

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/19

4:15 p.m., February 10, 1988

R. D. Erb, Acting Chairman

Executive Directors

Dai Q.

A. Donoso
M. Finaish

A. Kafka

Mawakani Samba
Y. A. Nimatallah
G. Ortiz

G. A. Posthumus

G. Salehkhoul

K. Yamazaki

Alternate Executive Directors

E. T. El Kogali
C. Enoch
R. Comotto, Temporary

E. L. Walker, Temporary
J. Prader
G. Seyler, Temporary

I. Zaidi, Temporary
G. Goos
R. Wenzel, Temporary
J. Reddy
J. Hospedales
G. D. Hodgson, Temporary

I. A. Al-Assaf

M. Fogelholm
D. Marcel
G. Pineau, Temporary
G. P. J. Hogeweg
C.-Y. Lim
I. Sliper, Temporary
O. Kabbaj
L. E. N. Fernando
A. Vasudevan, Temporary
S. Yoshikuni
S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant

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Also Present

African Department: D. J. Scheuer. Asian Department: H. Neiss, Deputy Director; U. Baumgartner, M. J. Fetherston, M. Ishihara, S. Ishii, D. J. Ordoobadi, G. Szapary. Exchange and Trade Relations Department: S. J. Anjaria. External Relations Department: H. P. Puentes. Legal Department: P. L. Francotte, A. O. Liuksila. Middle Eastern Department: D. B. Noursi. Treasurer's Department: D. Williams, Deputy Treasurer; D. Berthet, J. E. Blalock, P. J. Bradley, D. V. Pritchett, P. S. Ross. Bureau of Statistics: T. T. Luu. Office of the Managing Director: C. P. McCoy. Advisors to Executive Directors: A. G. A. Faria, S. M. Hassan, P. D. Péroz, J. E. Zeas. Assistants to Executive Directors: N. Adachi, A. A. Badi, F. Di Mauro, V. J. Fernández, B. Fuleihan, S. Guribye, M. A. Hammoudi, M. Hepp, G. K. Hodges, L. Hubloue, K. Kpetigo, M. A. Kyhlberg, V. K. Malhotra, J. A. K. Munthali.

1. OVERDUE FINANCIAL OBLIGATIONS - SIX-MONTHLY REPORT

The Executive Directors considered the six-monthly report on overdue financial obligations to the Fund, together with a statistical update (EBS/87/252, 12/2/87; and Sup. 1, 2/8/88).

The Deputy Treasurer noted that arrears had continued to rise, having reached SDR 2.15 billion in the past few days, although that figure was expected to fall soon as some payments seemed to be late for administrative reasons.

Mr. Lim stated that the level of overdue obligations remained a pressing problem. Arrears had continued to increase and had become more protracted.

With respect to existing policies to deal with that problem, considerable emphasis should be placed on preventive measures, Mr. Lim observed. In that connection, reference was made on pages 4 and 5 of the staff paper to a requirement for assessing the debt servicing capacity of members making use of Fund resources. As the staff noted, "under the guidelines for preparation of these assessments, analysis of the member's medium-term prospects is to focus clearly and explicitly on the member's capacity to meet its obligations to the Fund." Although it was sometimes difficult to make, there was a clear requirement, in the view of his authorities, for a frank and comprehensive assessment of a member's ability to repay the Fund in all papers prepared for the Board involving use of Fund resources.

On other policies, Mr. Lim said that he could endorse the staff's suggested clarification of the two types of decision relating to the suspension of a member's right to use SDRs. Similarly, he agreed that there was no need at present to extend the Fund's general policies and procedures on overdue obligations to overdues maintenance of value adjustments. Indeed, there seemed to have been a considerable improvement with respect to arrears in the latter connection since the issue had first been raised in the Board.

