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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/97

10:00 a.m., June 20, 1990

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
G. K. Arora	L. E. N. Fernando
	C. Enoch
C. S. Clark	G. C. Noonan
	D. Powell, Temporary
Dai Q.	Zhang Z.
T. C. Dawson	B. S. Newman, Temporary
	J.-P. Schoder, Temporary
E. T. El Kogali	L. B. Monyake
	S.-W. Kwon
E. V. Feldman	
L. Filardo	
R. Filosa	
M. Finaish	A. M. Othman
	I. H. Thorlåksson
M. R. Ghasimi	
G. Grosche	H.-J. Scheid, Temporary
J. E. Ismael	T. Sirivedhin
A. Kafka	L. M. Piantini
J.-P. Landau	J.-F. Cirelli
Mawakani Samba	
Y. A. Nimatallah	
G. A. Posthumus	
K. Yamazaki	

J. W. Lang, Jr., Acting Secretary
S. L. Yeager, Assistant
M. J. Miller, Assistant

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Also Present

African Department: M. E. Edo, M. Katz. Asian Department: R. S. Teja. Central Banking Department: D. Folkerts-Landau. European Department: M. Guitián, Deputy Director; U. Dell'Anno, G. C. Pastor; S. M. Thakur. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; T. Leddy, Deputy Director; S. Kanesa-Thasan, G. R. Kincaid, J. P. Pujol, B. C. Stuart. External Relations Department: E. Ray. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; L. J. Ordoobadi. Secretary's Department: C. Brachet, Deputy Secretary; A. Tahari. Treasurer's Department: G. Laske, Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, K. Boese, D. Gupta, R. B. Hicks, B. E. Keuppens, C. P. McCoy. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J. Ferrán, Deputy Director; A. M. Jul, C. G. Muñiz B., P. Ramlogan. Office of the Managing Director: A. K. Sengupta, Special Advisor to the Managing Director; E. A. Milne; Internal Audit: R. Noë, Director. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: M. B. Chatah, Z. Iqbal, K.-H. Kleine, M. J. Mojarrad, A. Raza. Assistants to Executive Directors: G. Bindley-Taylor, C. Björklund, B. A. Christiansen, T. T. Do, A. Fanna, S. K. Fayyad, B. R. Fuleihan, M. A. Ghavam, J. Gold, A. Hashim, M. Hepp, J. Heywood, O. A. Himani, L. Hubloue, K. Ichikawa, M. E. F. Jones, P. Kapetanovic, G. Montiel, M. Mrakovcic, S. Rouai, G. Serre, M. J. Shaffrey, Shao Z., Wang J., J. C. Westerweel.

1. OVERDUE FINANCIAL OBLIGATIONS - RIGHTS APPROACH - OPERATIONAL MODALITIES

The Executive Directors continued from the previous meeting (EBM/90/96, 6/18/90) their consideration of a staff paper on operational modalities of the "rights" approach relating to overdue financial obligations to the Fund (EBS/90/102, 5/29/90).

The Chairman made the following summing up:

This has been an important discussion, following the guidance of the Interim Committee at its meeting in May 1990, to establish broad guidelines for the application of the "rights" approach and "rights accumulation programs," as we shall now call them. Drawing on our earlier discussions, Executive Directors have endorsed the main features of rights accumulation programs and of the financing of rights as set out in the staff paper for this meeting, while emphasizing the need for flexibility in the different and difficult circumstances that we may face. It is intended that this summing up provide a description of the key characteristics of the rights approach for reference in the decisions that are to be taken on the gold pledge and extended burden sharing.

Under the rights approach, a member in arrears to the Fund will be able to earn rights, conditioned on satisfactory performance under an adjustment program monitored by the Fund, toward a disbursement from the Fund once the member's overdue obligations have been cleared and upon approval of a successor arrangement by the Fund. Utilization of the rights approach will be limited to the eleven members that had financial obligations to the Fund overdue for six months or more at the end of 1989. I would note here that it is not expected that all of these members would make use of the rights approach; indeed, two of them are likely to settle their arrears shortly without recourse to the rights approach. It is intended that utilization of the rights approach would be further limited to those of the eleven members that adopt a comprehensive economic program that can be endorsed by the Executive Board as a rights accumulation program by the time of the spring 1991 meeting of the Interim Committee. I have noted the view of some Directors that a longer time might need to be envisaged, but that this is not the view of the majority. If there were to be a compelling reason, we would be able to return to the question as we approach the spring 1991 meeting.

Executive Directors considered a three-year period to be appropriate as a norm for a rights accumulation program, but with scope for variation in either direction. The member would be expected, with support as appropriate from other sources, to make maximum efforts to reduce overdue obligations to the Fund during the period of the rights accumulation program, so as to minimize the necessary recourse to rights. We will seek to incorporate a reduction of arrears to the Fund into programs and to introduce appropriate contingency provisions for additional payments to the Fund where developments are more favorable than expected. The magnitude of rights to be accumulated will clearly require case-by-case judgments by the Executive Board. But it is understood that, in cases where it appears unavoidable, rights may accumulate up to the amount of arrears outstanding at the beginning of the rights accumulation program. Some Directors noted that special action might have to be considered in highly exceptional circumstances, but it is not necessary to revisit the understanding placed in the record on this subject during the course of our deliberations prior to the recent meeting of the Interim Committee.

The member would be expected to generate the financing needed to meet the requirements of its economic program under the rights approach and, at a minimum, to remain current with respect to obligations to the Fund and the World Bank falling due during the period of the rights accumulation program. In this effort, it would be envisaged that the member would be assisted by creditors and donors through support groups, consultative groups, and/or other arrangements as appropriate. Resources that become available pursuant to the proposal for voluntary contributions originally made by Mr. Arora, which has been warmly welcomed by the Interim Committee and is expected to be discussed by the Executive Board in July, would complement these efforts.

Executive Directors agreed that rights accumulation programs should adhere to macroeconomic and structural policy standards associated with programs supported by arrangements under the extended Fund and enhanced structural adjustment facilities and that the Fund would draw, as appropriate, on Fund policies and guidelines associated with the use of such facilities. In particular, rights accumulation programs would need to help create the conditions for sustained growth and substantial progress toward external viability.

There was a preference among Directors for even phasing of the accumulation of rights within annual programs, based on quarterly monitoring. Executive Directors did not, however, rule out the possibility of some front-loading of rights within the first annual program if warranted by special circumstances. With respect to performance tests, the Fund's policies on waivers and modifications would be applied so as to allow for continuation of the program and rights accumulation if performance criteria were not observed but performance had been brought back on track. If waivers or modifications were not granted, Executive Directors considered it reasonable to permit the member to retain its previously accumulated rights for six months before they would lapse. Several Directors indicated that they would prefer that rights lapse in their entirety after six months, but most others considered that such a rule would be too rigid. On balance, we will plan that normally rights would lapse at a rate of 25 percent of accumulated rights per quarter; but that this rate could be more or less rapid depending on the circumstances, including, inter alia, the period of satisfactory performance under the rights program before it went off track and the reasons for the nonobservance of performance criteria. Again, the Executive Board will need to consider these questions on a case-by-case basis. If, after rights had begun to lapse, a new rights accumulation program were endorsed by the Executive Board, the member would resume accumulation of rights and the program period would normally be extended to permit the member to accumulate the rights needed to help clear its arrears.

Accumulated rights would be financed by a Fund disbursement upon approval of a successor arrangement with the Fund, following satisfactory performance under the rights accumulation program and once the member's overdue financial obligations to the Fund had been cleared. For SAF-eligible members, the mix of financing between the resources of the structural adjustment and enhanced structural adjustment facilities (SAF/ESAF) and the resources of the Fund's General Resources Account (GRA) would be approved as part of the successor arrangements, although some tentative indication of an anticipated mix could be given earlier. I would not intend to propose approval of a commitment to use ESAF Trust resources for the financing of rights before the decision on the gold pledge for the use of ESAF Trust resources for the financing of rights has been adopted.

Where a blend of General Resources Account and SAF/ESAF resources was considered appropriate, use of General Resources Account resources would normally be under an extended arrangement, and in such cases, the extended and SAF/ESAF arrangements would operate concurrently. Total access to the resources of the enhanced structural adjustment facility by a member would in all cases be in accordance with the access limits of that facility. I have taken note of the proposal made concerning the attribution of payments to the SAF/ESAF which would also make possible the application of all of the Fund's deterrent measures should arrears emerge; I suggest that we consider this proposal in connection with the forthcoming review of those facilities.

Our discussion has provided guidance that will enable us to proceed with concrete planning for rights accumulation programs in individual cases and with what we all hope will be a definitive phase in resolution of the arrears problem. Other issues will no doubt emerge as specific programs are developed, and these will need to be addressed case by case as they arise.

Mr. Grosche recalled that during the discussion on modalities of a gold pledge for the use of ESAF Trust resources in the context of the rights approach, the staff had confirmed that the Fund's commitment to consider all initiatives to assure full repayment of ESAF Trust creditors, including the Chairman's summing up of the Board's discussion on December 15, 1987 (EBM/87/171), was still valid. As there had been no summing up of the discussion on the modalities of a gold pledge, he wondered whether a sentence confirming the Fund's earlier commitment could be included in the summing up on operational modalities of the rights approach.

Mr. Yamazaki said that he supported Mr. Grosche's suggestion.

The Chairman observed that a summing up was not canceled or superseded unless that was explicitly provided for in a subsequent summing up. Moreover, the concern expressed by Mr. Grosche and Mr. Yamazaki at earlier meetings on the subject had been addressed by the statement that "it is not necessary to revisit the understanding placed in the record on this subject during the course of our deliberations prior to the recent meeting of the Interim Committee."

The Deputy General Counsel recalled that at the previous meeting he had indicated that Executive Board Decision No. 8759-(87/176) ESAF, adopted December 18, 1987, and the summing up of December 15, 1987 would not be superseded by the proposed decision on the use of gold. On a practical point, the summing up on the rights approach contained a reference to the gold pledge decision and to its relationship to the extension of loans from the ESAF Trust in the context of the rights approach. As the commitment set out in the 1987 decision was not related to the rights approach but was a more general commitment of the Fund, it would not be appropriate to reaffirm that commitment in a summing up on the rights approach.

The Chairman remarked that it was clearly understood that the explicit gold pledge that was being given in the context of the rights approach was in addition to the existing security provided by the Fund for the ESAF Trust, and that understanding would be recorded in the minutes of the meeting.

Mr. Dawson said that the statement that "where a blend of General Resources Account and SAF/ESAF resources was considered appropriate, use of General Resources Account resources would normally be under an extended arrangement, and in such cases the extended and SAF/ESAF arrangements would operate concurrently" raised some problems. His authorities had always favored the use of nonquota resources in support of the rights approach, and he was uncertain whether the Chairman's formulation would meet their concerns in that regard. He therefore had to reserve his position on that point for the time being.

The Chairman observed that with Mr. Dawson's reservation, the summing up was acceptable to Executive Directors.

2. EXTENDED BURDEN SHARING - IMPLEMENTATION; AND MODALITIES OF SPECIAL CONTINGENT ACCOUNT (SCA-2)

The Executive Directors considered a staff paper on the implementation of extended burden sharing and modalities of the new Special Contingent Account-2 (EBS/90/105, 6/6/90).

The Chairman commented that the staff had not intended to reopen the discussion on extended burden sharing, but the question of the extent of coverage of Special Contingent Account-2 had not yet been dealt with by Directors at previous discussions. The staff had suggested that that Account be used to cover general risks related to purchases from the Fund. The Board would have to decide whether that was appropriate, or whether it would be advisable to circumscribe more narrowly the risks it was designed to cover .

The Treasurer stated that the staff, in developing its proposal, had been guided by the Board's discussions in preparation for the Interim Committee meeting. The staff believed that it was recommending a prudent and financially responsible course of action.

