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Statement by Mr. Al-Jasser on Review of Guidelines for
the Allocation of Currencies Under the Operational Budget
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Introduction

The Fund's operational budget is the mechanism through which members with strong external positions make foreign exchange available to members with weak external positions. A member's currency is included in the operational budget if its combined balance of payments and gross reserve position is considered "sufficiently strong." Once a member is deemed "sufficiently strong" for inclusion in the operational budget, the amount of its currency allocated under the budget is determined by "take(ing) into account the balance of payments position and developments in the exchange markets, as well as the desirability of promoting over time balanced positions in the Fund." The issue before us today is the standard by which members' positions in the Fund should be balanced.

As emphasized in the Chairman's summing up of the June 1, 1990 discussion, the method used to allocate currencies to be sold by the Fund should not compromise the Fund's liquidity position, nor impair its flexibility in meeting the legitimate financing needs of the membership. The method should also be transparent, stable, and workable, and it should be in line with a members' reasonable capacity to finance the operational budget without imposing an unfair or inequitable burden on members. Such a system is best attained through the use of primary reserves as the standard for harmonization, while ensuring that a member's currency is not excessively used.

Harmonization with Respect to Primary Reserves

It is abundantly clear that the external position of members should be the primary determinant of the currencies to be included in the budget, and of the amount of those currencies used for transfers in the budget. It follows, therefore, that the standard for balancing positions in the Fund should ensure the allocation of currencies of members with large or rising reserves. This is the only way to protect the liquidity of the Fund and satisfy the needs of debtors for foreign exchange without jeopardizing the liquidity of creditor members. Hence, the Fund's traditional approach to allocating currencies under the operational budget, namely balancing positions in the Fund in the relation to a member's gross holdings of gold and foreign exchange reserve, remains the optimum approach.

As I have argued before, the most crucial and attractive feature of this procedure is its inherent flexibility that allows the Fund, and the membership at large, to benefit from, and adjust to, the changing circumstances of individual members. Therefore, it is important to view this system from an intertemporal rather than from a static perspective.

The experience of Saudi Arabia provides a helpful illustration of the benefits of this dynamic approach. Saudi Arabia's reserve tranche position increased from 25% of quota in 1975 to 83% of quota in May 1983 and then gradually declined to 10.7% of quota by December 1991. More significantly, Saudi Arabia's reserve tranche position as a proportion of total reserves dramatically increased in the 1980s to reach 58.4% in 1986. Thus, over time, Saudi Arabia's active participation in the operational budget has corresponded to its ability to do so. The Fund and the membership, at large, benefitted greatly from this flexibility.

The staff paper lists three drawbacks to this system which, it is stated, have been pointed out recently. While these drawbacks have always been acknowledged, the traditional approach to balancing members' positions in the Fund is the only system that minimizes them. First, members may not be indifferent to a shift in the proportions of their reserves held in foreign exchange, in Fund positions, and in SDRs. Second, members choose to hold different levels of reserves. Clearly, both these drawbacks would be seriously aggravated in a quota-based system where the likelihood of the emergence of a large reserve tranche position relative to total reserves is greatest. Third, members' preferences between holding a Fund position and foreign exchange are affected by relative yield considerations. This, however, is not a new development. It should be noted that in the recent past the rate of remuneration has not always been equal to the SDR rate of interest. Indeed, between 1979 and 1987 these rates have diverged significantly. Again, Saudi Arabia held a very large share of its reserves with the Fund at a large cost of foregone income. The difference is that the long-term cooperative nature of the system was considered predominant by those who had borne the brunt of that burden. Hence, the issue of relative yields predates the present and temporary burden-sharing problem.