As for the suggestions for extending existing policies, Mr. Lim continued, at least one of the countries in his constituency would be prepared to support the imposition of penalty charges on overdue obligations. Those authorities, while they endorsed the traditional cooperative approach to the settlement of arrears, believed that it could be supplemented by some further financial penalties. However, on balance, his chair was probably a little less sanguine about the preventive effects of penalty charges. Nevertheless, if penalty charges were to be implemented, they should be applied early on, rather than--as suggested on page 14 of EBS/87/252--as a last step before procedures were initiated for the compulsory withdrawal of a member; such charges were unlikely to be effective at that late stage.

As to other suggestions in the staff paper, his chair could support the suspension of technical assistance to members that had been declared ineligible, rather than just overdue, Mr. Lim remarked. Technical assistance was a scarce Fund resource, one that was highly sought after by many members, including those that made considerable sacrifices to remain current with the Fund. Admittedly, on some occasions, it might be counter-productive to withhold technical assistance from a member. To deal with such cases, a provision for making an exemption from such suspension would be needed; for instance, perhaps a member's access to technical assistance would be suspended, except where, in the view of management, such assistance would be likely to contribute materially to the resumption of normal relations between the Fund and the member.

At the present stage, his chair would not support formal communications between the Fund and other institutions or major creditors on the question of a country's arrears to the institution, Mr. Lim stated.

Finally, the authorities of one country in his constituency had suggested that the procedures for declaring a member ineligible should be made more automatic than was the case at present, Mr. Lim concluded. They would prefer virtually automatic ineligibility for a member that had been in arrears for three months.

Mr. Seyler made the following statement:

The positive aspects of the present review--such as the decrease in total payments late as a percentage of total obligations due, and total members late as a percentage of total members with obligations--seem to show that most debtors recognize the preferred creditor position of the Fund and make strong efforts to settle their obligation to it. Consequently, it would be a mistake for the Fund to make any changes which would seem to negate the importance of these efforts.

Although it is difficult to demonstrate a solid connection between this limited success and actions taken in the past by the Board, I do believe that the present practice of declaring members with protracted arrears ineligible for further access to Fund resources gives all members a strong incentive to settle their obligations. Maintenance of this policy is therefore desirable, especially in the context of the enhanced structural adjustment facility, because any relaxation of it would almost surely accelerate the growth of arrears and weaken the credibility of the Fund.

Turning now to the downside of the staff's report, there has been almost no progress on the part of the six countries declared ineligible for further access to Fund resources, so that arrears may be expected to increase over the medium term as these debtors' upcoming obligations fall due. Table 6 shows that, other things being equal, the overdues problem will not

begin leveling off until after 1990. The statistical update circulated yesterday adds still more clouds to the already rather gloomy picture, since both the total amount of the overdues and the number of countries causing them rose sharply at the end of January 1988. I would like to make the following points about future actions the Fund might decide to take in this connection.

Since the group of countries causing most of the overdues problem is small and stable, any provisioning undertaken by the Fund would be directed to this group, raising the issue of moral hazard: indeed, similar considerations now seem to be making the U.S. commercial banks rethink their own position. To avoid moral hazard, these countries should instead be further isolated from the general membership; it should be pointed out to other countries that they are being forced by the mechanism of burden sharing to pay for those delinquencies. This will increase the pressure on both the countries that cannot pay because they have not been pursuing appropriate economic policies, or those that could pay but do not because their obligations to the Fund are not at the top of their priorities.

Clearly, the Fund should maintain its dialogue with countries that cannot pay because of structural problems. Innovative solutions will have to be sought for these countries in collaboration with their authorities, their creditors, their donors, and potential investors. For this reason, I believe the proposal to suspend technical assistance to overdue members is too rigid and could prove counterproductive. Management certainly needs some degree of flexibility and should be allowed to proceed on a case-by-case basis.

We are unconvinced by the arguments of the advocates of penalty charges because in practice it is impossible consistently to distinguish unwillingness to pay from inability to pay. In the latter case, penalty charges would only aggravate the member's balance of payments and debt problems. Moreover, the present system of special charges on overdue financial obligations patently does not increase members' willingness to pay: in the most serious cases of protracted arrears, the special charges also went unpaid.

