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November 22, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Debt and Debt Service Reduction Operations -
Early Repurchase Expectations

Attached for consideration by the Executive Directors is a paper on early repurchase expectations with respect to debt and debt service reduction operations, which is tentatively scheduled for discussion on Wednesday, December 13, 1989. A draft decision appears on pages 10-12.

Mr. Francotte (ext. 7798) or Mr. Stuart (ext. 4579) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

Debt and Debt Service Reduction Operations -
Early Repurchase Expectations

Prepared by the Legal Department and the
Exchange and Trade Relations Department

(In consultation with other departments)

Approved by François Gianviti and L.A. Whittome

November 22, 1989

Introduction

The guidelines on the Fund's involvement in the debt strategy contemplate the possibility of approval by the Fund of requests for additional purchases up to 40 percent of quota under a stand-by or an extended arrangement for interest support in connection with debt or debt service reduction operations. 1/ The guidelines specify that, if a member draws such additional amounts for interest support, it would be expected to make an early repurchase of these resources to the extent that it does not use them for the intended purposes within an appropriate period of time.

During the Executive Board's informal discussion on Mexico's financing package on July 27, 1989, the staff was asked to examine ways, in particular through the creation of an early repurchase provision, in which, when there is an acceleration of purchases of set-aside amounts, the Fund's resources could be protected if the member's program subsequently went off track.

The present paper proposes provisions for an expectation of early repurchase in both these cases. As in the cases of overcompensation under compensatory financing purchases and of noncomplying purchases under stand-by or extended arrangements, it is proposed to establish an expectation, rather than an obligation, to make an early repurchase. 2/ It would be possible to establish an obligation of early repurchase, in the sense of accelerating the due date of the

1/ "Summing Up by the Chairman - Fund Involvement in the Debt Strategy" EBM/89/61 (5/23/89), Buff 89/89 (5/24/89).

2/ With respect to overcompensation, see paragraphs 16 and 38 of Decision No. 8955-(88/126) adopted August 23, 1988 as amended, Selected Decisions, Fourteenth Issue p. 112. With respect to noncomplying

repurchase obligation, either under Article V, Section 7(c) or (d) 1/ or, in certain cases, under Article V, Section 4. An expectation to repurchase would, however, appear to be preferable in the circumstances envisaged, because it would offer many of the same safeguards (see Section II below), while at the same time providing the Fund with a more flexible and workable instrument of protection of its resources. An acceleration of the repurchase obligation under Article V, Section 7(c) or (d) could be established only by a decision taken by an 85 percent majority of the total voting power. In addition, this shorter repurchase period would have to apply to all members in the same fashion, leaving little room for case-by-case judgment by the Executive Board, and, after it had been established, it could be set aside in individual cases (for example, concerning accelerated set-aside amounts, where the nonobservance of performance criterion is minor and/or reversible) only through a postponement under Article V, Section 7(g).

2/ (Cont'd. from p. 1) purchases, see Decision No. 7842-(84/165) adopted November 16, 1984, Selected Decisions, Fourteenth Issue, p. 107. Expectations of repurchase also arise with respect to buffer stock purchases in case of distribution of currency to members by the buffer stock: see paragraph 1(b) of Decision No. 5703-(78/39) adopted March 22, 1978 as amended, Selected Decisions, Fourteenth Issue, p. 172; as well as in some other circumstances specified in decisions concerning specific buffer stocks: see Decision No. 7247-(82/147) adopted November 12, 1982 (Sixth International Tin Agreement); Decision No. 5597-(77/171) adopted December 16, 1977 (1977 International Sugar Agreement); Decision No. 7246-(82/147) adopted November 12, 1982 (1979 International Natural Rubber Agreement); Selected Decisions, Fourteenth Issue, pp. 145, 147 & 150, respectively.