Mr. Nimatallah made the following statement:

> Extended burden sharing and the establishment of Special Contingent Account-2 are integral parts of the enhanced strategy to deal with overdue obligations to the Fund. Despite the potential contentiousness, the Interim Committee reached a delicate compromise regarding the broad outlines of the modalities of Special Contingent Account-2. Indeed, this chair supported, and continues to support, that delicate compromise, on the basis of the Fund's operational procedures.
>
> Several loose ends of Special Contingent Account-2 remain to be dealt with, however. During the previous deliberations on this issue, it was our understanding that, should the floor to the remuneration coefficient be reached, the time period would be lengthened. Nonetheless, I can go along with the staff proposal to compensate any shortfall resulting from reaching that floor when the remuneration coefficient rises above the floor.

During previous discussions, the use to which the generated balances would be put--for partial financing of the rights approach or for backing the use of the General Resources Account--was left intentionally vague. Some may argue that such a differentiation is irrelevant, since the real effect is to increase Fund liquidity. Nonetheless, it has always been clear that Special Contingent Account-2 is a temporary mechanism created for the specific purpose of bolstering liquidity for enhancing the arrears strategy in respect of the eleven members currently in arrears. Another vagueness has been added in the staff paper--namely, whether the backing is intended to meet any possible write-off, or whether it is confined to liquidity enhancement in case repayments from the eleven countries currently in arrears to the Fund are delayed.

As long as the assumption holds that these obligations will eventually be paid back to the Fund, then the purpose of Special Contingent Account-2 in enhancing the Fund's liquidity remains valid. But if the Board decided to give up hoping for repayment from one or two of those eleven members, forcing them to withdraw, and causing the Fund to write off the obligations of the withdrawing members, then technically the Fund will confront a lower level of assets, making a corresponding reduction in liabilities necessary. That could be achieved either through a reduction in reserves, or in capital--Fund quotas. I also understand that the Fund's General Reserve of roughly SDR 1.3 billion is intended for meeting deficiencies in income to the Fund, and not for covering the impairment of assets, unless the loss is charged first to an expense account, through which it is then transformed into a loss of income, and then charged to the General Reserve. Special Contingent Account-1 is meant to cover lost assets; but what if that Account turns out to be too small to cover potential reductions in liabilities corresponding to the write-off of lost assets? It follows, therefore, that the reduction on the liabilities side should come from the capital of the Fund--its quotas. That would distribute the burden equitably on all members in proportion to their quotas.

If the Board decides that Special Contingent Account-2 is for increasing liquidity only, and that the Fund's quotas will absorb any potential asset loss, I cannot see how Special Contingent Account-2 could be extended beyond the liquidity purpose within the enhanced arrears strategy. One simply cannot say that amounts in Special Contingent Account-2 will be refunded at the end of the strategy, while at the same time saying that they should remain as a general protection against financial risks to cover any write-off of assets due to the compulsory withdrawal of members.

Therefore, I do not agree with the staff that the purpose of Special Contingent Account-2 should be widened beyond what has already been established in the package.

Mr. Dawson made the following statement:

This chair has been possibly one of the strongest advocates of strengthening the Fund's financial position by increasing reserves and precautionary balances. In the past, we have sought larger increases in reserves than provided by the 5 percent target, and supported placing surplus income in reserves rather than distributing it to members. Most recently, we sought a Special Contingent Account-2 of at least SDR 1.5 billion, in order to assure adequate nonquota resources to finance the General Resources Account portion of the rights program, and to protect the Fund from the risks associated with refinancing arrears. We therefore welcome the recent conversion of the staff with respect to the need for additional general precautionary balances.

The agreement to establish Special Contingent Account-2 from the proceeds of extended burden sharing was part of a carefully balanced package of measures relating to the quota increase and the strengthened arrears strategy. My authorities' support for the arrangements to finance that Account, including having creditors absorb the lion's share of the cost, was based on four considerations. First, that the amount being sought was finite, limited to SDR 1 billion over roughly five years; second, that the floor on the rate of remuneration would be maintained; third, that the resources in Special Contingent Account-2 were for a defined purpose related to the use of General Resources Account resources for the rights program; and fourth, that contributions to Special Contingent Account-2 would be temporary, and that the resources would be returned to creditors and debtors when the rights financing was repaid.

We are concerned that the specific staff proposals to implement Special Contingent Account-2 broaden its purpose and would upset the careful balance which produced the compromise on extended burden sharing. In particular, we believe it is important to keep Special Contingent Account-2 separate from general reserves, and to use it solely in connection with the rights program.

The staff's proposal to use Special Contingent Account-2 as though it were a general reserve would raise serious doubts about the adequacy of the SDR 1 billion to finance the General Resources Account's role in the rights program from nonquota resources. In effect, a portion of the SDR 1 billion would have to be available as a provision against all Fund lending risks. Moreover, it would be inconsistent with the notion that contributions to Special Contingent Account-2 were temporary and would be returned when the rights financing is repaid. While the proposed staff decision indicates that contributions would be returned when arrears are cleared and rights financing repaid, the text of the paper implies that Special Contingent Account-2 would be a permanent addition to Fund reserves. Staff comments on this apparent inconsistency would be appreciated. Finally, the staff proposal would alter the basis for the agreed means of allocating the cost of Special Contingent Account-2 by, in effect, having creditors absorb a larger share of the total cost of the Fund's general reserves. We agreed to the 3:1 allocation of the cost of extended burden sharing in light of the existing mechanisms for financing the general reserves and Special Contingent Account-1, and as a means of achieving a more balanced distribution of the overall costs of strengthening the Fund's financial position. The staff's approach shifts the overall burden sharing and weakens the basis for the agreed method of allocating the costs of Special Contingent Account-2.

We are not persuaded by the staff's arguments for a broader interpretation of the purpose of Special Contingent Account-2. The staff's concerns that a limited purpose of Special Contingent Account-2 would represent a precedent that could create the need to provision for specific country risk has been weakened considerably by the decision to provide a gold pledge to creditors to the enhanced structural adjustment facility. Indeed, in our view it would be desirable to establish such an explicit provision, in view of the obvious risks associated with arrears. Staff fears that use of Special Contingent Account-2 solely for rights-related risks would raise questions about the adequacy of reserves to cover other arrears cases is well taken. The decision to adopt additional remedial measures, including the proposed amendment on suspension of voting and related rights of membership, represents an explicit recognition of the grave risks to the Fund posed by countries which fail to cooperate in meeting their financial obligations. The answer to the staff's concerns is to increase Special Contingent Account-1 and reserves through the agreed methods for financing them, rather than by using Special Contingent Account-2 for that purpose, a purpose which is inconsistent with the spirit of the agreement on Special Contingent Account-2.

We also believe that Special Contingent Account-2 should be kept separate from Special Contingent Account-1 and the general reserves for the purpose of charging losses. Losses on overdue obligations not associated with the rights program should be charged to Special Contingent Account-1 and, if necessary, the general reserves. Any losses on General Resources Account resources in connection with rights financing would be charged to Special Contingent Account-2. The staff's proposal to charge losses against Special Contingent Accounts-1 and 2 in proportion to the aggregate contributions made to these Accounts would alter the effective burden sharing between and among debtors and creditors. It also ignores the role of the existing general reserves in protecting the Fund's financial position. If these reserves are inadequate, the Fund has mechanisms for increasing them, either by raising net income or selling assets; it should not be altering Special Contingent Account-2, which was intended for another purpose.

We believe that Special Contingent Account-2 should be dissolved when all purchases under the rights program are repaid. Similarly, Special Contingent Account-1 would be dissolved when overdue repurchases from countries not participating in the rights program are eliminated. We are concerned that the staff's proposal to expand the purpose of Special Contingent Account-2 and to apportion losses on nonrights financing to that Account would lengthen substantially the period that Special Contingent Account-2 contributions remain outstanding, and worsen the risks associated with such contributions beyond those envisaged in the initial agreement.

My authorities accepted the arrangements for distributing the cost of extended burden sharing as a means of strengthening the Fund's financial position, despite serious reservations about the equity of the method of allocating those costs among members, particularly creditors. We are concerned that over the long term the staff's proposals would weaken, not strengthen, the Fund's financial position and support for the Fund. It would inevitably lead to pressures to limit future increases in the reserves and Special Contingent Account-1, and shift additional amounts of the cost of protecting the Fund's financial position to creditors, especially those members with large reserve positions in the Fund relative to their quota share. This would create serious moral hazard problems, as debtors would have reduced incentives to stay current on their Fund obligations. It would also weaken creditor willingness to hold a portion of their official reserves in the form of reserve positions, a problem already confronting the Fund in the discussions regarding the allocation of currencies in the operational budget. Therefore, we could not support proposals to expand the function of Special Contingent Account-2 beyond the financing of the General Resources Account share of the rights program and to provide additional security for the risks associated with rights-related financing.

We can support the staff's proposal to offset shortfalls in creditor contributions to Special Contingent Account-2 resulting from the floor on the rate of remuneration, when the remuneration coefficient rises above the floor. This would help to assure that the target income of SDR 1 billion can be achieved within the agreed time frame without altering the agreed contribution ratio. However, we would expect that similar treatment would be given to shortfalls in the target income for the general reserves by the borrowers as was done in financial year 1989.

In response to a question from the Chairman, Mr. Dawson said that Special Contingent Account-2 should cover the risks arising only from those countries with overdue financial obligations to the Fund which were embarked on a program under the rights approach. Since it was likely that 2 of the 11 countries currently with Fund arrears would not take up the program, Special Contingent Account-2 would apply only to the risks arising from the remaining 9 members with arrears.

Mr. Nimatallah commented that the question arose as to whether the Account was intended to make up for losses in Fund liquidity arising from the use of General Resources Account resources to finance rights, or whether it was designed to provide security against the nonpayment of rights financing by the members which took up the program. If the former, refunding would not appropriate, in his view; if the latter, refunding could take place once all the repurchases of financing for the accumulated rights had been made. There was thus a difference between using the Account as security to cover eventual losses, and using it to make up for liquidity which the Fund might need for its operations.

The Chairman remarked that it would be difficult to specify a limitation on the coverage of Special Contingent Account-2 along the lines Mr. Dawson had suggested, without actually drawing up a list of countries to be so covered. That was why the option the staff had suggested was limited to the 11 current cases of arrears.

Mr. Dawson said that he did not agree that Special Contingent Account-2 should be used to cover the risks to the Fund from countries in arrears which were not following the rights approach. It was not to be used as a reserve for countries which persisted in not cooperating with the Fund. A country which cooperated with the Fund would, by definition, either be in a rights program, or would clear its arrears, in his view.

Mr. Landau remarked that he agreed with Mr. Dawson that Special Contingent Account-2 should be used to cover the risks only from countries embarking on rights programs, not from all countries with arrears.

Mr. Arora stated that Mr. Dawson and Mr. Nimatallah had presented very forceful arguments as to why the scope of the extended burden sharing under Special Contingent Account-2 should not be widened, and he associated himself entirely with them as far as the political conclusion was concerned.

He had been baffled by the staff paper regarding the coverage of risks, because the approach had arisen, as Mr. Dawson had said, in the context of the enhanced arrears strategy to deal with the problem of protracted arrears. In 1986 and 1987 there had been some controversy in the Board regarding the general concept of provisioning, and the Board's broad conclusion at that time had been that the Fund should not embark on a provisioning mechanism. He had therefore been surprised that that conclusion had been disregarded in considering that the coverage of Special Contingent Account-2 should be widened. The intensified collaborative strategy was predicated on the assumption that there would be no future case of arrears, which was why so much stress had been placed by many Directors during the negotiating process on preventive and deterrent measures. It appeared that the staff was considering that, in contradiction, there would be future cases of arrears. In his view, the coverage of Special Contingent Account-2 should be limited to the 11 members currently in arrears, or to those members entering into the rights approach.