Therefore, as a means of increasing members' willingness to pay, we prefer two proposals.

First, we favor introducing a rule that the discharge of overdue payments to the Fund takes precedence over quota payments. This rule could be highly effective by establishing the principle that members that do not fulfill their obligations to the Fund will be deprived of some of the fundamental rights of membership.

Second, the idea of communicating with other international institutions and creditors should be pursued. The argument that most international institutions have a common group of shareholders, making such notification unnecessary, is not convincing. Experience has clearly shown that it was precisely the lack of shared information which prevented creditors from taking decisive action at a moment when the present debt situation could still have been averted. Besides this, the smaller creditor countries do not belong to all international organizations and so are deprived of some of the information they need to protect their interest as creditors.

Finally, the problem of overdue maintenance of value obligations is more technical in nature and should be treated separately from the general issue of arrears. Any members with unsettled obligations in this area that are requesting access to Fund resources should have their negligence explicitly pointed out in the relevant staff paper, and should be made aware of the negative effect such negligence must have on the Board's deliberations concerning their cases.

Mr. Nimatallah recalled that he had already presented his views on the issue of overdue financial obligations several times; there was no reason to repeat them, but he had a few points to emphasize.

To begin with, clearer differentiation should be made between members with overdue payments that were willing but unable to repay, on the one hand, and those that were able but unwilling to repay on the other, Mr. Nimatallah stressed. For that purpose, the criteria for the identification of such members needed to be developed. For those unwilling to pay, the additional procedures proposed should be pursued. For instance, the reversal of the catalytic role of the Fund; the denial of quota increases; serious consideration of penalty charges; and the intensification of all means of moral suasion on countries in arrears, in the way suggested once by Mr. Abdallah, namely, through governments, especially those of developing countries.

In addition, the staff should inform the Board, on a regular basis, about its intensified follow-up procedures with members falling into arrears, and about any success it was having in spreading the bunching of payments due, Mr. Nimatallah said. He would also like the staff to show in its reports the financial impact of overdue payments on lenders to the Fund and creditor members as unsettled charges were financed and as the Special Contingent Account was strengthened.

Finally, Mr. Nimatallah made two general observations. He was pleased to note that preventive measures were being taken by the Fund to secure the revolving character of its resources. He had also been pleased to observe the vigorous attempt by the Fund to convince willing but unable members to adopt corrective measures in their economies. The establishment

of the enhanced structural adjustment facility fell within those efforts, and he hoped that all eligible members, particularly those with overdue obligations, would take advantage of that facility's existence; creditor members certainly hoped that eligible, low-income countries would pursue and sustain structural reform and adjustment measures. Owing to the limited period of three years within which eligible members could enter into an arrangement supported by the enhanced structural adjustment facility, he was worried that the need for bridge financing might prolong the negotiations, making it difficult for some members in arrears to conclude arrangements under the facility within the coming three years. For that purpose, he hoped that the Fund would some day be flexible enough, and on an exceptional basis, to allow some countries to enter into arrangements under the enhanced structural adjustment facility, even if they had not first obtained bridge financing to clear their arrears to the Fund.

Mr. Pineau remarked that the staff paper provided a clear and extensive assessment of the arrears situation. He could endorse most of the views expressed in that paper, and would limit his intervention to a few points.

First, on the main feature of the problem the Fund was facing, he could not but agree that the concentration of overdue obligations on a small and unchanging group of members called for a comprehensive solution going beyond the mere treatment of arrears, Mr. Pineau said. The staff had rightly stressed that for the time being, no visible progress had been registered in dealing with the protracted nature of the problem, mainly owing to the fact that all the elements of a lasting solution were not yet in place. However, with the entry into force of the enhanced structural adjustment facility and the growing awareness among major concerned creditors that the only workable approach involved overall (debt) restructuring schemes, the year 1988 could hopefully offer better prospects. But that would be so only if, for their part, the concerned debtor countries were truly committed to comprehensive adjustment policies. Significant further steps in the treatment of the case of Sudan would be a crucial test in that regard.