1/ The relevant legal basis would depend on whether the resources to be repurchased had been drawn under the credit tranche policy (e.g., under a stand-by arrangement financed with ordinary resources exclusively), in which case the decision would be taken pursuant to Article V, Section 7(c), or whether they had been drawn under a special policy, such as the extended fund facility or, with respect to borrowed resources, the enlarged access policy, in which case the relevant basis would be Article V, Section 7(d). If the resources had been purchased under both the credit tranche policy and a special policy (e.g., purchases under a stand-by arrangement that were financed partly with ordinary resources and partly with borrowed resources), the decision of accelerating the repurchase obligation for these resources would be taken under paragraph (c) (for the ordinary resources) and under paragraph (d) (for the borrowed resources) of Article V, Section 7.

As for Article V, Section 4, it empowers the Fund to impose conditions, including a shorter repurchase period, for granting the waiver of the limitation in Article V, Section 3 (b)(iii) that is required whenever a member's purchase would cause the Fund's holdings of that member's currency to exceed 200 percent of its quota. In contrast with Article V, Section 7(c) or (d), the establishment of a shorter repurchase period under Article V, Section 4 would require a simple majority of the votes cast, and the appropriateness of establishing it in an individual case could be decided on a case-by-case basis at the time the waiver is granted (that is, at the time the request for augmentation or for acceleration of the availability of set-aside amounts is approved). The shorter repurchase period could, however, only be imposed in those cases where a waiver is necessary, and, like an early repurchase obligation created under Article V, Section 7(c) or (d), it could be set aside after its creation only by way of postponement under Article V, Section 7(g).

In contrast, an expectation of early repurchase can be established by a simple majority of the votes cast; is not contingent on the granting of a waiver; may be established on a case-by-case basis in the light of the circumstances of the case, and may, if judged appropriate by the Executive Board, be set aside after its establishment without postponement under Article V, Section 7(g).

The following sections discuss the establishment of an expectation of early repurchase with respect to purchases of additional resources for interest support and with respect to accelerated purchases of set-aside amounts (Section I) and the effects of the failure by a member to discharge such an expectation (Section II). A proposed decision appears in Section III.

I. Establishment of Expectation of Early Repurchase

It is proposed below to provide for an expectation of early repurchase 1/ in two cases: (i) with respect to additional resources for interest support, if these resources are not used by the member as intended within an appropriate period of time; and (ii) with respect to accelerated purchases of set-aside amounts, if the member's program subsequently goes off track.

1/ Instead of the repurchase, the member has the option to request the Fund to use an equivalent amount of its holdings of the member's currency in the Fund's transactions and operations, in which case the member would be subject to the conversion obligations in Article V, Section 3(e). A decision of the Fund giving effect to such a request could be taken in the context of the decision establishing the repurchase expectation for the member.

A. Additional Resources for Interest Support

As noted, the guidelines on the Fund's involvement in the debt strategy contemplate that a member that has drawn additional resources for interest support would be subject to an expectation of early repurchase if it does not use these additional resources within an appropriate period of time for the intended operations.

It is proposed to give operational effect to this guideline by adopting the procedure described below, which would be applied whenever the Fund approves a member's request for such additional resources:

(i) The interest support operations for which these additional resources were intended and the period of time during which they could be so used would be described in the letter of the member requesting these resources, and would be specified in the decision of the Executive Board approving the member's request in a form that would permit the Fund to assess *ex post* whether the resources were used for the intended purposes;

(ii) If the member did not use all or part of these resources for the specified purposes within the specified period of time, the Managing Director would, after consultation with the member, promptly report the matter to the Executive Board. In his report, the Managing Director would recommend that the member be expected to make an early repurchase of the resources that were not used for the specified operations, or would recommend such other action as may be appropriate. For instance, an extension of the period of time during which these resources could be used to finance interest support operations could be considered if there were good prospects that the operations would take place within a reasonable period of time. There may also be circumstances in which the Fund might decide to allow the use of the additional resources for interest support operations that differed from the operations originally specified.

