in the early part of the year. With the expected recovery in economic activity and consequently also imports, the current account is expected to record sizable deficits over the medium term. In this context, it will therefore be important to maintain an appropriate restraint on wage developments to prevent any further erosion of external competitiveness through a further appreciation of the real effective exchange rate. In addition, the authorities should also proceed with the elimination of structural impediments to a sustained growth in exports, particularly through a dynamic restructuring of the enterprise sector and further liberalization of the trade and exchange system.

With these comments I support the completion of this second review under the Stand-By Arrangement, and wish the authorities well in their future endeavors.

Ms. Wang made the following statement:

It is encouraging to learn that the Bulgarian economy has continued its turnaround from the deep crisis of early 1997, and that the performance criteria for end-September 1997 were met. I generally agree with the staff appraisal and endorse the staff's proposal for the completion of the second review under the Stand-By Arrangement. However, I would like to emphasize the following points.

As this chair stated during the last discussion, fiscal performance is critical to the success of the program and thus it is very important for the authorities to maintain a tight fiscal policy stance to underpin the currency board arrangement and the medium-term financial sustainability. Meanwhile, I'm sympathetic to the authorities' concern that growth needs to be spurred in order to consolidate political and social support for the reform. In this regard, I welcome the authorities' intention to reduce the corporate profit rate, to revaluate the long-term fixed assets, and to accelerate the depreciation for machinery and equipment, which are necessary measures to enhance the investment ability of enterprises, as well as to speed up growth. However, the adverse effect of these measures on revenue should be clearly realized and I support the authorizes' intention to offset this negative effect through broadening the tax base and strengthening tax administration. Further, I share the staff's opinion that the authorities should stand fast against any pressures for further tax preferences or increase in noninterest expenditure and keep expenditures in line with revenue performance in order to achieve a strong fiscal position.

As regards the external sector, both exports and imports are expected to grow strongly. In order to achieve a sustainable external position, export competitiveness should be closely monitored. For the capital account, I fully agree with the staff that a favorable environment for investment is more important for investors. Although the preferential tax treatment is a positive factor, its negative effect on revenue and the distortion it creates in the tax system should not be disregarded.

On structural reform, I believe the comprehensive privatization plan adopted by the authorities is very ambitious and I sincerely hope that it can be achieved. However, I agree with the staff that great efforts should be made to strengthen the authorities' capacity for implementation.

On the financial sector, I welcome the measures taken by the authorities to strengthen banking supervision, and, once again, I would like to emphasize that bank decisions should be free of government intervention as this chair stated during the last discussion.

With these remarks, I support the proposed decision and wish the authorities greater success in the future.

Mr. Pascual made the following statement:

First, I would like to commend the authorities for the continuous efforts made since the program was approved last April. Their commitment has already produced praiseworthy results and is creating a firm foundation for the stabilization and reform process ahead. In fact, their intention of concluding an Extended Arrangement with the Fund is very welcome, because it is not only a clear demonstration of their commitment to the program, but a desire of deepening the reforms to make the process durable.

The authorities have been winning the battle for confidence so far, as interest convergence already shows. There is no doubt the ambition of the fiscal reserve account target has something to do with it. However, there is no room for complacency yet. Inflation has been dramatically reduced but it is still high and should confirm its downwards trend. Unemployment has risen, thus undermining the social support for the program. Loss-making state-owned enterprises and inefficient subsidies remain, which could impede the budgetary adjustment. Therefore, a vigilant attitude and a firm commitment continues to be required.

Since I mostly share the staff thrust, I will just make a few comments for emphasis.

On fiscal policies, although I agree with the authorities in the need for a tax reform, I must support the staff's view in subordinating any reform to the assurance of the fiscal target.

On the financial sector, in spite of recognizing the cost and difficulties of the matter and the efforts already made to improve their efficiency, I must strongly urge the authorities to adopt whatever measures should be needed to guarantee the soundness of the system. In fact, an effective strengthening of the supervisory powers of the central bank would be very welcome. Measures to liberalize and increase competitiveness would also be very positively assessed by the markets.