With respect to the protection of the Fund's financial position, Mr. Pineau continued, the agreement reached recently on the upward revision of the income target had to be taken into consideration. In that context, the case for introducing penalty charges, which already had not appeared very strong, was further weakened by the forthcoming increase in Fund reserves. In contrast, the preventive approach reviewed by the staff in its paper seemed more in line with the cooperative nature of the Fund. In particular, the maintenance by member countries of SDR holdings sufficient to meet scheduled financial obligations to the Fund should be systematically promoted.

As for the possibility of denying a member country in arrears the right to effect its quota increase, he had no strong feelings on the matter for the time being, but looked forward to the paper currently under preparation on the issue, Mr. Pineau stated.

He had no difficulty in supporting the new wording proposed by the staff for decisions related to the suspension of the right to use SDRs, Mr. Pineau concluded.

Mr. Yoshikuni observed that the rapid increase in overdue financial obligations in recent years had been a cause of concern for all in the institution. Most recently, the Board had approved a decision on additions to the Special Contingent Account to safeguard the financial position of the Fund in face of the growing amount of overdue obligations. The Board had already been informed on that occasion that overdue obligations had increased further to SDR 1.8 billion in mid-January, compared with SDR 1.6 billion at the end of September 1987; the latest information was that that figure had increased further. Indeed, if there was yet a further deterioration in the situation, monthly rather than six-monthly reports on the issue might be required.

While the six-monthly report noted that the average number of members in arrears on a daily basis had peaked, Mr. Yoshikuni continued, the arrears had become concentrated on a limited number of countries, to such an extent that members declared ineligible to use the Fund's general resources accounted for 96 percent of total arrears. The implication, he feared, was that the situation in individual countries would become even more difficult to deal with. In striving to increase the precautionary balances of the Fund, including through the establishment of the Special Contingency Account, passive measures rather than fundamental solutions had been introduced. It was therefore important to come up with effective procedures that enhanced the incentives of members to repay their overdue obligations. In that connection, the staff paper discussed some options already suggested by Executive Directors. Regrettably, however, as the staff itself had noted, although each option had its advantages and disadvantages, none had been found to be very effective. While further study on such measures was recommended, he wished to stress that the solution to the problem ultimately rested on the individual member's steady effort to implement adjustment programs. Accordingly, the Fund's assistance to member countries should continue to be given an important role.

His authorities generally supported the staff view on the two procedural matters raised, Mr. Yoshikuni concluded, and requested that the staff continue to monitor the situation concerning maintenance of value obligations.

Mr. Hodgson remarked that as the staff had already noted, arrears to the Fund currently exceeded SDR 2 billion and posed a serious threat to the Fund's financial position. The Board's recent decision to make further additions to a Special Contingent Account was therefore an appropriate one since it protected the Fund against events that could not be foreseen.

A few procedural questions had been raised in the staff paper that required mentioning, Mr. Hodgson continued. With respect first to decisions on suspending the right to use SDRs, the modified wording proposed by the

staff was acceptable. On maintenance of value, he saw no reason to alter the present practices. As the staff recognized, the vast majority of delays in completing maintenance of value adjustments stemmed from legal and administrative problems. He agreed, however, that the Board must continue to attach strong emphasis to timely valuation adjustments.

On penalty charges, his chair had argued in the past, Mr. Hodgson recalled, that such charges were not likely to modify the behavior of members with overdue obligations in a positive way, and might actually make the payments position of the member concerned more difficult. After reading the arguments set out by the staff both for and against penalty charges, his authorities remained doubtful about their value. Therefore, they saw no need to introduce such a system of penalty charges at the present time.