(iii) If the Executive Board decides that the member is to make an early repurchase, the member would be expected to make the repurchase within 30 days from the date of that decision, or within such longer period as the Executive Board may decide.

B. Accelerated Disbursement of Set-Aside Amounts

The guidelines provide that, in appropriate cases, the Fund would be prepared to agree to set aside part of the resources available to a member under a stand-by or extended arrangement to support operations involving debt reduction. The Fund has approved stand-by or extended arrangements providing for such set-asides for four members so far

(Costa Rica, Mexico, the Philippines and Venezuela). 1/ In all four cases, the arrangement provides for the setting aside of a fraction of each purchase under the arrangement to be made available to the member after a review of the debt reduction package negotiated by the member with the commercial banks. In addition, the arrangements for these four members contain a clause to the effect that the Fund may agree to accelerate the availability of all or part of the set-aside amounts not yet accrued under the arrangement, and two of these members (Mexico and the Philippines) have indicated their intention to request such an acceleration.

It is clear that if the Fund agreed to such an acceleration, with the result that purchases could be available at a relatively early stage of the program and in larger amounts than had been envisaged in the original phasing, its resources would be subjected to a comparably greater risk than under the original schedule. Indeed, whereas, under the original schedule, the rights to the set-aside amounts would have accrued in line with performance under the arrangement over a period of time, under the accelerated schedule, financing would precede performance. Therefore, in taking a decision approving a member's request for an acceleration of the availability of set-aside amounts, the Fund should be satisfied that there are adequate safeguards for the temporary use of these resources, as required by Article V, Section 3(a). The principal safeguard would, of course, remain the adequacy of the program being implemented by the member. It follows that, before approving a request for acceleration, the Fund should be satisfied that, notwithstanding the acceleration, the member's program continues to provide the necessary safeguards for the temporary use of the Fund's resources.

In addition, it would seem appropriate for the Fund to have the option, if the member's program were subsequently to go off track, to call on the member to restore the situation that would have prevailed if there had been no acceleration. Indeed, if the availability of these amounts had not been accelerated, they would not have been disbursed to the member after its program had gone off track. Accordingly, it is proposed that, in such cases, the Fund could decide that the member would be expected to make an early repurchase of the accelerated set-aside amounts to the extent that they had not yet accrued to the member in line with its performance under the program by the time the program went off track. The Executive Board would decide in each individual case whether it is appropriate to establish an expectation of early repurchase, in the light of all relevant factors

1/ "Costa Rica - Stand-By Arrangement" EBS/89/87, Supp. 3 (5/31/89);
"Mexico - Extended Arrangement" EBS/89/91, Supp. 2 (6/6/89);
"Philippines - Extended Arrangement" EBS/89/59, Supp. 3 (6/1/89);
"Venezuela - Extended Arrangement" EBS/89/107, Supp. 2 (7/6/89).

including, for instance, the reasons for which the program went off track, the corrective actions taken by the member to bring the program back on track, as well as the member's balance of payments position and the level of its reserves. Also, there may be cases where the Fund would be prepared, on the basis of understandings reached with the member, to permit the resumption of purchases under the arrangement by granting the necessary waivers of the nonobservance of performance criteria or completing the necessary reviews. In those cases, an early repurchase of the accelerated set-aside amounts would not be necessary, since the program would be back on track.

Accordingly, it is proposed to apply the following procedure when the program of a member that has drawn accelerated set-aside amounts subsequently goes off track. The evidence that the program is off track would be provided by the inability of the member to make a purchase under the arrangement on the date this purchase becomes available under the phasing provision in the arrangement ("the availability date") because of the nonobservance of a performance criterion, the noncompletion of a review or the failure to meet another condition under the arrangement (e.g, incurrence of arrears to the Fund). Cancellation of the arrangement before its expiration by the member would have the same effect.