On structural reforms, apart from specific measures focused on precise sectors, two general targets should attract the efforts of the authorities: increase the efficiency and expertise of the administration in the new fields where it is more needed—privatization, tax enforcement, justice, etc.—and create an environment conductive to attract investment and foster growth.

Finally, I would say that I simply support the proposed decision and I wish the Bulgarian authorities the best.

Mr. Alosaimi made the following statement:

I welcome Bulgaria's good performance under the Stand-By Arrangement. Policy implementation and economic developments have remained broadly on track. These achievements notwithstanding, I urge the authorities to accelerate structural reforms especially privatization and liberalization of some sectors. It is also timely to consider further strengthening of the institutional structure and the legal system. These measures should create an encouraging environment for investments and help the economy achieve stability and sustainable growth.

On the fiscal side , I am encouraged by the improvement in the budgetary position. However, given the high level of public debt, further efforts are still needed. Therefore, I agree with staff that expenditures need to be contained in line with expected budgetary revenues.

Turning to the banking system, I welcome the improvement in the this sector. In this regard, the authorities' strategy to strengthen banking supervision and to complete the divestiture of state-owned banks is well-placed. However, more efforts are needed to reduce the uncovered foreign exchange position and cut operating costs. Such efforts are essential for creating a competitive and efficient banking system.

On the external side, It is encouraging that there is a remarkable improvement in the overall balance of payments for 1997. The increase in foreign direct investment is a sign of increased confidence in the economy. However, the high external debt which amounted to 99 percent of GDP is a concern. Therefore, the authorities should make every effort to achieve the projected reduction in the debt ratio envisaged in the program. In this regard, the move to normalize relations with all creditors is a step in the right direction. The ongoing efforts to liberalize trade and exchange system are also priorities.

With these remarks, I support the proposed decision and wish the authorities further success.

Mr. Watal made the following statement:

I simply wish to note that I agree with the staff's analysis, support the proposed decision, and congratulate the authorities for their strong stabilization and reform measures. I wonder whether the staff would clarify why it projects a financing gap of $190 million in 1998 (paragraph 24 of the staff paper) versus a projection of only $93 million at the previous review.

Mrs. Paris made the following statement:

Commendable implementation of the program and results achieved so far have easily gained our support for the proposed decision. I find myself in broad agreement with the thrust of the staff appraisal and certainly join them in stressing the need to persevere with financial discipline and implementation of structural reforms. Having said that, I would limit my statement to a few comments related to the banking sector.

The strengthening of the banking sector over the past six months is welcome: it is critical at this stage to continue to reinforce the supervisory framework and to undertake measures aimed at improving banks' efficiency. Efforts directed to close uncovered foreign exchange positions are also strongly encouraged. Beyond this, the fact that privatization of banks/of the banking sector is slower than anticipated is certainly disappointing, although I understand that some of the delays were outside the authorities' control. In that respect, I wonder whether staff could be more specific in their reference to the possible need of anticipating alternative solutions to current privatization initiatives, should they not bring results. In any case, what appears of the utmost importance is to ensure that bankers learn the modern risk-assessment practices so that they can understand business proposals and make appropriate lending decisions.

Mr. Daco made the following statement:

Bulgaria's currency board arrangement has contributed greatly to restoring a sounder macroeconomic environment. Progress in reducing inflation and consolidating the public finances has been impressive. Continuation of these efforts permits but also requires the acceleration of much needed structural reforms. I will focus on three points: fiscal consolidation, financial intermediation, and competitiveness.

The authorities have undertaken an ambitious fiscal strategy including major reformation of the tax system, revaluation of the fixed assets of enterprises, and reformation of the pension system. Though I understand why the staff favored a more gradual approach to avoid jeopardizing progress toward a balanced budget, I also understand that the government needs to launch a broad package responding to calls from all sectors of society. Of course this will require close monitoring of the revenue performance to ensure that the benefits of the tax reform are materializing as planned. With a contingency spending plan amounting to 1.3 percent of GDP, I believe that 1998 budget includes appropriate safeguards for capping the overall budget deficit at 1.6 percent of GDP in 1998 and balancing the budget in 1999.