The background documentation attached to the staff paper on the suspension of membership and other legal issues was appreciated, Mr. Hodgson said. At present, suspension of membership and recourse to national courts did not seem to be viable options. However, further thought would need to be given to postponement of quota increases for countries in arrears to the Fund; he hoped that the staff could set out various options for discussion during the Ninth General Quota Review.

On technical assistance, he accepted the staff's argument that it might be counterproductive to deny technical assistance to countries with arrears, if that assistance was being used directly to strengthen the balance of payments or attract other sources of financing, Mr. Hodgson went on. However, he tended to agree with Mr. Nimatallah and would be less willing to support technical assistance in other areas not directly related to solving the arrears problem. In some chronic cases of arrears, the Fund had extended technical assistance that had never been acted upon; that experience should not be repeated.

Finally, the question of Fund communication with other international financial institutions was a delicate one. It was true that those institutions had shareholders in common with the Fund, and in general they were broadly aware of a given country's financial relations with the Fund. Yet he felt that the Fund should also keep other financial organizations fully informed of its arrears situation, if only to ensure that each institution had complete access to information relevant for its own decision-making purposes. Perhaps informal rather than formal communication would be sufficient, but the Fund should not be shy about protecting its financial position, since ultimately all other international organizations depended to a great extent upon a strong and healthy Fund.

Mr. Reddy said that he had noted from the staff paper that although the size of overdue obligations had increased, the problem remained basically concentrated in a small group of countries, and that the number of members in arrears to the Fund had been falling since early 1986. He was essentially satisfied with the preventive and precautionary measures that had made a major contribution to mitigating the problem.

In stating briefly his position on several issues raised in the staff paper, Mr. Reddy referred first to the issue of overdue maintenance of value obligations. He agreed with the staff that the rules and procedures for overdue financial obligations should not be applied to overdue maintenance of value obligations, which were fundamentally different in nature. In addition, the problem was more an accounting one and not a real problem affecting the Fund's liquidity position. The delay in most cases was attributable to legislative and administrative causes rather than to reluctance to pay.

As for penalty charges, he believed that they would be counterproductive because they would only exacerbate the problems of countries in arrears, Mr. Reddy stated. The idea of collecting overdue obligations in national courts might also not be advisable. Even if national courts agreed to adjudicate on the issue, the Fund might not be able to retain its preferred creditor status. Such action could also create a dangerous precedent and open the way for other countries to seek to settle their disputes with the Fund in national courts.

Finally, Mr. Reddy said that he wished to register his opposition to the suggestion that the Fund withhold technical assistance from members in arrears. It was in such countries that technical assistance could, and had, played an extremely useful role in promoting adjustment; it could also be a useful means of keeping channels of communication open with the authorities.

Mr. Goos considered that the recent developments in overdue obligations were extremely worrisome and in fact increasingly frustrating. Despite continued efforts to remedy the problem, the arrears remained on a rising trend, one that had even accelerated dramatically recently, when compared to the latest six-month period covered in the staff report. In that context, he had found it most disquieting that the number of cases of protracted arrears was on the rise, at least as he read Table 1 in the statistical update, and that in the only area where the staff found itself able to indicate some improvement--namely, in the average number of overdue members--the latest statistical information appeared to indicate a pronounced turn for the worse. Moreover, he was most concerned about the jump of 30 percent in arrears to the Trust Fund since September 1987 and its possibly negative impact on the financing of the enhanced structural adjustment facility.

That bleak picture certainly made a strengthening of the Fund's capacity to deal with overdue obligations desirable, Mr. Goos went on. Yet it seemed, for the time being, that there was little scope for increasing the number of instruments at the Fund's disposal--with the notable exception perhaps of making individual quota increases subject to prior clearance of overdue obligations. Personally, he favored such an approach, which should be pursued in the context of the ongoing review of quotas.