(i) If, on the availability date, the member is unable to make a purchase because its program is off track (as defined above), a period of 90 days would start running from that date, by the end of which the Managing Director would report the matter to the Executive Board, unless the program was back on track. A period of 90 days is proposed in order to allow time for delays in the reporting of data by members with respect to performance criteria and for discussions between the Fund and the member regarding steps that may be necessary to bring the program back on track. The program would be considered to be back on track if the member were again able to make purchases under the arrangement (for instance because the nonobservance of the performance criterion had been cured by waiver or otherwise, or because the review had been completed). In other words, the matter would be submitted to the Executive Board only if the problem had not been resolved during that 90-day period.

(ii) If the program is off track by the end of the 90-day period, the Managing Director would promptly submit a report to the Executive Board describing the situation and making a recommendation on whether the member should be subject to an expectation of early repurchase. If negotiations with the member on appropriate corrective policies and measures were well advanced, the Managing Director might recommend a short extension of the 90-day period.

(iii) If the Executive Board decides that the member is to make an early repurchase, the member would be expected to effect the

repurchase within 30 days of that decision, or within such longer period as the Executive Board may decide. Also, there should be an expectation to repurchase only to the extent that the member purchased as a result of the acceleration larger amounts of set-asides than it would have been able to purchase in the absence of acceleration.

(iv) If, within this 30-day period (or such longer period as the Executive Board may have specified), the program comes back on track before the repurchase has been effected, the expectation to repurchase would be automatically rescinded. In contrast, if the member failed to meet the repurchase expectation within the specified period of time, the expectation would not be automatically rescinded even if its program later came back on track. In such a case, the rescission of the expectation would require a decision of the Executive Board.

(v) If, after the early repurchase has been effected within or after the 30-day period the member's program comes back on track, this would not restore by itself the member's access to the repurchased amounts. Since committed amounts have been used and repurchased, such access would constitute an augmentation of the commitment, and Fund policies do not provide for such automatic augmentation. An increase in the amount of the arrangement corresponding to all or part of the repurchased amounts could, however, be considered at that time in the light of all relevant circumstances.

II. Effects of a Breach of an Early Repurchase Expectation

Repurchase expectations are not obligations under the Articles: therefore, their breach may not give rise to a limitation of the use of Fund resources by the member under Rule K-2, a declaration of ineligibility under Article XXVI, Section 2(a), or compulsory withdrawal. This does not mean, however, that a failure to meet an expectation of repurchase would have no legal consequences. As noted in the 1981 staff paper that examined the legal status of an expectation of repurchase, such a nonobservance could damage the member's credibility and adversely affect the member's relations with the Fund. 1/

In particular, two consequences could attach to the failure to meet the repurchase expectation: (i) it may provide, in some cases, the basis for initiating the procedure contemplated in Article V, Section 5, which may culminate in a declaration of ineligibility; and (ii) the Fund could decide not to allow the use of its resources by a member that fails to meet such an expectation, as it has done in the

1/ "Representation of Intention as to Repurchase" SM/81/234 (12/2/81), p.9.

case of noncomplying purchases. These two consequences are discussed below.

A. Application of Article V, Section 5

Under Article V, Section 5, the Fund may initiate a procedure that may lead to a declaration of ineligibility to use the general resources of the Fund (although not to compulsory withdrawal) against a member that "is using the general resources of the Fund in a manner contrary to the purposes of the Fund". Therefore, if a member that fails to meet an expectation to repurchase pursuant to the proposed decision were regarded as using the general resources of the Fund "in a manner contrary to the purposes of the Fund," the Fund could initiate against the member the procedure contemplated in that provision.

The applicability of Article V, Section 5 to a member that would fail to meet an expectation of repurchase pursuant to the decision proposed in this paper would depend on the actual use made by the member of the resources that it is expected to repurchase. ^{1/} In this connection, a distinction may need to be made between the cases of additional resources for interest support, on the one hand, and the accelerated purchases of set-aside amounts, on the other.