In light of changes in the international capital markets, some have questioned whether international reserves, as defined by the Fund, remain the best indicator of a member's ability to contribute to the financing of Fund operations. The staff paper provides convincing evidence which shows that, while a country's international liquidity has been improved by access to credit markets, both the access to, and the cost of borrowing from credit markets deteriorate when the need to borrow increases. Accordingly, a member's need for primary reserves remains "closely" related to its external transactions. Therefore, the staff conclude that "primary reserves continue to be a relevant indicator on which to base the distribution of resources provided to the Fund." I would, however, go further than the staff in this respect, because I believe that primary reserves remain the best indicator, albeit imperfect, on which to base the distribution of resources provided to the Fund. Consequently, I am disappointed that the staff has not placed sufficient emphasis on the Fund's traditional harmonization in relation to gross holdings of gold and foreign exchange reserve as the best option by which to allocate currencies under the budget. Moreover, this exclusion runs counter to the understanding that the adoption of the current transitional arrangements would in no way prejudice the original system or pre-judge the final outcome of the Board's deliberations.

Harmonization with Respect to Quotas

During previous discussions, quotas have been proposed as an appropriate standard by which members' positions in the Fund could be balanced. The staff paper develops irrefutable arguments against the use of quotas for such purposes. Indeed, quotas change only infrequently and are not an indicator of a member's ability to make foreign exchange available to the Fund. Also, it should be recalled that the variability of the balance of payments position plays an important role in the determination of a member's quota. Thus, quotas reflect a members potential need for Fund resources. Clearly, the adoption of a quota-based system would lead to members holding a reserve tranche position that would be very large in proportion to their primary reserves, irrespective of their ability to contribute. This would adversely affect their ability and willingness to provide resources to the Fund. Hence, such a shift in a member's portfolio could lead it to withdraw from the budget and possibly to draw its reserve tranche position. More significantly, this would dramatically complicate attempts to bring back members into the operational budget. This approach would, therefore, limit the list of members that are included in the budget and intensify the burden placed on the remaining members, thereby unleashing a vicious circle which could only impair the Fund's liquidity position.

Harmonization with Respect to Income Forgone due to Burden Sharing

The staff paper also suggests that income forgone as a result of burden sharing could be used as a basis for balancing Fund positions. This would be undertaken if there is a desire to incorporate the costs due to temporary burden sharing arrangements into the method of allocating currencies under the operational budget. In my view, this is an unacceptable proposition since the burden-sharing arrangements relate to a temporary problem. Indeed, it is both dangerous and illogical. It should be recalled that the burden of financing the Fund's operational budget did not emerge with the present discussion of burden sharing, and I see no reason to tamper with a system that has served this institution well, in order to compensate for a temporary problem. As indicated above, the rate of remuneration and the SDR interest rate have diverged markedly, averaging about 93 basis points between 1979 and 1987, and reaching a peak spread of 172 basis points in 1981. This period coincides with Saudi Arabia's heaviest involvement in the operational budget, which occurred without any complaint regarding the opportunity cost of providing resources to the Fund. Therefore, it would be unfair to creditors who contributed significantly during that period to change the rules of the game at this stage, without taking into consideration their previous contributions. The point here is that the cost of financing the operational budget is not a new phenomenon.

Moreover, it seems inappropriate to devise a system to equate the contributions of creditors to the burden sharing arrangements without providing an equivalent mechanism for the contribution of the rest of the membership. In the extreme, this alternative is analogous to a system that determines access to Fund resources on the basis of equalizing users' contributions to the burden-sharing arrangements in terms of quota, and not

Government. The states are, therefore, under increased pressure to pay their debt service punctually to the Federal Government. States rescheduling their debts by agreement will undertake not to issue securities during seven years. States that do not wish to enter into restructuring agreements will have their borrowing capacity limited by a prohibition on rollovers of more than 82-88 percent of their bonded debt as well as by debt-service limits.

