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To: Members of the Executive Board

From: The Acting Secretary

Subject: Draft Report of the Executive Board to the Interim Committee of the Board of Governors on Overdue Financial Obligations to the Fund

Attached for consideration by the Executive Directors is a draft report of the Executive Board to the Interim Committee of the Board of Governors on overdue financial obligations to the Fund, which is scheduled for discussion on Tuesday, August 30, 1988.

Mr. Blalock (ext. 8341) or Mr. Kincaid (ext. 7356) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Report of the Executive Board to the Interim Committee of the Board of Governors on Overdue Financial Obligations to the Fund

August 10, 1988

I. Introduction

The communiqué of the Interim Committee issued after its meeting on April 14-15, 1988 stated that:

> In its discussion of conditionality, the Committee reaffirmed the cooperative nature of the Fund and stressed the importance of preserving the revolving character of its resources. Members should continue to give the highest priority to fulfilling their financial and other obligations to the institution. Failure to honor these obligations had adverse effects on overdue members' financial standing and imposed an undue burden on other members. The Committee requested the Executive Board to review the question of the overdue financial obligations and to submit a report at the next meeting of the Committee on measures to reduce and eventually eliminate arrears.

The problem of protracted overdue obligations to the Fund, while remaining confined to a relatively few members, poses serious costs and risks not only for the individual members concerned but for the membership at large and for the Fund itself. Steps that have been required to protect the Fund's financial position in the face of rising arrears do not themselves resolve the problem. While supporting the Fund's income position and strengthening its precautionary balances, they have imposed substantial direct costs on members, debtors and creditors alike, that meet their obligations to the institution, and the scope for further protective action under existing provisions and arrangements is limited. If not satisfactorily resolved, the problem of overdue obligations to the Fund threatens to undermine the Fund's liquidity, the revolving nature of its resources, and its financial integrity; the credibility of the economic programs supported by the Fund; and the willingness of members to support the Fund through increases in its resources. It thus poses a threat to the Fund's continued ability to assist members and to perform its broader responsibilities in the international economic and financial system.

The Executive Board has reviewed the situation and the policies and practices adopted since the emergence of serious problems of overdue obligations in 1983-84. Executive Directors are unanimously of the view that there is an urgent need for new initiatives to solve the problem of arrears and to prevent its reemergence. This report proposes for the Committee's consideration and guidance a framework for a revitalized and strengthened approach to resolving the problem of arrears, consisting of three broad elements:

(i) strengthened action of a preventive nature, to safeguard the future use of Fund resources and prevent the problem from spreading or reemerging;

(ii) a cooperative international initiative to help those countries now facing problems of protracted arrears to the Fund to clear those arrears, provided they, themselves, will demonstrate concretely their own active collaboration, including implementation of strong economic adjustment programs; and

(iii) renewed demonstration of the Fund membership's determination to deal resolutely with members that would not be prepared to collaborate in maintaining or normalizing their financial relations with the institution.

While the Executive Board has not reached full agreement on all detailed aspects of the framework outlined below, most Executive Directors emphasized that it should be viewed in light of the following general principles. First, given the pervasive effects of arrears on the Fund and its membership and the deep difficulties facing many of those now with protracted arrears, Executive Directors are of the view that a positive resolution of the problem must be collaborative in nature, involving not only the member concerned but also the Fund, its membership and the international community in general. Second, Executive Directors have stressed the unique position of the Fund as an international cooperative institution, its role in the international monetary system, the revolving nature of its resources, and the consequent need for all members, in practice, to treat the Fund as a preferred creditor. Accordingly, members should accord the highest priority to the settlement of their obligations to the Fund, and, in the view of most Directors, the Fund must avoid opening the way to rescheduling of repurchases or payment of charges in local currency. Finally, Executive Directors have emphasized that the approach outlined below is to be regarded as a broad strategy and framework for action. The situations and positions of individual countries vary markedly. The strategy may not be applicable to all countries facing protracted arrears, and it is to be expected that the detailed elements of the approach to be taken with respect to each will be determined individually, on a case-by-case basis.

II. A Framework to Reduce and Eliminate Overdue Obligations to the Fund

1. Preventive action

In the 1970s, most of the members now facing protracted arrears to the Fund relied heavily on foreign assistance or other capital inflows, including from private sources, to finance their sizable external current account imbalances. By the early 1980s, the economic and external payments positions of these countries had weakened markedly, reflecting both adverse external developments and inadequate economic policies. At the same time, serious debt servicing difficulties emerged and capital inflows, especially from private sources, declined sharply. As corrective policies were not adequate and the international economic environment worsened further, these members found it increasingly difficult to meet their debt service obligations, including those to the Fund.