The expectation to repurchase the set-aside amounts could be triggered if the member's program subsequently went off track, but the

^{1/} It could be argued that the failure by a member to meet an expectation of repurchase would by itself constitute a use of resources in a manner contrary to the purposes of the Fund; it would follow that a member that fails to meet either expectation to repurchase under the proposed decision could be declared ineligible under Article V, Section 5. This interpretation does not appear, however, to give adequate weight to the condition in Article V, Section 5 that the use of the resources be contrary to the "purposes of the Fund." Indeed, the conclusion could not be reached that a member is using the resources of the Fund in a manner contrary to the purposes of the Fund without first considering the actual use made by the member of these resources. A better interpretation would therefore be that, in considering whether a member is using the Fund's resources in a manner contrary to the purposes of the Fund, the Fund must examine the actual use by the member of the resources, rather than rely on the failure to meet the expectation. Similarly, in cases where the Fund would specify the use that a member could make of certain resources of the Fund, the failure by the member to use the resources as intended would not by itself demonstrate that the member is using the resources in a manner contrary to the purposes of the Fund; to reach that conclusion, an assessment of the use made by the member of these resources would be necessary.

subsequent derailment of the program would not appear to be a sufficient ground to consider that the member is using the accelerated set-aside resources in a manner contrary to the purposes of the Fund. If it were, it could be argued that, in all cases of derailment of a member's program after a purchase under a stand-by or extended arrangement, the member could be declared ineligible to use the Fund's resources.

In contrast, the failure of a member to use the additional resources for the interest support operations that had been specified could be *prima facie* evidence of a use of Fund resources contrary to the purposes of the Fund. However, as discussed above, a definitive conclusion that the member is using the Fund resources in a manner contrary to the purposes of the Fund could not be based on the mere fact that the member did not use the resources for the specified purpose; the Fund would have to examine the actual use to which the member put the additional resources purchased from the Fund and make a judgment on the consistency of this actual use with the purposes of the Fund. This judgment would depend on whether the Fund would have approved such a use of its resources if the member had requested it. This procedure could prove rather slow and contentious, in view of the large measure of subjectivity that would inevitably be involved in this judgment.

B. Suspension of the use of the Fund's General Resources

The Fund may decide to attach to a breach of a repurchase expectation several of the consequences that flow from a breach of obligation. Thus, the Fund could decide that, as in the case of a breach of a financial obligation to the Fund, (i) the member's right to make further purchases under the arrangement shall be suspended as long as the repurchase expectation is not complied with; and (ii) the Managing Director would not recommend approval by the Executive Board of, and the Executive Board would not approve, any request for the use of the Fund's general resources as long as the expectation of repurchase is not complied with. The Executive Board has decided to apply these measures to members that fail to comply with an expectation of early repurchase pursuant to the guidelines on corrective action with respect to a noncomplying purchase, and the staff recommends that they be applied also in the case of failure to comply with an expectation of early repurchase proposed in Section I above. The procedure in Article V, Section 5 could, of course, always be resorted to if the circumstances warranted it. This expectation would apply to all purchases under stand-by or extended arrangements made after the date of this decision; for stand-by and extended arrangements already in effect, the appropriate provisions would be incorporated at the time of approval by the Fund of the member's request for augmentation or for acceleration of the availability of the set-aside amounts.

As in the case of other expectations to repurchase, the Managing Director would promptly report to the Executive Board the failure of a member to comply with an expectation of repurchase under the proposed decision.

The following decision, which could be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board.