12. The recent decision of a Federal Judge of First Instance raising Social Security pensions in the state of Rio de Janeiro has caused a great deal of confusion. This decision is not final. But even if it should not be overturned and should be generalized to the country as a whole, it would not affect the economic program. The Constitution is absolutely clear that the Government cannot pay pensions beyond the amounts appropriated for social security purposes. Transfers from other appropriations, additional appropriations and extraordinary appropriations can only be proposed by the Executive. The President has declared and reaffirmed that he will not propose such transfers or increases unless the Congress creates sufficient additional non-inflationary sources of revenue. Moreover, the Constitution expressly prohibits the creation of increases in social security benefits without the specification of a source of funds clearly supported by the law of budgetary directives. That law can only be proposed or amended at the initiative of the Executive. Finally, the Constitution prohibits the financing of current expenditures by issuance of debt or by recourse to the Central Bank. A recent decree prohibits the payment of benefits even in accordance with a court order, if such a payment would result in violation of the constitutional requirement that all public sector liabilities must be discharged in the chronological order in which they become effective. Moreover, the decree confirms that, absent a specific provision in the budget, payments under adverse judicial rulings must be delayed until the subsequent fiscal year and that payments under such court orders require a specific form of judicial notification ("Predatório"). This notification must be issued no later than July of the year preceding that when the payments can be made. This implies that, in 1992, no further increased benefits can be paid under court order and that increased benefits under such orders can be paid only in 1993, provided that a specific judicial notification to that effect has been made before July 1992; in that event, the 1993 budget will foresee adequate fiscal adjustment to maintain the operational surplus mentioned above. The decree has been upheld by the Supreme Court.

Price and Wage Policies

13. Price controls have been virtually eliminated and the scope of price monitoring has been greatly reduced and both controls and monitoring are being phased out.

14. The Federal Government has succeeded in keeping its freedom to set public sector wages and salaries (other than the minimum wage) and has submitted to Congress guidelines to ensure that wage adjustments by the

Federal Government remain constrained. Despite the legal provision for limited retrospective indexing--up to three minimum wages--of private sector wages, the effect of this provision is in practice greatly limited. Brazil is one of the countries in the developing world which operates a system of unemployment compensation which makes possible flexible employment practices without major costs to individual firms. Under these conditions, firms are free, if they wish, to escape the effect of indexation by replacing workers whose wages would otherwise be readjusted upwards.

15. The authorities have also developed a social program targeted at children of low income families so as to produce a degree of poverty relief at relatively limited cost.

External Policies

16. The movement to open the economy which started in 1990 will continue under the present program, with the implementation of the final stages of the multi-year import tariff reform, the further reduction of non-tariff barriers, and the elimination of the requirement of prior authorization for imports of products related to data processing. The liberalization program will be further strengthened through Brazil's free trade agreement with Argentina, Paraguay, and Uruguay and is expected to count with the technical and financial support of the World Bank and the Inter-American Development Bank. A substantial liberalization of exchange controls has already taken place and multiple currency practices and other exchange restrictions are being dismantled as quickly as possible. In this context, the authorities expect to conduct policy so as to avoid the appearance of large and sustained spreads between the exchange rates in the commercial and tourist or parallel markets; we have already commented on the unprecedented appearance of a negative spread.

17. The currency was devalued in October of last year, and policies which ensure maintenance of adequate competitiveness have given a considerable stimulus to exports, as indicated by exchange transactions. The present level of the real commercial rate seems to be appropriate.

18. A restrictive monetary policy permits--but also requires--trade and other liberalization measures which we have mentioned. Under the monetary policy described, any danger of a weakening of balance of payments performance would seem to be limited; on the other hand, the progressive liberalization of imports will compensate for what is expected to be a substantial continuing inflow of capital, which, if left unchecked, would lead to a harmful expansion of liquidity and demand, and to a harmful appreciation of the exchange rate.

19. The authorities are adopting further measures to speed up the privatization of public enterprises. In this context, they also are proceeding with liberalization of foreign direct and portfolio investment.