In part in light of these developments, and with growing experience in assembling financing packages to support adjustment programs, the Fund has increasingly paid attention to securing adequate assurances that programs are fully financed from the outset and has sought a more appropriate balance between resources provided by the Fund and other sources of financing. The use of medium-term scenarios has become more extensive and refined with the aim of ensuring medium-term viability, an adequate level of international reserves to cushion against exogenous shocks, and the capacity to repay the Fund according to schedule. Explicit assessments of capacity to repay the Fund have become a feature of staff papers on requests for use of Fund resources. Exceptional access levels and front-loading of disbursements are less prevalent now than in earlier years. Increasing attention has been given to the experience gained with the implementation of Fund programs and to improvements in program design. Structural aspects of member's adjustment problems and the need for growth-oriented policies have received increased emphasis. For the Fund's low-income members, the Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF) permit the use of resources on highly concessional terms particularly suited to their needs. The changes in the financial terms of the EFF should also provide an incentive to members to enter into medium-term arrangements for structural reform. The establishment of the Compensatory and Contingency Financing Facility will better enable the Fund to assist members in responding quickly to unanticipated exogenous shocks within the framework of a Fund-supported program.

Executive Directors stressed the importance of preventive measures, which are a matter of continuing concern and policy adaptation, in avoiding the emergence of overdue obligations to the Fund. They have requested the management and staff to give particular attention to strengthening preventive actions in developing and presenting proposals for the use of Fund resources, including the establishment of arrangements, on a case-by-case basis, to help ensure that members have on hand sufficient SDRs or other readily available resources to meet forthcoming obligations to the Fund as they fall due. Such arrangements would not change the member's foreign exchange inflows or requirements under the arrangement but would represent a form of strengthened reserve management, intended to improve the prospects for timely payment to the Fund and help safeguard against possible interruption of the member's program.

2. Intensified collaboration

The actions described in the preceding section are intended in part to reduce significantly the risk of new overdue obligations emerging, as well as to strengthen more generally the Fund's ability to assist its members. In examining solutions to existing problems of large protracted arrears to the Fund, the Executive Board has recognized that some of the present cases of protracted arrears will require special attention and exceptional efforts by the international community. The Executive Board has reached a broad consensus on a framework for organizing an intensified collaborative effort of the international financial community to reduce and eliminate overdue obligations to the Fund and to enhance the ability of the members concerned to service regularly all of their external obligations. Such an approach could pave the way for a restoration of orderly relations with all creditors and donors, renewed financial flows, and a resumption of sustained economic growth.

The framework as described below would be implemented on a case-by-case basis with adaptations appropriate to the individual circumstances, and would not be expected to apply generally or simultaneously to all members having protracted arrears to the Fund. The principal determinants in each individual case would be the willingness of the member to embark on, and sustain, the required growth-oriented adjustment policies, and the preparedness of donors and creditors, including multilateral institutions, to provide supporting financing on appropriate terms. This framework would consist of an integrated approach with three key elements. These elements are envisaged as distinct, but possibly overlapping phases, with the first being implemented while the other elements are put into place.

The first element is the adoption and forceful implementation of a medium-term program of strong comprehensive economic reforms by the member with overdue obligations to the Fund. Frequently, the member's poor record of implementation of economic policies would seem to necessitate the establishment of a new track record in order to overcome doubts about the ability of the member to overcome its payments difficulties.

The member's economic program would be negotiated with the Fund, but would not involve access to Fund resources pending clearance of arrears to the Fund--effectively a "shadow" program--and would be submitted to the Executive Board for its endorsement that the member's program met the Fund's conditionality standards. Initial external financial assistance would in most instances be needed to meet the minimum foreign exchange requirements for such "shadow" programs. The member would be expected to resume payments to the Fund to meet financial obligations to the Fund as they fall due during the program. The program, which would be part of a medium-term strategy aimed at achieving sustained growth and external viability, would be developed in close collaboration with the World Bank. In helping to design programs for individual members and as background for the Executive Board and for potential donors and creditors, the Fund staff would provide an analysis of the factors that had led to the emergence of overdue obligations to the Fund and of the member's prospective debt-servicing capacity.

The second element of this approach, framed in the context of continuing implementation by the member of a strong adjustment effort, would center on a restructuring as necessary of the member's external debt, mobilization of resources for the clearance of overdue obligations to the Fund, and the organization of other financing needed to support the continuing adjustment effort.