His chair, along with others, had originally opposed Special Contingent Account-2 on two grounds, Mr. Arora continued. First, on the grounds that the Fund was not facing a liquidity crisis, that resources of the General Resources Account, structural adjustment facility and enhanced structural adjustment facility were available for the disbursement of rights, and that therefore there was no need for such an Account to finance the rights approach. In any case, there had been a proposal that if additional liquidity was needed, it would be provided through contributions. Second, on the grounds that the idea of provisioning was wholly inconsistent with the Fund's character as a cooperative institution. He had agreed with the Chairman that provisioning was needed in a general sense to strengthen the Fund's financial position, but that was very different from saying that the Fund would need to provision for probable losses that might occur in the enforcement of the rights approach. It was particularly worrying in light of the fact that when the gold pledge for the enhanced structural adjustment facility had been discussed, a number of speakers--among them Mr. Enoch--had stressed that no additional security was required because the Fund as a whole stood behind it, and second, that the Fund's policy guidelines on conditionality and program quality provided an even greater security to the Fund. What was good enough for the enhanced structural adjustment facility should be good enough for the General Resources Account. It appeared that the Fund was saying that if the period of its assistance were extended, conditionality would no longer be adequate to safeguard the Fund's resources.

Consequently, he saw no need to extend the coverage of the Special Contingent Account-2, Mr. Arora stated. Moreover, as Mr. Kafka had pointed out, there was no need to build up the Fund's precautionary balances at present, since the programs under the rights approach would only begin in 1993 or 1994. He saw no reason to bolster immediately the Fund's reserves in anticipation of the failure of those future programs. The assumption of failure, and thus of Fund losses, was in itself a flawed idea, in his view.

To broaden the coverage of Special Contingent Account-2 would also undermine the Fund's cooperative nature and push it even further in the direction of a commercial, rather than an international, organization, Mr. Arora concluded. Therefore, he would very strongly suggest that the idea of a broader coverage for Special Contingent Account-2 be dropped.

Mr. Yamazaki made the following statement:

> The extension of burden sharing and creation of Special Contingent Account-2 are important elements of the package agreed by the Interim Committee. As fully elaborated in the Managing Director's report to the Interim Committee, the Board had almost reached a full consensus on Special Contingent Account-2, in the context of the evolution of the rights approach. I will refrain from looking into the modifications made at the Interim Committee, including, notably, the creditors' and debtors' shares, as they represent a very sensitive compromise among the Governors. Nevertheless, I firmly believe that our progress with regard to the other aspects of Special Contingent Account-2 made prior to the Interim Committee was fully accepted by the Committee, and constitutes a firm basis for a balanced solution to extended burden sharing.
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> It is necessary for us to establish the modalities for Special Contingent Account-2 which reflect fully the Governors' agreement, and which will facilitate members' collaboration under the scheme.
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> In this regard, while I can go along with the staff's proposal on the implementation of burden sharing--the mechanism for adjustment of the rate of charge and the rate of remuneration to generate the target amount--I am doubtful about the proposed scope of Special Contingent Account-2. While the staff proposes to extend the coverage of Special Contingent Account-2 to all the overdue obligations to the General Resources Account, the Executive Board developed Special Contingent Account-2 in order to finance additional resources in response to the evolution of the rights approach. I am not aware that our Governors made any important change to this basic scheme.
>
> In the report to the Committee, Special Contingent Account-2 is described as intending to generate added liquidity for the General Resources Account, both as a basis for funding purchases from the General Resources Account under the rights approach, and to generate additional precautionary balances. The report also emphasizes that resources should be accumulated in Special Contingent Account-2 at least to the point where the balance sufficiently covers the General Resources Account resources provided under the rights approach. It is clear that Special

Contingent Account-2 was developed in order to finance and cover the risks associated with the rights approach. Any additional coverage, however, was not envisaged during the discussion.

The Interim Committee communiqué, although less explicit in indicating the purpose of each proposal, clearly discusses extended burden sharing, together with two other proposals on burden sharing, in close connection with the rights approach. Therefore, it would be fair to say that agreement was reached in the Committee on Special Contingent Account-2 as the additional backstop for General Resources Account resources provided under the rights approach. As to the financing of the rights approach, which was presented as another purpose of Special Contingent Account-2 in the Managing Director's report, we have carefully scrutinized the legal problems of the formulation. We feel that we can now handle this matter more or less as a presentational question. However, any ceilings should not be decided a priori in such a formulation. I believe that the staff could elaborate on the presentation of the modalities in this respect, in order to obtain the broad satisfaction of the members.

The staff proposal therefore seems to reopen an issue that had already been settled by the Governors in a sensitive compromise. In addition, if we extend Special Contingent Account-2 to cover all the overdue obligations to the General Resources Account, an inconsistency would be created vis-à-vis the gold coverage for the enhanced structural adjustment facility, as I stressed during Monday's discussion. On that occasion, the staff tried to justify the inconsistency by pointing out the problem of existing arrears to the General Resources Account. However, the ESAF Trust is also subject to the possible danger of arrears outside of the context of rights disbursement; and, what is more important, provisions against nonrights-related arrears were made for the General Resources Account in the form of Special Contingent Account-1 and the Special Reserve. However, since we initiated the rights approach--which is an extreme exception to the Fund's established financial policy--we agreed on introducing additional security for the rights disbursement--namely, the gold pledge and Special Contingent Account-2. Therefore, the most appropriate way to address the staff's concern about the limited coverage for the existing arrears and the imbalance between Special Contingent Account-1 and Special Contingent Account-2 is to strengthen Special Contingent Account-1. At this stage, we cannot accept reducing the security for the rights disbursement from General Resources Account resources by extending the coverage of Special Contingent Account-2.

Accordingly, the provision on the attribution of losses needs to be revised. As the coverage of Special Contingent Account-2 should be limited to the rights disbursement, any losses not attributable to the rights approach should be attributed exclusively to Special Contingent Account-1 and the Special Reserve. By contrast, rights-related losses should be attributed to the Special Contingent Accounts-1 and 2 in accordance with the modalities of each.

I strongly suggest that the risk coverage of the Special Contingent Account-2 should be limited to General Resources Account disbursements under the rights approach, and, accordingly, the attribution of losses to Special Contingent Account-2 should be restricted. I firmly believe that this approach reflects most appropriately the agreement reached by the Interim Committee, and that it will also be consistent with the gold coverage for limited disbursements from the enhanced structural adjustment facility. At the same time, once the framework is solidly established, the presentation should be made in such a way as to ensure its wide acceptability to members.

The Chairman stated that it was apparent that there was inadequate support in the Board for a broadening of the risks to be covered by Special Contingent Account-2 as recommended by the staff, given that a 70 percent majority of the total voting power in the Board would be required to implement the staff's proposal. He would therefore suggest that speakers indicate whether the Special Contingent Account-2 should cover the risks associated with the 11 current arrears cases, or whether it should be circumscribed even further, to cover only the risks associated with those countries which embarked on a rights program.

Mr. Grosche commented that he had heard no disagreement from speakers as to the burden sharing part of the proposed decision. The difficulty seemed to be chiefly with the modalities of Special Contingent Account-2.

Mr. Nimatallah said that another issue was the exact purpose of Special Contingent Account-2. Would it be used to cover written-off assets; to enhance Fund liquidity during the period of rights programs; or would it be used to actually finance rights programs, as Mr. Dawson had recently suggested? After the purpose of the Account had been agreed, then the limitation of its coverage could be discussed.

Mr. Grosche observed that it would be very difficult to agree on the philosophical underpinnings of the Account, and such a discussion would probably be very lengthy. It might be recalled that he had had doubts about Special Contingent Account-1 as a matter of principle, and he still had problems with Special Contingent Account-2. In general, he saw the Account in the role of strengthening the Fund's financial position by increasing its precautionary balances. That in itself had liquidity implications, which might be helpful in the financing of rights programs for the 11 countries currently in arrears. Perhaps the Board might deal with how losses would be handled--whether through the Fund's income account to its reserves, or directly, through Special Contingent Account-2. It was his opinion that it would be legally rather difficult to do the latter.

The Chairman remarked that refining the philosophy behind the Account might better be left to the Interim Committee. However, he hoped that the Board would take a practical decision so that it could be put into operation.

Mr. Nimatallah said that he did not wish to pursue a philosophical discussion, but that it was apparent that the same account could not be used for two different purposes. Either the amounts in the Account would be returned, or they would be used to cover losses; they could not be used for both.

Mrs. Filardo stated that she wished to associate herself with the comments of Mr. Arora and Mr. Nimatallah. The risks to be covered by Special Contingent Account-2 should be limited to those associated with the 11 members currently in arrears. She fully agreed with Mr. Nimatallah about the need to decide how losses would be attributed. In her view, losses should be attributed to the General Reserve or charged against Fund quotas, and not to the Special Contingent Accounts, because the amounts in those Accounts were to be returned to the contributors once the problems which caused them to be created had disappeared.

Mrs. Filardo then made the following statement:

> The discussion of quotas and their link to the amendment of the Articles of Agreement to introduce the suspension of votes and related rights of membership was long and unduly difficult. The irritation was caused by the staff's insistence on the creation of a second contingency account to back the risk involved in the rights approach, based on the unfair mechanism of extending burden sharing. Nevertheless, in the end the Governors at the Interim Committee reached a compromise, with four essential elements: an increase in quotas of 50 percent; the maintenance of the enlarged access policy until the quota increase takes effect; the possibility of amending the Articles of Agreement; and the extension of the burden-sharing mechanism so that SDR 1 billion would be accumulated over a five-year period, financed by contributions of creditors and debtors in a proportion of 3 to 1, but with the understanding that the rate of charge would be adjusted by a maximum of 35 basis points, in light of the present high rate of charge.
>
> In the past, many Directors expressed doubts about extending burden sharing in the way proposed by the staff, given the high rate of charge, the uneven distribution of the burden among member

countries, the floor to the remuneration coefficient as mandated in the Articles, and the recognition that, in many cases, countries willing to cooperate were not able to do so through lack of financing given the reluctance of support groups to make contributions. However, in spite of all these concerns, a compromise was reached. Shortly after that compromise, the staff has presented a proposal which is completely at variance with it.

I wonder whether the staff, knowing of the resistance to the extension of the burden-sharing mechanism, thought, tactically, that perhaps it would be preferable to make a more irritating proposal, in order to be able to obtain, at least, the original compromise. Alternatively, perhaps the staff's strategy was to make the Board believe that a final agreement had been reached--subject to review and adjustment when countries in arrears use the rights approach and solve the arrears problem--so that, once that was accepted, it could proceed even further, presenting to the Board additional elements not previously contemplated--for example, the possibility that other cases of arrears could emerge, which was an issue raised by many, but not accepted, given that the strategy was to be limited to only the 11 countries currently in arrears.

Regardless of the staff's motives, the proposal should be seriously questioned, not only because it deviates from the original consensus, but because it will endanger the cooperative nature of the Fund. The question arises as to why the staff did not present to the Board before a comprehensive and realistic analysis of the situation, and of the risks involved. It appears that the staff has opened Pandora's box.

The arguments used for assessing the risks which Special Contingent Account-2 is supposed to cover look very similar to those used by commercial banks in their accounting practices. Is the Fund therefore a commercial bank, or a cooperative institution? Is what we preach contradicted by what we practice? Why should we be excessively cautious in evaluating risk, creating all kinds of backing for the financing of the rights approach, when we are finally giving the countries in arrears the opportunity to enter into a collaborative strategy, in which financing will be available? The 11 members currently in arrears deserve to be given the benefit of the doubt as to whether or not they will seize that opportunity and commit themselves under the strengthened arrears strategy. Also, it might be wiser to presume that the mechanism will work--rather than it will not--and that the support groups will play their part. Personally, I am optimistic that we will be able to solve the 11 cases of arrears in a relatively short period of time, so that an amendment of the Articles will not be necessary. Nevertheless, a special ambassador will be needed to persuade the country in arrears to enter into the strategy, and the donor countries to support the authorities' efforts to implement a strong growth-oriented adjustment program on a timely basis. Therefore, the risk should be limited to the 11 current cases of arrears.