On technical assistance to members with overdue obligations, Mr. Goos said that like Mr. Nimatallah and Mr. Hodgson, he was not in favor of the Fund granting technical assistance that was not related directly to solving arrears problems of individual countries.

It seemed necessary to concentrate on using existing instruments as effectively as possible, as proposed in the staff paper, Mr. Goos added, with respect to both preventive measures and efforts to assist countries in clearing their arrears. As to the former, he attached particular importance to the assessment of the debt servicing capacity in the context of the use of the Fund's resources. In that respect, however, when studying members' requests for arrangements, he had often had the impression that the Fund was walking a tightrope between the objectives of easing the adjustment burden of countries requesting Fund-supported programs and of assuring repayment to the Fund, with the balance often being tilted against the latter. Therefore, he encouraged the staff to provide in the design of programs for a sufficient margin against unexpected adverse developments, in particular through provision for a sufficient buildup of reserves in the course of adjustment. Moreover, it went without saying that the Fund needed sufficient assurances that an appropriate capacity to manage debt was in place in all countries requesting the use of Fund resources. In case of doubt, Fund arrangements should provide for the explicit earmarking of foreign exchange reserves to meet the debt-servicing obligations to the Fund.

He could go along with the staff's recommendations on the procedural matters covered in the staff paper, Mr. Goos said.

Finally, referring briefly to the issue of access to Fund resources by members in arrears, Mr. Goos considered that it was necessary to maintain the existing policy, namely, of precluding overdue members from having access to the Fund's resources, including those of the structural adjustment and enhanced structural adjustment facilities. That policy was of fundamental importance in order to safeguard the unique character of the Fund as a cooperative monetary institution. Moreover, he stressed that a discussion of the issue during the current period of negotiations with the contributors to the enhanced structural adjustment facility would be anything but helpful. Those contributors, he felt, had a legitimate interest in receiving the same degree of protection of their claims that applied to the Fund's resources. Therefore, he strongly endorsed management's view, as reiterated by the Deputy Managing Director at the Board's meeting on the Special Contingent Account (EBM/88/11 and EBM/88/12, 1/29/88), namely, "the existing arrears policy is not changed or modified in the context of the enhanced structural adjustment facility."

Mr. Hospedales made the following statement:

The continuation of large, prolonged and growing overdue obligations to the Fund remains one of the pressing problems which must be tackled by this institution over the near term. These obligations have now reached SDR 2 billion, and are now

more than the level of Fund reserves; yet, the data presented in the latest six-monthly report, and its update, do not suggest that the Fund is confronted with the generalized risk of nonpayment of outstanding credit. In fact, our preventive efforts and the wide-ranging collaborative action among creditors, unilateral financial institutions and the debtors themselves have served to contain the problem to a limited amount of chronically overdue members. The six members that have been declared ineligible to use the Fund's general resources account for 96 percent of the total overdue financial obligations.

It seems to us, therefore, that there is an urgent need to concentrate our efforts on resolving the problems of these members whose financing needs are substantial, relative to their quotas. Moreover, most of them are, at present, actively working with the Fund to design and implement Fund-supported programs that could serve as the basis of the Fund's financial support once their arrears are cleared. We continue to believe, therefore, that the Fund must strengthen its current initiatives to resolve these deep-seated problems. We would put increased emphasis on enhanced dialogue with members, providing, where appropriate, technical assistance in designing adjustment programs. We consider this process to be a key condition for attracting external financing to clear arrears with the Fund and to remain current thereafter.

Clearly, the limited prospects for attracting required financing for these members, despite their willingness to adopt the necessary adjustment measures, have been a major stumbling block, in our view, to the resolution of the problem. For this reason, the staff's bold and imaginative proposal to use the enhanced structural adjustment facility as the principal catalytic channel for resolving these protracted problems should merit our strongest support. The staff's proposed modalities for dealing with the problem as outlined on pages 24-26 of the paper entitled "Enhancement of the Structural Adjustment Facility—Considerations Relating to Access and Monitoring Procedures," (EBS/87/230, 11/9/87) meet the requirements of the situation, in particular the possibility of members having an enhanced arrangement and receiving disbursements while still in arrears to the Fund. The procedures relating to access to the resources of the enhanced facility in exceptional cases and the frontloading provisions could be central elements in dealing with the problem.