The third element would comprise restoration of normal relations between the member and the Fund in the context of the Executive Board's approval of an arrangement involving use of Fund resources in support of the member's medium-term growth-oriented adjustment program. Many Executive Directors have noted that very large external financing requirements would be associated with resolution of some cases and have stressed the need for an appropriate financing role for the Fund following clearance of the arrears. In particular, a number of Executive Directors expressed interest in the proposal of the U.K. Chancellor of the Exchequer that retroactive (or front-loaded) access under the ESAF be considered for low-income countries, once they have established a successful record of policy implementation under a "shadow" program and have become current with the Fund. In some circumstances where a "shadow" program has yielded satisfactory performance and convincing assurances on the future stance of economic policies, some front-loading of purchases or disbursements under Fund arrangements may be justified. Directors will give further consideration to this matter in the near future. Use of any Fund resources would need to be consistent with the Fund's policies and practices regarding their use, including the applicable access limits and the need for satisfactory assurances regarding the overall availability of financing and the member's capacity to repay. In this connection, Executive Directors have reaffirmed that ESAF resources are to be used in support of strong programs of structural reform, and that the use of ESAF resources is not to shift the burden of overdue obligations from the Fund's General Resources Account.

Moreover, the magnitude of financial resources and the degree of cooperation and coordination that will be required for this strategy to succeed in some cases is beyond the customary experience of the various parties involved, including, in many instances, agencies and institutions which have not in the past had occasion to work in close collaboration with the Fund. For these reasons, the Executive Board is of the view that, for such a collaborative strategy to succeed, it will be important for the Fund to take the initiative to promote the establishment of support groups of major donor and creditor countries for members with substantial arrears to the Fund that are prepared to cooperate in this strategy and willing to implement fundamental economic and financial reforms.

Such support groups, comprising high-level governmental representatives, would have a crucial coordinating role with respect to financing. Members of the support groups would need to have sufficient stature and authority to recommend to participating governments the provision of financing, including as appropriate means of helping to alleviate the debt burden of the members concerned, for the phases of the strategy outlined above. They would also be in a position to provide assurances to national authorities not only that they were participating in a collaborative international effort but also that the adjustment programs they were being asked to support were commensurate to the requirements.

A number of Executive Directors have indicated that their authorities would be prepared, under appropriate conditions and safeguards, to participate in the formation of support groups for individual countries. While typically it might be anticipated that a support group would be chaired by the creditor or creditors with the strongest associations with the member in arrears, the features of such groups will need to be determined case by case, in keeping with the member's international economic and financial relations, including the history of its relations with the international financial institutions, donors, and creditors.

The Fund itself would of course play a central role in all aspects of the approach. The management and staff would have an active part in the process of collaboration and coordination, maintaining contacts with the support group, in particular as regards the process of matching a program's financing requirements with available resources, and reporting to the support group on progress under the program. The Executive Board would be involved directly from the outset, in considering "shadow programs" and subsequent Fund arrangements, assessing financing needs, reviewing developments under Fund-endorsed programs, and more broadly in evaluating the overall implementation of the collaborative approach.

3. Remedial action

In considering the elements of a comprehensive initiative to deal with the problem of arrears to the Fund, a number of Executive Directors expressed the view that the most effective deterrent against such arrears is the prospect for a member of increased financial isolation and the experience of prolonged economic deterioration. Nonetheless, most Executive Directors considered that, as part of a strategy offering collaborative solutions, the range of remedial measures to be taken or to be considered should be widened in order to demonstrate clearly the membership's determination to deal firmly with members that would not be prepared to cooperate actively in maintaining or normalizing their relations with the Fund.

In this connection, a number of Executive Directors have expressed interest in the possibility of establishing objective criteria that might be helpful in distinguishing between members that would seem to be in a position to meet their obligations to the Fund but are unwilling to do so, and those that are willing to pay but unable to do so. The Executive Board is mindful that there are inherent difficulties in making such distinctions and risks that they could lead to differing treatment of members facing essentially similar circumstances. At the same time, many Executive Directors considered that further analysis of such criteria or indicators, including a number suggested by individual Directors, could be of assistance to the Executive Board in assessing the relative performance of members in arrears to the Fund and could, indeed, complement more broadly the continuing effort to extend and strengthen the Fund's analyses of capacity to repay in connection with use of Fund resources. The Executive Board will accordingly return to this matter in the near future.