With respect to whether a loss should be attributed to either one of the two accounts, or to both of them in a balanced way, I fully agree with Mr. Nimatallah that a loss should be attributed either to the General Reserve or to the Fund's capital--that is, through an adjustment in quotas. Special Contingent Accounts-1 and -2 were created with the understanding that they would be temporary, and the contributions returned to creditors and debtors once the problems which necessitated their creation have disappeared. In the case of Special Contingent Account-2 in particular, the Account should last until repurchases of rights financing have taken place. Any losses should be charged first against the Fund's quota base in such a way so that some members are not more affected by it than others, taking into account the perversity of the mechanism which implies that debtors will be more affected than creditors.

We therefore cannot accept the proposed decision.

Mr. Ismael stated that Special Contingent Account-2 should be used to cover the risks associated with those of the 11 countries currently in arrears which opted for rights programs.

Mr. Thorláksson stated that he could accept the proposal regarding the implementation of extended burden sharing and the establishment of Special Contingent Account-2. However, on the exact modalities for Special Contingent Account-2, he was opposed to the proposal to broaden the purpose of Special Contingent Account-2 to cover financial risks resulting from Fund credits in general. Not only did that constitute a major departure from the original intention of the Account and the spirit in which the negotiations in the Interim Committee were held, but it also ran counter to the cooperative nature of the institution, since it would imply a transfer of risks from the membership as a whole to mainly the creditor countries, given the asymmetrical nature of the Account. Moreover, he wondered whether the proposed very specific criteria for the dissolution of Special Contingent Account-2--which he could endorse--were in fact compatible with a broadened scope for that Account.

Despite the staff's arguments to the contrary, therefore, the Nordic countries firmly believed that the scope of Special Contingent Account-2 should be limited to that of providing protection against risks connected with the encashment of rights, Mr. Thorláksson continued. The exclusive link between Special Contingent Account-2 and the risks associated with the encashment of rights could be further justified by the fact that the Fund's exposure to countries embarking upon a rights accumulation program would most likely be much greater than its exposure to other countries, especially if the likely extension of Fund credit beyond the accumulated rights was taken into account.

The agreement reached in principle by the Interim Committee to extend the burden-sharing mechanism was only one element in a very delicate compromise, and was in itself a controversial issue, Mr. Thorláksson concluded. To go beyond the intended scope of Special Contingent Account-2 would certainly undermine the basis of that agreement. Therefore, the decision on the modalities of Special Contingent Account-2 should be modified, so that they fully reflected the agreement reached by the Interim Committee.

Mr. Enoch stated that he had two proposed amendments to the draft decision. First, he would suggest that paragraph 3(a) read:

> Distribution of the balances held in Special Contingent Account-2 shall be made when there are no purchases outstanding for financing of rights as defined....

In paragraph 3(d), he would suggest that the first part of the sentence read:

> Any loss in relation to an undischarged repurchase obligation in respect of a purchase from financing of rights shall be charged against the balances held in Special Contingent Account-2....

Mr. Enoch then made the following statement:

> The United Kingdom fully supports the decision to establish a new Special Contingent Account, financed through an extension of the current burden-sharing arrangements. Given the inherent uncertainties surrounding the size of potential drawings under the rights approach, we would have preferred to see a more rapid and more substantial buildup of resources in this Account. Nevertheless, as part of a wider package designed to combat the continuing problem of protracted arrears to the Fund, my authorities are willing to go along with the Managing Director's proposal to set the initial target for Special Contingent Account-2 at SDR 1 billion, to be collected over five years. Clearly, the appropriateness of this target will need to be assessed carefully each year in the light of evolving developments.
>
> The most important of the outstanding questions with regard to the modalities of Special Contingent Account-2 which the staff has identified is that of what exposure or risks the new Account should cover. As the staff notes, the establishment of Special Contingent Account-2 was originally conceived as a way of

providing backing for General Resources Account purchases made under the rights approach. There has perhaps been some ambiguity about what precisely is meant by the backing of rights disbursements. However, there has been no ambiguity about which members would be covered by Special Contingent Account-2. This Account is an integral accompaniment of the rights approach. As such, it should be limited to only those members receiving General Resources Account disbursements under the rights approach.

Against this background, I was surprised at the suggestion that Special Contingent Account-2 might be used more generally to provide protection against the risks associated with any credit extended by the Fund. The arguments put forward by the staff are reasonable in themselves. However, they miss an essential feature of the proposed new Account. This is that the resources to be placed in Special Contingent Account-2 are intended to increase the liquidity of the General Resources Account, effectively providing additional, nonquota resources with which to finance General Resources Account disbursements under the rights. If, instead, the resources held in Special Contingent Account-2 were used to stand behind Fund credit more generally, the additional liquidity provided by the Account might, in extremis, be fully exhausted before the first rights disbursements are made. In these circumstances, General Resources Account disbursements under the rights approach would have to be financed out of the Fund's normal quota resources--something which a number of Directors have been extremely keen to avoid.

In effect, what the staff proposal would do is to transform the new Special Contingent Account into a general reserve. This would seem to be inappropriate for three reasons. First, as the staff itself says, it would be difficult to argue that the overall riskiness of the Fund's loan portfolio is greater now than it was before the strengthening of the arrears strategy. If the Fund's general reserves were broadly acceptable one year ago, it is not clear why it should be felt necessary now to contemplate a rather sharp increase in the Fund's general precautionary balances.

Second, if indeed the staff believes that Special Contingent Account-2 is needed to cover risks which extend beyond General Resources Account rights disbursements that might be made in the future to members currently in protracted arrears, it is not clear why it proposes that Special Contingent Account-2 be wound up when these members have fully repurchased their rights purchases.

Third, relating to the financing, the creditor members have agreed, on a wholly exceptional basis, to a 3:1 contribution ratio for the funding of Special Contingent Account-2. This degree of asymmetry reflects in large part the special, one-off, nature of the new Account, and its particular role in providing resources to back the rights approach. It is far from certain that such a departure from normal financing methods would have been acceptable to the creditors had they expected that Special Contingent Account-2 was to be used as a general reserve against the entire stock of current and future Fund credit. For these reasons, I would prefer to see Special Contingent Account-2 used for the rather narrower purpose for which it was originally conceived.

The only losses that should be attributed to Special Contingent Account-2 should therefore be those arising out of overdue repurchases of disbursements made under the rights approach. I agree with the staff that logic dictates that amounts in Special Contingent Account-2 should be refunded when rights disbursements have been fully repurchased.

I can go along with the staff's proposal to offset shortfalls resulting from the floor to the remuneration coefficient as and when the coefficient rises above the floor.

Mr. Ghasimi stated that he had supported the enhanced strategy to deal with countries in protracted arrears to the Fund at previous Board meetings. His understanding was that that strategy would be part of a special, limited, and hopefully temporary policy for dealing with the 11 cases of arrears. He continued to urge all those countries to embark on a comprehensive adjustment program under the rights approach as soon as possible, in order to clear their arrears with the Fund and resume normal relations with the international financial community.

When the extension of burden sharing in support of the resolution of arrears to the Fund had been discussed, he had indicated that while addressing the case of countries in arrears, it was important to keep in mind the impact of the Fund's policies on the rest of the membership, and particularly on those debtor countries that continued to fulfill their financial obligations to the Fund on a timely basis, and sometimes under extremely difficult conditions, Mr. Ghasimi remarked. Those concerns, which had been motivated by the already costly burden sharing and the increases in the basic rate of charge, which was at a historic high, formed the basis of his reluctance to accept the extension of burden sharing.

The proposed decision did not fully reflect the Board's previous understandings, Mr. Ghasimi commented. Like previous speakers, among his main concerns was the fact that Special Contingent Account-2 would cover financial risks associated with credits extended to all members, not only to those members that availed themselves of the rights approach. Also, the dissolution of Special Contingent Account-2 would be dependent on the elimination of all overdue obligations to the Fund, which could include countries other than the present 11 arrears cases. Consequently, the refunding of amounts in that Account to contributors could be delayed as long as there are countries in arrears to the Fund. For all those reasons, he had some concerns about the proposed decision.

With respect to the implementation of extended burden sharing, the staff had raised the issue of potential shortfalls resulting from reaching the floor for the remuneration coefficient, Mr. Ghasimi concluded. Only the amount that could not be generated by the full adjustment in the rate of remuneration would be recovered or compensated for in subsequent periods. In order to safeguard the agreed contribution ratio, he would prefer that the adjustment to the rate of charge generate only one third of the amount generated by the reduction of the rate of remuneration when the floor for the remuneration coefficient was reached. Similarly, the shortfalls resulting from both the floor to the remuneration coefficient and the corresponding limitation on the adjustment to the rate of charge should be recovered in subsequent periods.

Mr. Feldman stated that he wished to associate himself with the comments of Mr. Arora and Mr. Nimatallah. The coverage of Special Contingent Account-2 should be limited to the risks arising from the 11 members with protracted arrears at the end of 1989 and eligible for the rights approach, which was consistent with the Board's understanding of the temporary nature of the Account, as well as its eventual dissolution.

Mr. Kafka said that the Account's coverage should be limited to the risks associated with disbursements under rights programs. He agreed with the rewording of the draft decision which Mr. Enoch had proposed.

When he had agreed to the consensus on extended burden sharing and the creation of Special Contingent Account-2, it was understood that the new Account would be specifically used to back the encashment of rights earned under the rights approach, Mr. Kafka noted. The staff appeared at present to be concluding that the balances in Special Contingent Account-2 should be delinked from the encashment of rights, and that the Account should cover all risks of Fund losses. That was contrary to the Board's original understanding, and, in a sense, contrary to the concept of the new Account itself, which, on the staff's proposal, would differ from Special Contingent Account-1 only in its funding. He therefore could not support the staff's proposal.

Neither could he accept the views of the staff on the dissolution of Special Contingent Account-2, Mr. Kafka continued. If the purpose of Special Contingent Account-2 was specifically to back the encashment of rights, then its dissolution must be based on the repurchase of the encashed rights accumulated under the Fund-monitored program.

In light of the suggestions that had been made in the staff paper, he wished to highlight an important aspect of the original agreement on burden sharing--that no change could be made in the proposed formulation for burden sharing except with a 70 percent majority of the total voting power, Mr. Kafka concluded. He hoped that that point would be mentioned in any summary of the discussion.

Mr. Mawakani said that he wished to associate himself with the comments of Mr. Ghasimi and Mr. Ismael. Like other speakers, he had been puzzled by the proposal to broaden the scope of Special Contingent Account-2 to cover risks that were not envisaged initially when the principle of that Account had been discussed. He shared the arguments of Mr. Nimatallah and Mr. Arora on the scope of coverage of Special Contingent Account-2. The implementation of extended burden sharing should be according to the package that had been agreed in the context of the intensified collaborative strategy on overdue financial obligations to the Fund. Therefore, like Mr. Ghasimi and Mr. Ismael, Special Contingent Account-2 should be confined to covering the risks stemming from the 11 members currently in arrears and to other members that could become eligible for the rights approach. He could support the proposed decision, with the amendment of sections 3(a) and 3(d).

Mr. Kwon stated that like previous speakers, one or two aspects of the staff paper caused his chair considerable concern. The chief one was the proposal that the new Special Contingent Account cover the risks associated with credit extended to all members. It had been his firm understanding during the Board discussions on extended burden sharing that the resources of Special Contingent Account-2 would be directed solely at the risks associated with the credits to be extended from the General Resources Account under the rights approach, and, despite the staff's arguments to the contrary, he saw no reason to alter that. As the Chairman had stated in his summing up of the discussion on extended burden sharing, the understandings reached as to the purpose of Special Contingent Account-2 were an integral part of the strengthened arrears strategy, and he believed that the Account should be directed at backing up innovations in that strategy. For the same reasons, he was not in favor of the proposal for attributing losses to Special Contingent Account-2. With those reservations, he could go along with the remainder of the proposed decision.