External Debt

20. The program foresees set asides up to 25 percent to provide enhancements which would enable Brazil to negotiate agreements with its commercial bank creditors that include debt-service reduction. Brazil has made a series of proposals on debt rescheduling and debt reduction which it is presently discussing with its bank creditors. Brazil's interest is to come to an agreement as quickly as possible. Similarly, Brazil intends to negotiate as soon as possible a rescheduling agreement on arrears in debt service on pre-cutoff date debt to official bilateral creditors. Of course, Brazil is current on post-cutoff debt to these creditors.

21. In the meantime, Brazil is continuing to pay 30 percent of the contractual interest on eligible medium- and long-term debt of the nonfinancial public sector, while private sector (and some public) enterprises are permitted freely to transfer exchange for the servicing of their external debt.

22. The program foresees a considerable external financing requirement for 1992-93. But, as the staff explains, this requirement is essentially for meeting amortization payments and does not reflect an increase in other creditors' exposure to Brazil.

III. The Medium Term

23. The medium-term projections incorporated in the staff paper are modest and, therefore, realistic. They foresee a return to a 5 percent growth rate of the Brazilian economy, which is considerably below the average realized after the Second World War and up to the eighties. It is also significant that the current account deficit is projected to fall after 1995, as does the debt-service ratio (by 1/4) and the interest service ratio (by 1/3).

24. The capacity to repay the IMF is amply discussed in the staff paper.

25. The program which we are presenting to the Board and which we have, as mentioned, already started to implement, is a difficult one. The Government is firmly resolved to continue to carry it out energetically and to step it up as additional constitutional and legal measures are enacted which enable us to speed up the achievement of its objectives. The initial stage of the stabilization program started in October represents a major effort given present constraints. The Fund's support for the program and a continuing close relationship between Brazil and the Fund are essential. As further results are added to those already achieved, we contemplate the transformation of the stand-by into an EFF.

Table 1 of EBS/91/205, Sup.3 (with 1993 column)
Brazil: Nominal, Operational and Primary
Balances of the Public Sector

(In percent of GDP)

	1988	1989	1990	Est. 1991	Prog. 1992	Prog. 1993
Total borrowing requirement	53.0	83.1	29.6	35.1	18.4	5.0
Federal Government	28.2	51.0	12.3	10.7	3.5	...
States and municipalities	11.4	16.6	8.6	12.0	7.3	...
Public enterprises	13.4	15.5	8.7	12.4	7.6	...
Monetary correction	48.2	76.2	30.9	32.9	15.7	5.5
Operational balance (deficit -)	-4.8	-6.9	1.3	-2.2	-2.7	0.5
Federal Government	-3.5	-3.9	2.3	-0.1	-0.1	...
Treasury 1/	-3.5	-5.1	4.8	1.7	-1.8	...
Central Bank net profits	0.1	1.2	-2.5	-1.8	1.7	...
States and municipalities	-0.4	-0.6	-0.4	-0.2	-1.1	...
Public enterprises	-1.0	-2.4	-0.6	-2.0	-1.5	...
Interest payments (net) 2/	4.4	6.4	0.9	3.2	5.7	3.5
Federal Government	2.0	3.2	-0.9	0.6	1.2	...
States and municipalities	0.9	0.9	0.7	0.7	1.8	...
Public enterprises	1.5	2.3	1.1	2.0	2.6	...
Primary balance (deficit -)	-0.4	-0.5	2.2	1.0	3.0	4.0
Federal Government	-1.5	-0.7	1.5	0.5	1.2	...
States and municipalities	0.5	0.3	0.3	0.5	0.7	...
Public enterprises	0.6	-0.1	0.4	--	1.1	...

Sources: Central Bank of Brazil; Ministry of Economy, Finance, and Planning; and Fund staff estimates.

1/ Includes decentralized agencies and social security system.
2/ Comprises interest payments on external debt plus the real portion of interest payments on domestic debt.