Table 8, depicting Bulgaria's macroeconomic framework for 1994-2004, shows that the dramatic reduction of interest payments will end in 1999. It will therefore be wise to aim at a sustainable fiscal position in 1999, with the primary surplus stabilized at around 4.5 percent of GDP.

Bulgaria experienced a major financial crisis in 1996, and measures were taken to consolidate the financial sector. The banking sector is understandably still very risk averse. At the same time, remonetization is proceeding rapidly, and there is a lot of liquidity in the system. Interest rates are very low; if I am not mistaken, they are even negative in real terms. Rather than lend their excess liquidity to enterprises, the banks prefer to place it in treasury bills issued by the government at a very low nominal interest rate, or to deposit it abroad in deutsche marks or U.S. dollars. The staff assumes that this credit crunch is temporary, and that both the improvement of the macroeconomic environment and the consolidation of the banking sector will induce the banks to begin again to lend to enterprises. In the meantime, the credit crunch has negative effects on the macroeconomic environment and by keeping enterprises from making investments, causes the loss of some growth. I wonder how this credit crunch will affect the expected pickup in domestic investment in 1998.

As to competitiveness, I note that the real effective exchange rate, measured in terms of unit labor cost, has increased rapidly these last few months. The same holds for the average wage in US dollars, which gave Bulgaria a comparative advantage over Romania during late of 1996 and early 1997 but has now regained Romania's level. This development will contribute to the deterioration of Bulgaria's balance-of-payments position expected over the next two years. The profit margin of enterprises is also suffering from the absence of a revaluation of their fixed assets since 1992. The squeezing of enterprise profits, together with the reluctance of the banks to finance enterprise investments, both damage Bulgaria's long-term investment potential. It is therefore important that the authorities closely monitor wage developments in the public enterprises and avoid any slippage in incomes policy. In addition, the revaluation of enterprise assets in the 1998 budget, and speeding up the privatization of public enterprises is an important measure. This is obviously an ambitious strategy, but the only way of enabling Bulgaria to achieve its growth potential.

With these remarks, I wish the authorities well.

Mr. Roaf made the following statement:

Like other chairs, I welcome Bulgaria's excellent progress to date. In particular, I concur with Mr. Melese d'Hospital, and some other speakers, who stressed the risk of complacency following the authorities' strong progress. This risk points to the need for a continuing strong role by the Fund and the World Bank in ensuring continued reform, especially securing financial discipline in the banking and enterprise sectors, which has always been the key concern in Bulgaria. While great progress was made in those areas in 1997, much of this was achieved simply to meet the demanding conditionality of the Fund and Bank; it is not yet apparent whether or not the authorities are entirely committed to financial discipline in those key sectors, absent conditionality of the international financial institutions. Indeed, enterprise privatization has slowed, and the court system seems to be reluctant to enforce financial discipline on enterprises. Thus, in the short term, the Fund and the Bank still have a role to play in maintaining firm conditionality on loss-making enterprises. In the longer term, these problems need to be addressed by legal reforms, and especially by more effective bankruptcy procedures.

Legal reforms are also needed to address pervasive corruption in the country. Moreover, I agree with Ms. Abdelati that such reforms will be more effective in encouraging foreign investment than granting tax breaks, which carry "dead-weight" costs. These points will be relevant to a subsequent Extended Arrangement for Bulgaria, which my chair hopes will succeed the current Stand-By Arrangement.

The staff representative from the European I Department commented that increased financing gap projected for 1998 reflected revised staff estimates for that year, in particular, to take into account projected higher imports.

The authorities were committed to the Fund-supported program, and had performed commendably thus far, the staff representative stated. Unquestionably, they were firmly committed to privatization, which was central to structural reform. While their implementation capacity was limited, and it would be difficult for them to meet the ambitious pace for privatization they had set themselves, the staff was helping to strengthen that capacity through various initiatives.