Mr. Schoder made the following statement:

> The staff paper is another step in the process of implementing the agreement reached during the spring 1990 Interim Committee meeting, and reflects fairly well the political compromise reached at that time.
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> We share the views expressed in the section on the implementation of extended burden sharing, in particular, the fact that this type of burden sharing will cover a period sufficient to generate the target amount of SDR 1 billion, unless decided otherwise by a 70 percent majority of the total voting power. We also agree on the targeted time span of five years as necessary to generate that amount, with the possibility of a limited extension

of the adjustment to the rate of remuneration in order to recoup previous shortfalls due to the floor to the remuneration coefficient specified in the Articles. On that point, do I understand that financial year 1991 will already produce such a shortfall, which then will have to be carried over to financial year 1992?

I do not share the staff's views, however, in the section on the modalities of Special Contingent Account-2. I was somewhat surprised by the views expressed with respect to the risks to be covered by Special Contingent Account-2. The Fund's efforts in rights accumulation programs justify, in our view, an exceptional effort by the membership to provide backing and security to the risks associated with credits from the General Resources Account to the 11 countries presently in overdues. It was crystal clear that the discussion on overdues centered on those 11 countries. The need to establish Special Contingent Account-2 was associated closely with the solution to the problems which those 11 countries posed to the Fund and to all its members. It would be a breach of a previously agreed compromise to introduce now modifications to the risks covered. Indeed, the staff's proposed modification is significant, as it has the potential for changing the very nature of the Fund. The Board recognizes and stresses the Fund's unique nature--in particular, its preferred creditor status. The proposal to provide protection against financial risks connected with credit extended to all members constitutes a significant shift in our financial policies toward commercial banking principles, a shift we cannot accept. Special Contingent Account-2 must therefore be strictly confined to covering the risks associated with purchases made by the 11 eligible countries under rights accumulation programs. We view Special Contingent Account-2 as intending to provide additional security against the risks associated with rights accumulation programs, but not as a means of financing those rights--contrary to Mr. Dawson's views. Mr. Dawson's approach would introduce segmentation into the General Resources Account, which, as Mr. Landau pointed out, is not within the Board's purview.

On the section of the paper on the dissolution of Special Contingent Account-2, because that Account is strictly targeted to the 11 countries now in overdues, its dissolution must be linked to the fate of those countries. Therefore, it should be possible to reduce partially the balances in Special Contingent Account-2 if the evolution of the Fund's financial relations with those countries warrants refundings, such as when repurchases in respect of previously encashed accumulated rights have been made. Also, it may be unrealistic to require as a condition for refunding that no overdues whatsoever exist from any member, as otherwise the amounts in that Account would, in effect, have been transferred to the Fund on a permanent basis. Again, that would run counter to

> the views unanimously expressed over recent months on the temporary nature of the commitment of resources to Special Contingent Account-2. Reimbursement of resources in that Account should be linked to the Fund's financial relations with the 11 members currently with arrears; reimbursements should not be precluded by solely technical arrears problems. It should also be noted that the conditions for the reimbursement of balances in Special Contingent Account-2 can always be changed, by a 70 percent majority of the total Board voting power, if members believe that circumstances warrant such a change.

Mr. Dai stated that the staff paper, in addition to reflecting previous Board discussions on the issue, put forward a new recommendation, namely, that the balances in Special Contingent Account-2 should be used to cover Fund lending risks in general, rather than limiting the risks covered to those applying to the rights approach. On that point, he could not agree.

Extended burden sharing was intended to cover risks associated with the encashment of rights, in comparison with the original burden-sharing arrangement, which covered Fund lending risks in general, Mr. Dai pointed out. The fact that Special Contingent Account-2 would provide protection against specific risks in the rights approach, analogous to the gold pledge in the case of resources used under the enhanced structural adjustment facility, did not suggest that the credits to certain members represented particular or more serious risks. Therefore, despite the staff's reasoning, he was not convinced that that specific proposal for the new Account should be retained.

When extended burden sharing was discussed in the Executive Board, some Directors were skeptical about the need and justification for Special Contingent Account-2. He had also expressed doubt about the need to generate SDR 1 billion, but, after the most recent Interim Committee meeting, it had been agreed to accumulate SDR 1 billion over five years, with the ratio of 1:3. The staff was now suggesting implicitly that that amount could be used to cover not only risks under the rights approach, but all risks associated with Fund lending in general as well. There thus appeared to be a change in the basic assumption on the potential need for coverage, which confirmed his earlier belief. The present staff view seemed to be that a large enough surplus would accrue in Special Contingent Account-2 to supplement Special Contingent Account-1, as the amounts in the latter Account were likely to be insufficient to meet the possible charges against it . That proposed change was not consistent with the original purpose of Special Contingent Account-2.

He therefore found it difficult to agree with the draft decision, Mr. Dai concluded. The coverage of Special Contingent Account-2 should be limited to providing protection with respect to credits extended to members in connection with the encashment of rights, as originally discussed at the Board.

Mr. El Kogali stated that the staff paper, by proposing that accumulated balances in the new Special Contingent Account be used to cover financial risks associated with credit extended by the Fund in general, was at variance with the consensus that had been arrived at after a long debate over extended burden sharing, as some previous speakers had noted. The understanding had been that Special Contingent Account-2 would provide backing to the risks associated with the encashment of rights under the intensified collaborative approach to the resolution of arrears. He did not believe that the proposed broadening of the purpose of the Account was warranted.

Mr. Nimatallah and others had made a number of pertinent points, with which he would like to associate himself, Mr. El Kogali continued. First, the temporary character of the Account should not be lost sight of; extending its purpose to cover all lending by the Fund could erode that feature. Second, there was no reason why the Fund could not take precautions in connection with a specific risk if it so desired, which was what the consensus had attempted to do. Third, the Fund should not be seen to act as a commercial bank in the type of provisioning it made against risks. Lastly, it was not a valid argument to suggest at present that linking Special Contingent Account-2 to the encashment of rights alone would be an anomaly, in that it would indicate that such encashment carried a more serious risk than other overdue obligations, despite the successful completion of a Fund-monitored program before the exercise of rights. Such an argument was tantamount to setting up a straw man. Many Directors had made the point during the discussions that a country's submission to a three-year Fund-monitored program should be a sufficient guarantee for the encashment of accumulated rights.

The Board should therefore stick with the original concept which had been endorsed by the Interim Committee, Mr. El Kogali concluded.

Mr. Posthumus said that he found it interesting that many speakers were objecting to the idea of provisioning, even though Special Contingent Account-1 had been agreed some time ago, as well as the gold pledge for enhanced structural adjustment facility resources. He could support the Managing Director's initial proposal, which he had considered as conservative. He could also support, however, the limitation of coverage of Special Contingent Account-2 to the risks arising from the 11 countries currently in arrears.

Mr. Filosa stated that he supported extended burden sharing. Special Contingent Account-2 should be used to cover the risks associated with those countries which actually entered into a rights program, and for which disbursements had been made.

Ms. Powell stated that her position was very close to that of Mr. Posthumus. She could support limiting the coverage of the Account to the 11 countries currently in arrears.

Mr. Grosche said that he could agree to the proposed decision on extended burden sharing. He would prefer to see Special Contingent Account-2 used only to cover the risks associated with those 11 countries currently in arrears which entered into rights programs, and for which General Resources Account resources had been disbursed. Therefore, the reimbursement to contributors to that Account should take place only after the General Resources Account resources had been repaid. The coverage of losses should be handled in the same way as for Special Contingent Account-1, except, of course, that such coverage would be limited to a loss incurred because of the failure of one of the 11 countries currently in arrears to make repurchases stemming from its rights program. He could support the amendments to the decision proposed by Mr. Enoch.

Mr. Finaish stated that since the basic elements of extended burden sharing had already been agreed upon and endorsed by the Interim Committee, he would limit himself to the issues which remained to be decided before putting the new mechanism in place. He welcomed the fact that in the proposed decision the staff had avoided the anomaly which existed in the current burden-sharing decision, and which he had referred to in earlier discussions. Under the current system, if at the time of setting the basic rate of charge for a new financial year there was no agreement, by a 70 percent majority of the total voting power, on what the rate should be, the rate of charge in effect at that time--which included adjustments associated with deferred charges and the funding of Special Contingent Account-1--became the basic rate of charge for the subsequent financial year. That anomaly had been avoided in connection with extended burden sharing, which he welcomed.

Regarding the risks to be covered by Special Contingent Account-2, Mr. Finaish continued, the staff had made a number of arguments in favor of a broader coverage of risk to include not only credit extended through the rights mechanism, but also the risk associated with overdue obligations in general. As Directors would recall, during the previous discussions on extended burden sharing he had used those arguments to question the basis of the extended burden sharing as it had been proposed. He was afraid that the preoccupation at that time with the distribution of the burden had overshadowed other issues, such as the purpose which the generated funds were supposed to serve.

If the staff's arguments were accepted, then one could go further than was suggested in the staff's proposal, and define the purpose of Special Contingent Account-2 and the conditions for refunding on the same basis as Special Contingent Account-1, that is, without any reference to the encashment of rights, Mr. Finaish pointed out. That would be perfectly consistent with the staff's arguments against an exclusive link to credit extended through the rights mechanism.

Although one could follow such an approach, a possible inconsistency with the spirit of the understandings which had been reached could be encountered, understandings which had been based on an assumption that Special Contingent Account-2 was being established for a specific purpose--to protect against the risk associated with the 11 members in protracted arrears, Mr. Finaish commented.

Given that dilemma, and on balance, he could have been prepared to support the staff's proposal, Mr. Finaish concluded. However, in light of the strong support for a narrow coverage that Directors had already expressed, he would be willing to join a Board consensus on the matter.

The Treasurer stated that, with respect to the question of the attribution of losses which Mr. Nimatallah had raised, the precondition for the Fund's recognition of a loss would be that no agreement had been achieved between the Fund and the withdrawing member on an orderly schedule for the settlement of the Fund's claims on that member as stipulated in the Articles of Agreement and in Schedule J at the time of the withdrawal. The Board would have to make an assessment that the Fund's claims had not been realized and that a loss had been incurred, and, as Mr. Nimatallah had pointed out, the total of the Fund's assets would have to be reduced by a corresponding amount.

The Board had taken the decision in 1987 that losses resulting from overdue financial obligations would be charged first to Special Contingent Account-1 in proportion to the contributions debtor and creditor members had made to that Account through paying higher charges or receiving reduced remuneration, the Treasurer continued. If the loss could not be covered by the balances in Special Contingent Account-1, the uncovered part of the loss would enter the Fund's income statement as an operational expense and would reduce, pro tanto, operational income for that year. If the loss was greater than the amount of operational income for the year, the Fund would suffer a deficit, which would have to be charged, in the first instance, against the Fund's Special Reserve. If the Special Reserve was not adequate to cover the loss, it would then go automatically against the General Reserve. If that also were inadequate, the balance would be shown as an offset against quotas and could eventually--when the Fund was liquidated--be charged against quotas, unless in the interim it had not been eliminated by achieving positive net income.

The staff had proposed modalities for Special Contingent Account-2 along the lines of Special Contingent Account-1, taking into account its interpretation of the Board's previous discussions and the guidance of the Interim Committee, the Treasurer concluded. Any loss would be charged against the two accounts together, in proportion to the contributions made by debtors and creditors, but that suggestion had not received the Board's support. The staff would thus look again at the method of attributing losses to Special Contingent Account-2.

The Deputy General Counsel, replying to a question from Mr. Grosche, said that losses stemming from any defined group of countries with overdue repurchases to the Fund could first be attributed to Special Contingent Account-2, and, to the extent the balances in that Account were insufficient to cover the loss, then to Special Contingent Account-1. However, the exact formulation of the decision would be for the Executive Board to determine.