The structuring of such modalities will constitute an important step toward the aim of addressing, in a systematic manner, the problem of overdue obligations to the Fund. We would insist on such a process; for this reason, we were very disappointed by the Deputy Managing Director's concluding remarks at the discussion on January 29 on additions to the Special

Concerning corrective measures, I continue to maintain that active collaboration among all parties involved, including the Fund, debtor, creditor and donor countries, is needed to resolve the issue of protracted, overdue financial obligations. Of particular importance in this regard is the role of the Fund as a cooperative financial institution to help members to identify the root causes of their problems in designing a comprehensive adjustment program to tackle the problems. Should the program run on track without interruption, the appropriateness, desirability, and effectiveness of the measures should be taken into account. Most of these countries have been severely affected over a period of time by unfavorable developments in the world economy and exogenous factors mostly beyond their control. Historically, high international real interest rates, declining primary commodity prices, intensification of protectionist pressures in major industrial countries and, in some cases, unfavorable weather conditions, have driven these countries into such difficult situations that without receiving adequate financial assistance on highly concessional terms, they would remain unable to address their protracted and deep-rooted imbalances. They should also be given sufficient time to grow and to be in a position to discharge their arrears.

Notwithstanding the Fund's efforts in assisting members with protracted arrears to arrange external financing in support of needed adjustment policies and despite members' willingness and readiness to embark on comprehensive adjustment programs, the difficult situations in many of these countries have yet to improve for lack of adequate and timely financing from other sources in support of these policies. Donor or creditor countries have not effectively participated in a significant way in helping to alleviate the debt burden of these countries. The situation suggests that the Fund should assume more responsibility and try to reduce the reliance on other financing sources, particularly in cases of members with arrears to the Fund. The establishment of an enhanced structural adjustment facility has laid a firm basis for the Fund to examine possible alternatives in this respect.

The staff has elaborated on a number of suggestions made by Directors during earlier Executive Board discussions on this issue. Most of the suggestions appear to be punitive and restrictive. These suggestions, particularly the creation of penalty charges would, as rightly pointed out by the staff, involve "difficult judgments," in particular when members make serious efforts to settle their obligations to the Fund on time. Furthermore, the staff is quite explicit in asserting that there is "no clear evidence that members' efforts to meet their financial obligations to the Fund are or would be significantly affected by the level of charges," and that "penalty charges may not be an effective means to deter members from falling into

arrears or to encourage them to settle outstanding overdues." Thus, penalty charges would merely be interpreted "as a decision by the Fund to seek punitive action rather than rely on a cooperative approach to overcoming the problem of overdue financial obligations to the Fund."

In brief, I fully endorse the convincing arguments presented by the staff on pages 11-14 of EBS/87/252, against the imposition of penalty charges. By the same token, this chair cannot support any of the other options outlined on pages 14-16, including suspension of membership; collection of overdue obligations of members in national courts (as argued in Attachment III, and to which arguments I would also add the potentially high costs of pursuing such an option); preventing the member country concerned *from paying its quota increase subscription until the elimination of its overdue obligations to the Fund*; withdrawing or withholding Fund technical assistance; and formal communications with other multilateral institutions and major bilateral creditors regarding members that are in arrears to the Fund. Such options are, once again, in conflict with the cooperative nature of the Fund, and would at best constitute another piecemeal approach which is not likely to produce an adequate solution. The root causes of these problems, as the staff appears implicitly to recognize, are often to be sought in industrial countries' economic and financial relations with these members.