The Executive Board has discussed the following possibilities for extending the range of remedial actions.

a. Executive Directors have agreed in principle that a member must first discharge its overdue obligations to the General Resources Account before it would be permitted to pay for an increase in its quota in connection with the Ninth General Review; and that, in the event the quota payment were not made within a prescribed period, the proposal for an increase in quota would lapse. Specific provisions to implement this approach will be incorporated into decisions to be taken in connection with the Ninth General Review of Quotas.

b. Executive Directors are also generally agreed that, in the absence of clear willingness on the part of a member to cooperate with the Fund in the resolution of its problems, withdrawal of technical assistance would be considered on a case-by-case basis, paying due regard to the need to maintain a dialogue with these members. A number of Executive Directors noted that the Fund's technical assistance is a scarce resource in heavy demand and that the continued provision of such assistance in such cases, particularly where not directly related to settlement of obligations to the Fund, would inappropriately deprive other members that meet their obligations to the Fund in full.

c. Executive Directors agreed generally that the Fund's policies regarding the provision of information on individual members in arrears, in the context of the Annual Report and the Fund's financial statements, should be extended to some extent. While some Directors considered that increased use of press releases would be appropriate in some cases, in particular following reviews of ineligible members and where it is concluded that the member is not cooperating actively, others felt that such increased publicity may be counterproductive.

d. A number of Executive Directors considered that, in certain cases, it would be appropriate for the Fund to inform other multilateral institutions and bilateral official creditors of a member's arrears to the Fund. There was less support for adding to such notifications a request that the institutions take the situation into account in their own relations with the member concerned. Most Executive Directors did not favor addressing notifications to private creditors.

e. Executive Directors' views on the efficacy of imposing penalty charges on overdue repurchases continue to differ. Among those Directors favoring such charges, some were attracted by the possibility of holding their application in abeyance if a member was judged to be collaborating actively with the Fund to reduce its arrears. The Executive Board intends to give further consideration to the matter of penalty charges on the basis of a paper outlining different forms of such charges.

f. Executive Directors are generally agreed that the step of compulsory withdrawal should be examined only in individual cases and only in the event that all other avenues had been exhausted. Some Directors have asked that possible forms of suspension of membership be examined further. Although it appears that the possibilities in this area are quite limited in the absence of an amendment to the Articles of Agreement, the matter will be given further consideration.

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While the suggestion differs in nature from the general approach described above, the Executive Board also heard a proposal by an Executive Director to the effect that the Fund "write off" overdue repurchases, while retaining the corresponding legal claims on the countries in arrears, and place equivalent amounts to the Fund's precautionary balances. These placements would be financed by adjustments to the rate of remuneration, while a ceiling would be set on the rate of charge. The Executive Board did not have an opportunity to consider this proposal in detail and has agreed to discuss it in the context of the review of the burden-sharing decision and the midyear review of the Fund's income position. In agreeing to discuss it further, however, a number of Executive Directors expressed immediate reservations regarding the very limited scope that exists for further adjustments to the rate of remuneration in the absence of an amendment to the Articles of Agreement, particularly in light of the need to cover deferred charges; the effects such action might have on debtors' attitudes toward the obligations in question; and the efficacy of such an approach in securing elimination of the overdue obligations, which is the object of the present initiative.

III. Conclusion

As noted at the beginning of this report, the Interim Committee requested the Executive Board to review the question of overdue financial obligations to the Fund and to submit a report at the next meeting of the Committee on measures to reduce and eventually eliminate arrears. The Executive Board believes that a comprehensive initiative to secure such reduction and elimination is needed urgently, and this report has outlined a strategy consisting of strengthened preventive actions, collaborative international efforts to secure settlement and regularize members' relations with the Fund, and extended remedial action by the Fund.

In supporting the thrust and broad outlines of the approach proposed, a number of Executive Directors have noted the exceptional efforts that will be required, not only of the countries in arrears but of the international community in general. The need to organize and obtain substantial financing in support of members' efforts to fundamentally reform their economies and regularize their relations with the Fund will in many cases necessarily involve institutions such as aid agencies that have their own lending priorities. The Fund, nevertheless, is confident that if the collaborative strategy is well understood, the necessary support will be granted. Indeed, by supporting this strategy, these institutions will contribute to restoring conditions in which their own operations in these countries can be most effective. Similarly, the suggested application of preventive and remedial actions will require firmness and determination on the part of the Fund's membership. For both reasons, the Executive Board emphasizes the need for governmental commitment to the approach to be adopted and requests the Interim Committee's guidance and endorsement.