The Chairman said that the staff would circulate a revised text 1/ of the proposed decision to take into account the views of Directors, for consideration the Board's discussion of the 1990 Article IV consultation with Malta.

3. MALTA - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Malta (SM/90/81, 5/2/90). They also had before them a background paper on recent economic developments in Malta (SM/90/86, 5/15/90).

Mr. Filosa made the following statement:

> The new approach to economic liberalization and market-oriented policies that has been pursued by the Maltese Government which took office in 1987 is proving successful, as recent economic developments confirm. In the 1988-89 period, both aggregate demand and output were strong; fixed investments increased rapidly, with national savings being the main source of financing; employment continued to rise, particularly in the private sector, bringing the economy to virtual full employment; inflation remained low; and the current account, for the fourth year in a row, registered a surplus, reinforcing Malta's sound external position. Available indicators suggest that these trends are likely to remain favorable in 1990.
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> However, the economy is still characterized by structural weaknesses that are mostly linked to the reliance on controls and intervention. Malta's authorities are fully aware of the existence of such weaknesses which, if not addressed decisively, could undermine the present efforts toward sustainable economic growth and external balance. The staff mission has made an excellent analysis of these aspects, and I wish to express the appreciation

1/ See EBS/90/105, Sup. 1, 6/22/90.

of the authorities, who, indeed, share the basic thrust of this analysis. Although the staff report shows some concern for the slowness of the liberalization process, the authorities consider the Government's achievement in this respect over the last three years to have been substantial. Moreover, the overall performance of the economy is generally favorable, so that no major drawbacks should be attributed to the gradual approach followed by the authorities in their efforts to move toward a more market-oriented economy. I will therefore present the authorities' points of view on the most relevant issues raised in the staff report, namely, the labor market, and the monetary, fiscal, and exchange rate policies.

The staff report stresses the importance of achieving more flexibility in the labor market. It is important to emphasize in this regard that the Government in 1987 removed the wage freeze--in existence since 1982--and encouraged wage determination through collective bargaining. The Maltese Government maintains the opinion that a consensus on a national income policy is of the greatest importance in the present situation. The task of formulating a national policy regarding wage determination in the private sector was entrusted a few months ago to the National Council for Economic Development, which includes representatives of the three social partners: the Government, trade unions, and employers. In addition, as stressed in the staff report, concrete steps have been taken to induce, through financial incentives, public enterprise employees to join the increasingly active private sector of the economy. With a view toward easing labor market rigidities, the Government has recently instituted an Employment and Training Corporation.

With reference to the monetary sector, the staff report strongly urges the acceleration of efforts to move toward a market-oriented interest rate structure and greater competition in the financial sector. The Maltese monetary authorities are fully committed to these goals. The emphasis, however, is currently on a further strengthening of bank capital and on institutional restructuring before proceeding with the liberalization of interest rates. One of the commercial banks has just increased its capital, offering 28 percent of the issued shares to the public. The other bank will follow suit in the near future. The two long-term institutions are about to be thoroughly restructured. The setting up of a stock exchange is also imminent. In order to create the environment in which monetary policy can be implemented through market-oriented tools, statutory reserve requirements are to be introduced in the latter part of 1990. Moreover, a stronger monetary strategy with regard to the issue of Government securities that should induce a higher participation rate from the nonbank public is in place. Once the new institutional setup is implemented, a more active monetary policy can be put into action.

The deterioration of public finances in recent years has been a major source of concern. In addressing this issue, however, several factors should first be emphasized. The increase in the public deficit in recent years has been mainly the result of a number of special factors which are not likely to occur again, such as the absolutely necessary infrastructural program currently under way. In addition, subsidies were made more explicit, and therefore incorporated in the Government's budgetary expenditure, as, for example, the assistance package to the Malta Drydocks awarded in May 1989. The surge of imbalances is also partly due to a backlog of payments arising from measures introduced in earlier years, such as the export stabilization scheme. Efforts to increase sectoral efficiency resulted, in some cases, in lower revenues for the Government. In particular, public enterprises and government-owned companies, especially banks, have increasingly been run according to market-oriented criteria. Consequently, profits have been retained to consolidate their capital bases, instead of being transferred to the Government. Taking all these factors into account, the increase in the fiscal deficit should be regarded as a temporary phenomenon, linked with the delicate phase of the economy's transition.

The authorities are aware, however, that they should improve the fiscal position in order to maintain low inflation and the present comfortable external position. To this end, the Government is actively considering steps to remedy, over the medium term, the present weaknesses of the fiscal position.

The envisaged broad reforms of the tax system should strongly enhance revenues in the near future. Revenue from indirect taxation will be boosted by an expenditure levy on goods and services. The legislation governing this levy was passed by the Maltese Parliament recently, and will come into force in the very near future. The intention of the authorities is to move to a more broad-based tax. In this respect, the Fund is providing technical assistance with a view toward implementing the second stage of the tax reform, particularly with the introduction of the value-added tax.

The fiscal position should also improve over the coming years, mainly because of the eventual commissioning of various major infrastructural projects, which would lead to a tapering-off of capital outlays and the generation of additional revenue; the expected sharp increase in receipts from social security contributions in the wake of an extensive campaign to collect outstanding arrears, and to bring into the contribution net previous defaulters; a reorganization and rationalization of the public service sector, which should contribute to increased efficiency and lower wastage--a process which must necessarily be lengthy; and the recently concluded financial protocols with Italy and the European Community for the coming years, which should also relieve the pressure on essential project financing.

With regard to competitiveness and the use of the exchange rate instrument as a means to improve the trade balance, two considerations are worth raising. First, following the introduction of the price freeze in early 1983, the real effective exchange rate has steadily depreciated, suggesting an improvement of Malta's export competitiveness over this period, despite its inherent weakness. Second, as the staff papers point out, exports rose fairly well in 1989, but the increase was concentrated in a very small number of firms, while, for some commodities, losses in market shares were registered. Such indications, however, do not necessarily imply a loss in competitiveness, but may reflect the inability of Maltese industry to keep up with the expansion of world demand for certain products. In this case, the policies pursued by the Maltese authorities, aimed at providing investment incentives in the manufacturing sector and implementing the necessary infrastructural projects, should prove more successful in the medium term with respect to an exchange rate devaluation. In this regard, the Maltese monetary authorities feel that an exchange rate adjustment at this stage could prove to be generally undesirable, rather than conducive to economic growth, in view of the present supply-side constraints on output growth, the very high import content of domestic production and consumption, and the likely reaction of trade unions to devaluations. Nevertheless, the Maltese authorities are undertaking a study on the appropriateness of the current level of the exchange rate. Future action would depend on the conclusion of this research.

The favorable performance of tourism naturally plays a fundamental role in economic activity, and is essential for the balance of payments. Although British tourists have continued to benefit from an exchange rate subsidy implicit in the so-called "forward buying rate," the authorities are committed to phasing out such guaranteed exchange rates over the medium term. In fact, they believe that in order to avoid disruptive effects on foreign exchange earnings and employment, given the high percentage of British tourists, the phasing out of the scheme should be gradual. In accordance with this policy, and as a clear sign of the Government's commitment to the phasing out of the scheme, the new rates guaranteed for the forthcoming summer and winter have been raised. In this respect, I would like to request a modification to the proposed decision. The last sentence of paragraph 2 of the decision should read: "The Fund notes the authorities' intention of phasing out the exchange rate guarantee scheme and urges Malta to terminate its other exchange restrictions as soon as possible."

Finally, the authorities' commitment to a more open external sector can be distinctly seen in their removal of most quantitative import restrictions at the end of 1989. The Maltese authorities have introduced tariffs to replace the quotas that had been abolished, and, although at present the level of some tariffs is high, the authorities intend to gradually reduce them, in line with their goal of eventually entering the European Common Market. In 1989 the export stabilization scheme was also removed.

Mr. Enoch made the following statement:

The Maltese economy has performed well overall over the last two years. Growth has been rapid and the external position has remained strong. Some important structural initiatives have been taken, including trade liberalization and tax reforms. These are well described in the staff papers and by Mr. Filosa.

Nevertheless, there are important questions about the sequencing of the policy reforms the authorities have undertaken, and hence about the sustainability of the recent rates of growth. At the heart of these questions are the authorities' massive infrastructure investment programs. In the longer term, development may well depend on such investment, but it is far from clear that it will be productive unless accompanied by other major policy reforms.

First, current public expenditure must be brought under control. As the staff warns, it becomes increasingly difficult to rein in a fiscal imbalance. The upward trend of the public sector wage bill, and the spiraling costs of the social security benefits, do not bode well for the fiscal position in the longer term. This is especially important if tax changes are likely to result in a loss in revenue ahead of tax base broadening.

Second, the labor market must be made more flexible. The Government's dominant role as an employer gives it a particularly direct influence. Overmanning in the public sector adds to the tightness of the labor market, just as headroom is required to allow the private sector to take advantage of infrastructure development. And, in an economy in which international competitiveness is essential, government pay policy sets an important standard. The reported emergence of some form of consensus on the need to reconsider wage determination provides an opportunity to tackle this central problem.

The tightness of the labor market in Malta in part reflects the low female participation rate, which is only about half the European average. The Appendix to the background paper on recent economic developments notes that income tax reforms will affect the way in which married women are assessed for taxes. I would be interested if the staff could indicate whether it expects that this may increase the female participation rate.

Third, the financial sector requires attention, in particular to avoid further monetary financing of the fiscal deficit. Last year's mission from the Central Banking Department identified what was required. I will only add some points of emphasis. First, the recommended shift to a market system should have come before the pressure for deficit finance. Second, although the growth of broad money and the behavior of velocity do not suggest any inflationary pressure now, the situation can change very rapidly. The discussion in the background paper on recent economic developments of Malta's recent monetary history demonstrates this clearly. Finally, I endorse the staff's view that it is probably not realistic to look for a thriving offshore sector unless the domestic sector is equally strong.

My last area of particular concern is competitiveness and the exchange rate. The basis for a competitive economy is a sound domestic policy stance. Malta has lost competitiveness, and a more balanced policy stance now would help limit further losses. But I support the staff in urging the authorities not to rule out a one-off adjustment against losses already incurred. I also support the staff in its arguments against discriminatory exchange rate subsidies, which are in themselves indicative of the competitiveness problem.

In this context, I welcome the assurances given by Mr. Filosa that the authorities intend to phase out this subsidy, and I can support his proposed amendment to the draft decision, as well as the decision itself.

The measurement of competitiveness is clouded by the inadequacies of the consumer price index, which needs to be drastically overhauled. I urge the authorities to implement the recommendations of last year's technical assistance mission on statistics; could the staff confirm that this extends to the GDP deflator, which is still using 1973 as a base?

Mr. Othman stated that the staff report and Mr. Filosa's statement showed that Malta's economic performance had been good in many respects since the previous Article IV consultation. Many of the main economic indicators, such as GDP growth, the unemployment rate, fixed investment, and the external current account, reflected clearly that good performance, for which the authorities should be commended. However, those favorable developments had been accompanied by some serious imbalances and continued structural weaknesses.

A major imbalance was the fiscal deficit, which, despite the temporary improvement in 1988, had risen to 6 percent of GDP in 1989, and was budgeted to rise to some 9 percent of GDP in 1990, Mr. Othman continued. While it was true that part of that increase reflected the long-needed financing of infrastructural projects, it appeared that current expenditures had also been growing rapidly during the previous two years. It would be important therefore that the fiscal adjustment efforts be focused on containing current expenditures. On the revenue side, it was important that the downward trend of the tax revenue to GDP ratio experienced during the 1980s be reversed. The authorities' request for further technical assistance from the Fund in order to accelerate progress in that area was welcome. In that connection, he had noted the call of the previous mission from the Fund's Fiscal Affairs Department on the urgent need for tax reform, and would encourage the authorities to move forward in the implementation of the recommendations of the previous mission.