III. Proposed Decision

In the context of the guidelines on the role of the Fund in the debt strategy, the Fund adopts the following decision on early repurchase expectations by members with respect to (A) purchases of additional resources for interest support under stand-by or extended arrangements, and (B) accelerated purchases of amounts set aside under such arrangements to support operations involving debt reduction:

A. Purchases of Additional Resources

1. Whenever the Fund approves a member's request for additional resources for interest support under a stand-by or extended arrangement pursuant to the Fund's guidelines on the role of the Fund in the debt strategy, the Fund shall specify in the decision approving the request the purposes for which, and the period of time within which, these resources can be used.

2. If the member, having purchased such additional resources, has not used them by the end of the specified period of time for the specified purposes, the Managing Director shall, after consultation with the member, promptly report the matter to the Executive Board. In his report, the Managing Director shall recommend that the Executive Board decide that the member is expected to make an early repurchase of the additional resources that were not used for the specified purposes, or shall recommend such other action as may be appropriate.

3. The Fund may decide that the member shall be expected to repurchase the additional resources that were not used for the specified purposes within 30 days of the decision or within such longer period as the Executive Board may specify.

B. Accelerated Purchases of Set-Aside Amounts

4. (a) If the program of a member that has previously made accelerated purchases of amounts set aside to support operations involving debt reduction under a stand-by or extended arrangement is off track on the date a purchase becomes available under the phasing provision in the arrangement, and is not back on track within 90 days after that date, the Managing Director shall report the matter to the Executive Board promptly after the expiration of the 90-day period.

(b) For purposes of this decision, a member's program is off track if the member is unable to make a purchase under the arrangement because of (i) the nonobservance of a performance criterion, the noncompletion of a review or the failure to meet any other condition under the arrangement, or (ii) the cancellation of the arrangement by the member before the purchase; the program is back on track if the member is again able to make purchases under the arrangement.

(c) Subparagraph (a) shall not apply if, on the date the purchase becomes available, all set-aside amounts that were purchased by the member by virtue of the acceleration would already have become available to the member under the phasing provision in the stand-by or extended arrangement in the absence of the acceleration.

5. In the report submitted under paragraph 4 above, the Managing Director shall recommend that the Executive Board decide that the member is expected to make an early repurchase of the set-aside amounts, or shall recommend such other action as may be appropriate.

6. (a) The Fund may decide that the member shall be expected to repurchase the set-aside amounts the purchase of which had been accelerated, to the extent that they would not yet have become available to the member under the phasing provision in the stand-by or extended arrangement in the absence of acceleration, within 30 days of the decision or within such longer period as the Executive Board may specify.

(b) A member shall not be expected to repurchase pursuant to subparagraph (a) above if its program is back on track within the period specified in that subparagraph.

C. General Provisions

7. The Fund shall not approve, and the Managing Director shall not recommend for approval, a request for the use of the general resources of the Fund by a member that is failing to meet a repurchase expectation pursuant to paragraph 3 or 6 above.

8. (a) Provision shall be made in stand-by and extended arrangements for the suspension of further purchases under the arrangement whenever a member fails to meet a repurchase expectation pursuant to paragraph 3 or 6 above.

(b) Paragraph 5 of the standard form of the stand-by arrangement in Attachment A to Decision No. 6838-(81/70) adopted April 29, 1981, as amended, shall be modified as follows:

"(Member) will not make purchases under this stand-by arrangement during any period of the arrangement in which

(member) has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase or pursuant to Decision No. [this decision]."

(c) Paragraph 5 of the standard form of the extended arrangement in Attachment B to Decision No. 6838-(81/70) adopted April 29, 1981, as amended, shall be modified as follows:

"(Member) will not make purchases under this extended arrangement during any period of the arrangement in which (member) has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase or pursuant to Decision No. [this decision]."

9. If a repurchase pursuant to the expectation under paragraph 3 or 6 above has not been effected within the specified period of time, the Managing Director shall submit promptly a report to the Executive Board accompanied with a proposal on how to deal with this matter.

10. Nothing in this decision shall be deemed to limit the power of the Fund to take any other action that may be taken pursuant to the Fund's Articles.