Mr. Wijnholds stated that he appreciated numerous Directors' interest in Bulgaria. Like other chairs, he had found the staff paper to be reassuring regarding the progress made. Nonetheless, it had to be kept in mind that the country had passed through profound difficulties earlier in 1998, reflected in the current average wage rate of less than $100 a month. With their reforms under way, Bulgarians could look forward to much-improved prospects versus those of merely a year previously.

The Acting Chairman added that reforms were still at an early stage, but that Bulgaria's economic turnaround had been quite astonishing. While the clinching argument in favor of establishing the currency board had been that it would be the only means of reducing interest rates quickly, those rates had, in fact, fallen much more rapidly than had been expected. Developments had turned out remarkably well, and the Fund would need to continue to monitor the situation closely to ensure—as Mr. Roaf had noted—that the authorities continue to implement the program.

The Executive Board took the following decision:

1. Bulgaria has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Bulgaria (EBS/97/53, Sup. 4, 4/15/97), as amended, and the fourth paragraph of the letter of March 24, 1997 from the Minister of Finance and the Governor of the Bulgarian National Bank, in order to conduct the second review of performance under the program supported by the arrangement and set performance criteria for end-March 1998.

2. The letter dated November 26, 1997 from the Minister of Finance and the Governor of the Bulgarian National Bank, with its attached Memorandum of Economic Policies, as amended, shall be annexed to the Stand-By Arrangement, and the letter of March 24, 1997 shall be read as supplemented and modified by the letter of November 26, 1997.

3. Accordingly,

(a) paragraph 3(a)(I)–(ix) of the arrangement, as amended, shall be replaced by the following text:

"(I) the ceiling on the overall deficit of the general government; or

(ii) the floor on the balance of the Fiscal Reserve Account; or

(iii) the ceiling on the contracting or guaranteeing of nonconcessional external debt by the general government or the Bulgarian National Bank with an original maturity of up to and including one year; or

(iv) the ceiling on the contracting or guaranteeing of nonconcessional external debt by the general government or the Bulgarian National Bank with an original maturity of more than one year; or

(v) the ceiling on the contracting or guaranteeing of nonconcessional external debt by the general government or the Bulgarian National Bank with an original maturity of more than one year and up to and including five years, as set forth in Annexes I, II, and IV of the memorandum attached to the letter of November 26, 1997, is not observed; or"

(b) paragraph 3(b)(ii)–(iii) of the arrangement, as amended, shall be replaced by the following text:

"(ii) does not fulfill the policy undertakings specified in paragraphs 1, 2, and 3 of Annex V of the memorandum attached to the letter of November 26, 1997; or

(iii) does not observe the floor on deposits of the Banking Department as set forth in Annex III of the memorandum attached to the letter of November 26, 1997; or"

4. The Fund decides that the second review contemplated in paragraph 3(c) of the Stand-By Arrangement is completed and that Bulgaria may proceed to make purchases in accordance with the provisions of the arrangement. (EBS/97/218, Sup. 1, 12/2/97)

Decision No. 11624-(97/121), adopted
December 15, 1997

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/120 (12/12/97) and EBM/97/121 (12/15/97).

5. JORDAN—EXTENDED ARRANGEMENT—MODIFICATION

Paragraph 2(a) of the Extended Arrangement for Jordan, as amended, is herewith further amended to read:

"2(a) Until February 15, 1998, purchases under this Extended Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 178.86 million, provided that purchases shall not exceed the equivalent of SDR 110.3 million until May 15, 1997, the equivalent of SDR 139.96 million until August 15, 1997, and the equivalent of SDR 161.79 million until November 15, 1997." (EBS/97/230, 12/8/97)

Decision No. 11625-(97/121), adopted
December 12, 1997
Effective December 15, 1997

6. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 97/47 are approved.

7. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director, as set forth in EBAP/97/108, Supplement 1 (12/12/97), is approved.

APPROVAL: March 8, 1999

REINHARD H. MUNZBERG
Secretary