Another question was the financing of investment through borrowing rather than current taxation, Mr. Othman remarked. While it might be justified sometimes to finance public investment with borrowing, provided that the rate of return on that investment was high enough to cover the cost, such a policy should be applied cautiously in light of the uncertainties associated with such investment, and the impact of such borrowing on future levels of taxation. The financing of the increasing noncontributory benefits also needed to be addressed, in order to avoid putting further pressure on the budget.

With respect to monetary policy, he was encouraged to note that the authorities were considering ways and means to implement the recommendations of the mission from the Fund's Central Banking Department, in order to introduce greater competition in the financial system, Mr. Othman concluded. The early implementation of those recommendations, as the staff had indicated, would help raise the nonmonetary financing of the deficit, thus avoiding inflationary pressures associated with monetary financing. In that regard, the special characteristics of the Maltese economy--such as its small size, openness and location, and the consequences of those factors for the conduct of economic policy--caused him to wonder whether the present rate of interest could be maintained in light of the recent developments in world financial markets, and the decision of the authorities to develop Malta as an offshore financial center. He could support the proposed decision.

Mr. Scheid stated that he endorsed the staff appraisal, and especially its concern about the rising fiscal deficit. In the absence of other effective means of demand control there was indeed a clear risk that the projected tripling of the deficit in terms of GDP over a period of just three years would undermine domestic and external financial stability.

There were already worrisome signs of increasing cost and price pressures, as reflected in the previous year's performance of the wage indicators and the GDP deflator, Mr. Scheid continued. Those pressures were bound to erode further Malta's external competitive position, which had been analyzed and described in an exemplary way in the staff report. That analysis had indicated the desirability of improving external competitiveness, and he would agree that exchange rate action to that end should not be ruled out. However, given present policies, he was concerned that a devaluation would be of little help, if not counterproductive; it might merely exacerbate domestic price and wage pressures, thereby frustrating the very objectives sought by the devaluation.

It therefore appeared that domestic demand restraint would be crucial to the restoration and maintenance of an overall satisfactory economic performance, Mr. Scheid concluded. Accordingly, he would urge the authorities to reconsider their fiscal policy stance without delay, and he would endorse the staff's recommendations concerning structural reforms with a view to strengthening monetary control, domestic resource mobilization, and economic efficiency.

Mr. Newman made the following statement:

> Malta has achieved impressive economic gains since its shift to a more liberal market-oriented policy in 1987. The economy has experienced good growth, low inflation, and a strong external position. This favorable situation provides an opportunity to deal with some of the more deep-seated and politically difficult structural problems confronting the economy.
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> The substantial rise in the fiscal deficit highlights the need to reduce the role of government in the economy if the new policy orientation is to succeed over the medium term. The authorities' desire to increase public infrastructure investment is understandable, but offsetting cuts in current spending are needed to contain the budget deficit. This will require the authorities to come to grips with excessive public employment, which still accounts for more than one third of the total labor force, and a wage bill that is absorbing an increasing share of total spending. With the private sector now expanding, the opportunity exists to reduce public employment and wage costs. We hope that the National Council for Economic Development will present specific proposals in the near future. Similarly, the recent welcome reform in the income tax system, including major reductions in marginal rates, should provide leeway to increase social security contributions to compensate for the more generous benefits that are now being provided.

The growing fiscal deficit also reinforces the need for a more flexible monetary policy as a demand management tool. Use of artificially low interest rates to encourage investment can lead to a serious misallocation of resources, by encouraging both overbuilding and a reliance on controls to prevent capital outflows. The recommendations of the recent staff mission are sound, and should be implemented promptly. It is, therefore, disappointing that the authorities continue to delay, and appear to be going in the opposite direction, by providing additional capital to the commercial banks, rather than increasing competition in the financial sector.

Malta's external position remains comfortable, although the competitive position of the economy is open to question. The recent generous wage increases and the centralized system for setting wages have left the economy vulnerable to external price shocks. The frequent tinkering with the currency basket reflects the lack of real wage flexibility in the economy, and the danger that imported price rises will trigger broad inflationary wage pressures. Moreover, the large and growing exchange rate subsidy to the tourist industry in recent years also suggests that Malta's competitive position in this vital sector has deteriorated. We see little reason why a developing country such as Malta should provide income supplements to the relatively well-off British middle class, and we welcome Mr. Filosa's statement that this subsidy will be phased out. This should be completed by a more transparent exchange rate policy, combined with more restrained macroeconomic policies and greater real wage flexibility as a means of maintaining Malta's competitive position.

Since the last Article IV consultation, Malta has implemented significant tax and trade reforms which will strengthen the economy over the medium term. However, the level of trade protection remains excessive. We support the staff's call for a reduction in the very high levels of tariffs on selected imports. We are concerned, however, that the staff's proposal for an import surcharge to raise revenue goes in the wrong direction, and would urge the authorities to implement promptly other measures to expand the tax base.

Malta has made impressive progress in recent years in reforming the economy, and the benefits are showing up quickly in terms of strong economic performance. However, this is not the time for the authorities to rest on their laurels. The continued reliance on subsidies, excessive import protection, and a growing fiscal deficit point to the need for continued structural reforms to improve the competitiveness of the economy and to build on recent successes.

Mr. Ichikawa made the following statement:

The Maltese economy had long been characterized by structural rigidities and official controls. We therefore welcome the important steps taken toward economic liberalization in recent years, particularly in the area of tax and trade reform. It seems that the real sector of the economy is also responding favorably to the improved situation. In particular, the further reduction in the unemployment rate, due to the strong growth of the private sector, is commendable.

As the staff report rightly points out, macroeconomic imbalances have widened in the public finances, and this is reflected in the higher inflation rate. We also share the staff's concern about the slowness of structural adjustments.

The sustainability of high growth hinges upon progress made in structural adjustment. If Malta is to join the European Community some time in the future, the authorities should seriously address the structural weakness of the economy and lay a sound foundation for sustainable growth, in order to assure the fruits of participation in the Community. In this regard, we are in broad agreement with the staff's appraisal.

We thank Mr. Filosa for his helpful statement, which elaborated the authorities' view. Nonetheless, more decisive initiatives could be taken in some areas, as the rigidities in those areas are clouding the prospects for market-oriented growth.

On fiscal policy, we share the staff's concern over the sharp increase in social welfare costs. While the authorities seem to be addressing the arrears problem, I wonder whether the soundness of the financial structure of the social security system over the medium term is assured. We welcome the recent legislation broadening the indirect tax base as an interim step toward a value-added tax system. Meanwhile, the authorities need to monitor revenue performance in order to attain a sound fiscal balance.

On the monetary front, we are concerned about the recourse to monetary financing of the fiscal deficit. While we note that progress is being made to strengthen the institutional arrangements of the banking sector, this process should be accelerated, as the pressure of the fiscal deficit is imminent, and market-oriented interest rates are essential to ensure efficient resource allocation.

The rigidities in the labor market constitute the most serious structural problem of the Maltese economy. The implications of those rigidities for the economy's competitiveness are particularly large. We understand the political difficulty surrounding the issue, and can endorse the current approach of entrusting private wage determination to the Council, although this is certainly not the final goal. We nevertheless encourage the authorities to continue sending a clear message to the Council that productivity considerations should be emphasized. In this vein, as the staff urges, the authorities should avoid introducing automatic wage indexation, which, on top of the current distorted wage structure, would make it very difficult to implement an appropriate incomes policy.

In the external sector, while we welcome the recent trade liberalization measures, much could be done to reduce the degree of protection. As the high protection is concentrated on consumer goods, the export sector may not benefit directly or immediately from liberalization actions; however, we are certain that liberalization will enhance the overall competitiveness of the economy in the long run, provided appropriate demand control is in effect.

On the proposed amendment to the decision, the lack of a clear timetable for the elimination of the exchange guarantee was the main concern of the staff. While we can basically support the proposed amendment, before committing ourselves to any position, we would like to hear the staff's view on the schedule for phasing out the guaranteed exchange rate, to which Mr. Filosa referred in his statement.

Mr. Schoder made the following statement:

In 1987, the newly elected Government of Malta made the important decision to steer the Maltese economy henceforth on a course of financial and economic deregulation--a decision which long predated similar changes in other parts of Europe. Since then, the problems of making the transition from a centrally planned economy to one with market-oriented structures have come to the fore in both the economic literature and economic policymaking. To succeed in such a transition, Maltese policymakers will need to have every possible advantage on their side. Unfortunately, this does not seem to be the case; recent developments in 1989 and 1990 have cast some doubt on the future course of events. It is now clearly recognized that during the course of an economic liberalization process, fiscal policy must be kept on a prudent path. The expansion of the fiscal deficit which was allowed to take place in Malta could well jeopardize the adjustment, by creating demand pressures and increasing the momentum of inflation. This is especially true in Malta's case, as the fiscal deficit is financed largely by monetary expansion. Of course, it could be argued that Malta's inflationary pressures must still be under control because the recorded levels of inflation do not show any marked shift, but that ignores the fundamental effect of price controls, which are so widespread in Malta that the consumer price index provides only a rough approximation of actual inflationary pressures.

Using relative consumer price developments as a basis for judgments about Malta's competitive position, and especially about the evolution of that position, is therefore very likely to lead to false conclusions. I wonder whether the staff is really sure that the real exchange rate of the Maltese lira depreciated by 2.5 percent in 1989, or if the evolution of the real effective exchange rate that was presented is really consistent with wage and productivity developments in the economy. I also wonder whether the staff has made any estimates of Malta's competitive position based on other criteria, such as relative unit labor price developments, and if they have, whether the results indicated a deterioration of the competitive position. In any event, under the plan to conduct wage settlements heretofore without government intervention, it will be crucial to include a consumer price index reflecting actual price developments if the bargaining process between the social partners is to produce economically sound results.

On the matter of the guaranteed exchange rates--or, as Mr. Newman has put it, the subsidy to the British middle class--I recognize that the staff's judgments reflect commonly accepted Fund doctrine, but we must be cautious about recommending the abolition of this system. Even though it entails costs for the economy, it is an essential factor in generating the substantial external earnings from tourism which practically cover Malta's entire trade deficit--equivalent to some 25 percent of GDP. I therefore side with the authorities' cautious approach, even though I recognize the theoretical validity of the staff's recommendations. The authorities clearly recognize the costs associated with the guaranteed exchange rate system, and they should be encouraged to make these costs more transparent. For these reasons, I agree with Mr. Filosa's amendment to the proposed decision, and with the decision itself, as so amended.

How does the staff assess the feasibility of creating a free, offshore financial sector exempt from the overregulation and constraints of the domestic financial sector? Would not the creation of a free sector normally result in a spilling over of transactions conducted there on a purely commercial basis into the administered domestic financial sector, and is not such spilling over all the more likely, given the authorities' desire to see employment and technology links between the two sectors? If this were so, would the authorities' intention of keeping the offshore sector strictly separate from the domestic branch of the financial sector be counterproductive to their efforts to develop a new source of revenue?

Mr. Noonan stated that the recent performance of Malta's economy had been fairly good, as outlined in both the staff report and in Mr. Filosa's statement. Moreover, significant structural reforms had been undertaken, and the authorities deserved to be commended for the progress they had made in that regard. There was, of course, room for greater progress. He would suggest to the authorities that the present favorable economic climate would facilitate speedier progress than might be practicable at a later stage, and that the balance of advantage would seem to lie with somewhat faster progress at present--particularly with public sector reorganization--than seemed to be contemplated by the authorities.

With respect to the labor market, in a small economy like Malta's, a consensus on incomes policy was of great importance, Mr. Noonan continued. He therefore welcomed the efforts of the National Council for Economic Development to reach agreement on the guidelines for an incomes policy, and also, the apparent recognition by all the social partners--referred to by the staff--of the need to bring productivity considerations, discretionary changes in income tax, and the concept of the social wage into the formulation of that consensus. He wished the Council well in its efforts, and hoped that they would contribute to labor cost competitiveness in a period of change.

The establishment of the Employment and Training Corporation was to be commended, Mr. Noonan commented. It was important to keep in mind that the primary purpose of the Corporation was to be responsive to the needs of its trainees. The authorities should seek to avoid the risk of having a structure geared more to the requirements of professional trainers than to those of trainees.

Mr. Filosa's reference to a stronger monetary strategy which would facilitate the sale of public debt to the nonbank private sector was welcome, particularly in the light of the disclosure by the staff that the rising fiscal deficit was being financed almost entirely by monetary means, Mr. Noonan noted.

With respect to the fiscal position, much depended on the extent to which many of the current expenditures were temporary, as Mr. Filosa had argued, but a question remained as to the degree of that temporariness, and on how worthwhile much of the infrastructural investments were, Mr. Noonan went on. In that context, he would query the high rate of social security payments--at some 16 percent of GDP--when there was relatively full employment. He would also be somewhat skeptical about the prospective outcome of the improved collection of social security contributions referred to by Mr. Filosa. He would also like to hear more from the staff on the evidence that the reduction of top marginal rates of income taxation had been conducive to improving work incentives, and had perhaps turned out to be self-financing. Some of his authorities had used analogous arguments before, and, if he could understate the response of the Fund's Board, those arguments had met with reservations.

He joined with the staff in urging the Maltese authorities to set out a timetable for the elimination of their peculiarly discriminatory exchange rate subsidy for package tour operators from the United Kingdom, Mr. Noonan concluded. Nevertheless, in the light of the other liberalizing actions taken by the authorities, he was willing to accept Mr. Filosa's proposed amendment of the proposed decision.

The staff representative from the European Department stated that the change in the tax laws enabling married women to file income tax statements jointly with their husbands, which had not been possible previously, might have an impact on the female participation rate in the labor force. However, it was difficult to provide an assessment of that impact in quantitative terms.

The present structure of import duties was highly skewed, the staff representative pointed out, with very high duties on consumer goods and many duty exemptions for imports of industrial raw materials. The authorities relied on duties for a significant portion of revenues. The staff had suggested that once the value-added tax was put in place, the level of duties should be reduced to the range of 3-5 percent. A combination of the implementation of a value-added tax and a reduction in duty levels would serve the twin purposes of efficiency and revenue raising.

In the very short term, it might be possible for the Maltese authorities to maintain a dual financial structure in which the domestic financial system remained highly regulated, hand in hand with an offshore financial center that remained basically free of restrictions, especially if domestic interest rates were controlled, the staff representative went on. In the medium to long term, however, such a dualism was of course not feasible, especially given the technological and employment linkages the authorities would wish to create between the two financial centers, and between them and the rest of the economy. The staff had emphasized the importance of the liberalization of the domestic financial sector on its own merits, regardless of the linkages between it and the offshore financial center.

The authorities were moving ahead to correct the statistical inadequacies in the consumer price index with the Fund's technical assistance, the staff representative stated. The authorities were giving priority to that problem. A statistical problem also existed in respect of the GDP deflator as well as the national accounts still used in 1973 as the base year. The staff hoped to be able to report substantial progress in those areas by the time of the following Article IV consultation discussion.

The authorities had stressed repeatedly their intention of phasing out the exchange rate subsidy for tour operators from the United Kingdom, and were convinced that it was not a desirable system in the long term, the staff representative concluded. No timetable for eliminating it had yet been formulated, however, although a period of 3-5 years had been discussed. The staff had no difficulty with Mr. Filosa's proposed amendment to the decision, recognizing that the authorities intended to phase out the scheme. In the interim, in order to make the subsidy more transparent, the staff was suggesting that it be included as an explicit subsidy item in the budget, rather than as an element of the exchange system. The staff understood that the authorities were seriously considering that option.

Mr. Filosa stated that he wished to relate that the Maltese authorities were extremely grateful for the several technical assistance missions from the Fund over the preceding years.

A number of special factors were behind the surge in the fiscal deficit, Mr. Filosa pointed out. The most significant was the fact that the program of structural adjustment had been postponed for a number of years, because of the need to develop the economic infrastructure. Consequently, investments had been made in the energy, electricity, and telecommunication sectors, without which further development would not possible. Many countries--including his own country, Italy--could vouch for the difficulties of controlling investment spending while significant essential infrastructural investments were being made. It was to be hoped that those expenditures would be temporary, and that structural adjustment and fiscal control would be possible in the subsequent period. Revenue-raising measures were another aspect of the authorities' attempts to ameliorate the fiscal deficit as well. The authorities had taken steps to improve tax administration, on the one hand, and to introduce a new tax, the value-added tax, on the other hand.

There were many shortcomings in the Maltese consumer price index, but notwithstanding those it could not be said with any certainty that a devaluation would improve competitiveness, especially at a time when there was a problem with the size of the fiscal deficit, Mr. Filosa went on. Moreover, evidence of a deterioration in Malta's competitiveness, other than of an anecdotal nature, was hard to come by. The paper on the subject of competitiveness that was being undertaken by the Central Bank of Malta promised to be very useful in that regard. It appeared unwise to argue in favor of a devaluation when the main explanation for any deterioration in Malta's competitiveness was on the supply side, stemming from Malta's lack of a productive system to keep up with the quantity and quality of world trade. Perhaps that could be attributed, in turn, to a lack of an appropriate or adequate supply system and a paucity of relevant enterprises, but that reinforced the argument for bolstering Malta's basic infrastructure, and was an apology for the authorities' current structural policy stance. An appropriate infrastructure, it was to be hoped, would provide the needed spur to the further development of the private sector.

The banking system was undergoing some privatization, as an auction had been conducted recently for private sector participation in the capital of some government-owned banks, and the concurrent reduction in the number of shares owned by the Government in the chief banks, Mr. Filosa noted. That process was expected to continue.

The authorities were embarking in a gradual way on a more flexible approach to monetary policy, Mr. Filosa continued. The Government, as he had noted, was reducing its stakes in the chief banks, with the hopes of introducing a more market-oriented system. By the end of 1990 the authorities hoped to reduce the reserve requirement. The Government also intended to finance a greater share of the public deficit through treasury bills. The gradualism of the Government's reforms was a matter of some debate, but, in that connection, perhaps it was advisable not to fix something that was not really broken. That epitomized the authorities' concerns in moving too fast, and also their decision to implement guarantees vis-à-vis incomes policy. As Mr. Enoch had pointed out, monetary velocity did not show any reason to worry at present in that connection, but he agreed that there was no room for complacency. He would convey the staff's concerns about the speed of the reforms to the Maltese authorities.

The staff representative from the European Department, responding to a question from Mr. Fernando, said that under the 24-month consultation cycle which the staff had recommended for Malta, the next Article IV consultation would have to be concluded by June 1992, although the precise dates could not be determined at that juncture.

The Chairman made the following summing up:

> Executive Directors noted that Malta's economic performance in 1989 had been characterized by strong growth of output and employment, relatively moderate inflation, and a small surplus on the external current account. This generally favorable performance was expected to continue into 1990. Directors welcomed the steps taken by the Maltese authorities since the last consultation toward implementing their agenda for economic reform, in particular, the reform of the income tax structure and the shift of the trade regime from one based primarily on quotas to one based on tariffs.
>
> Directors, however, noted that several long-lasting structural weaknesses, such as an overmanned public sector and an overregulated financial sector, remained to be addressed and that these, in turn, raised issues regarding the sequencing of structural reforms. In combination with the imbalances that had emerged in the macroeconomic area, especially in the public finances, these weaknesses could undermine the prospects for increasing the role of the private sector in the economy, and achieving sustainable economic growth in the medium term.

Executive Directors expressed concern at the deterioration in public sector finances in 1989 and at the budget deficit in prospect for 1990. Increased public investment in the infrastructure projects was in part responsible for the rise in the deficit but, to the extent that it was required to support private sector development, Directors urged steps to curb current expenditures, including renewed efforts to reduce overmanning and control wages in the public sector, and rein in social security benefits. Directors also urged action to broaden the tax base by putting in place a broad-based tax on consumption.

Directors also expressed concern about the authorities' reliance on the monetary financing of the rising budget deficit which could not but give rise to inflationary pressure. They urged the acceleration of efforts to move toward a market-determined interest rate structure and greater competition in the financial sector, along the lines of the recommendations made by the technical assistance mission from the Fund's Central Banking Department, to which Mr. Filosa has just referred. They stressed that greater market orientation would also facilitate the sale of public debt to the nonbank private sector. A liberalized domestic financial market also would be a condition for the offshore center to gain in scope.

Directors favored a greater role for collective bargaining in the wage determination process and generally stressed the need for greater flexibility and a reduced government involvement in the labor market. They also cautioned against any move to automatic indexation of wages to the cost of living. In this context, Directors stressed the importance of improving the coverage and measurement of the cost of living index as a precondition for successful collective bargaining.

Directors were of the view that notwithstanding the comfortable external current account and reserve positions, Malta's underlying competitiveness was weak. The loss of market shares experienced over the 1980s was worrisome. Directors felt that in view of the authorities' intention to further liberalize imports, they should not rule out the use of the exchange rate to improve competitiveness, but this will require that supporting policies to restrain demand and to limit the pass-through into wages and promote structural reforms are firmly in place. Directors called for an early termination of the exchange rate subsidy for tour operators from the United Kingdom, which, besides being discriminatory, gave rise to a multiple currency practice, and they noted the intention of the authorities to take steps in that direction.

It is expected that the next Article IV consultation with Malta will be held on the 24-month cycle.

The Executive Directors took the following decision:

1. The Fund takes this decision relating to Malta's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1990 Article XIV consultation with Malta, in the light of the 1990 Article IV consultation with Malta, conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions as described in SM/90/81 (5/2/90) and SM/90/86 (5/15/90) are maintained by Malta in accordance with Article XIV, Section 2, except that the restrictions on exchange allowances for foreign travel and the restrictions evidenced by a bilateral payments arrangement with a Fund member are subject to approval under Article VIII, Section 2(a), and the exchange rate guarantee for tour operators from a member country is subject to approval under Article VIII, Section 3. The Fund notes the authorities' intention of phasing out the discriminatory exchange rate guarantee scheme, and urges Malta to terminate the exchange rate guarantee and its exchange restrictions as soon as possible.

Decision No. 9469-(90/97), adopted
June 20, 1990

4. GUYANA - SETTLEMENT OF OVERDUE FINANCIAL OBLIGATIONS TO THE FUND

The Chairman informed the Executive Directors that the Fund had received on that morning a payment of SDR 107.1 million from Guyana in full settlement of its overdue financial obligations to the Fund. (see also EBS/90/118, 6/20/90).

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/96 (6/18/90) and EBM/90/97 (6/20/90).

5. PANAMA - SETTLEMENT OF OVERDUE FINANCIAL OBLIGATIONS IN SDR DEPARTMENT AND TERMINATION OF SUSPENSION OF RIGHT TO USE SDRs

The Fund decides that the suspension of the right of Panama to use its SDRs, as provided in Executive Board Decision No. 9205 (89/85) G/S, adopted June 30, 1989, as amended, is terminated with effect on May 23, 1990.

Decision No. 9470-(90/97) G/S, adopted
June 18, 1990

6. ADMINISTRATIVE BUDGET, FY 1990 - ADDITIONAL APPROPRIATIONS AND TRANSFER OF APPROPRIATIONS

The Executive Board approves the proposals set forth in the memorandum attached to EBAP/90/154 (6/12/90).

Adopted June 19, 1990

7. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/90/157 (6/15/90) and by an Assistant to Executive Director as set forth in EBAP/90/158 (6/15/90) is approved.

APPROVED: April 30, 1991

LEO VAN HOUTVEN
Secretary