Thus, as has been suggested by many observers, it is, at least partly, the responsibility of major creditors to these few members with large overdue obligations to assist them to meet their overdue obligations to the Fund. In this respect, I would like to commend the staff, once again, for its vigorous efforts in candidly contacting donors and creditors, in line with the catalytic role of the Fund, in order to encourage them to provide adequate required financing for Fund-supported adjustment programs so as to facilitate the discharge by these members of overdue obligations.

In conclusion, based on the Fund's experience to date with the very ineffective system of special charges, I would again propose that the staff undertake a comprehensive review of the policy on special charges on overdue obligations and consider the possibility of its termination.

Mr. Ortiz said that although the increase in overdue obligations came as no surprise, it was troubling because it indicated no improvement in the overall situation of countries that were indebted to the Fund. At the same time, the tendency of overdue obligations to be concentrated in a few cases that had become apparent in the past year and a half seemed to have been confirmed by the latest data. The earlier apprehension with respect to the proliferation of arrears thus seemed to have been allayed, at least

for the time being, which was a positive feature. The negative aspect was that there was no end in sight to the arrears problem in those few cases, and there would thus be an accumulation of overdue payments in the future. Nevertheless, the shape the problem was taking might allow the Board to concentrate on the important cases of arrears and find more tractable solutions than if the problem were more widespread.

With respect to the more specific issues raised in the staff paper, the position of his chair remained that, in general, retaliatory measures against member countries with overdue obligations did not constitute the most appropriate approach, Mr. Ortiz said. The strategy followed should be a pragmatic one, aimed at maximizing every possibility for collecting overdue payments. The current procedures appeared to offer the necessary flexibility to attain that objective. In addition, steps had been taken to strengthen the Fund's financial position, and although his chair was opposed to the notion of linking the strength of the Fund's financing to the problem of overdues, like others, it had gone along with the Board's decision to increase the Special Contingent Account.

He agreed with the staff's assessment that a policy applied to overdue obligations should not be applied to maintenance of value adjustments, Mr. Ortiz added. The two problems were different, as the staff had explained clearly. He also agreed with the staff judgment on the general futility of imposing penalty charges. The complications that might arise from the application of penalty charges on an ad hoc basis, which to be effective would call for a judgment in defining ability and willingness to pay, would seem to far outweigh the possible advantages. He could agree in theory with the idea of trying to separate cases of willingness but inability to pay and vice versa, but the practical difficulties mentioned by the staff did not make that line of thought promising.

Some of the other proposals considered in the staff paper that had been put forth at different times did not have sufficient merit, Mr. Ortiz stated. He was not in favor of suspending technical assistance to members with overdue obligations. Nor would communications with other international financial organizations on the Fund's relations with individual member countries in arrears be helpful for the reasons mentioned in the staff paper. However, the suggestion that a member in arrears should not be able to have its quota increased should be discussed further in the course of the Ninth General Review of Quotas.

In conclusion, the situation should continue to be monitored carefully, with attention being concentrated on the especially difficult cases, Mr. Ortiz concluded. As several Directors had pointed out--with the various caveats that had been added--the enhanced structural adjustment facility offered some possibility of helping certain countries in arrears to overcome their current problems.

Mr. Fogelholm said that although they recognized that the problem of prolonged overdue payments to the Fund was limited to a few member countries only, the Nordic countries remained deeply concerned about that problem.

In order to prevent an increase in the number of member countries in arrears, and in view of the limited possibilities for strengthening present Fund procedures, as well as the importance of maintaining the revolving character of the Fund's financial resources, it must be underlined that in considering new financial commitments, a close evaluation by the Fund of the repayment capacity of member countries was needed on a continuing basis.

With respect to the possible strategies to deal with the existing problem of overdue payments, his constituency believed that the elimination of the arrears would require close cooperation between the Fund, the member countries concerned, and often also the most important multilateral and bilateral donors, Mr. Fogelholm added. Such cooperation would require a commitment by the members concerned to adopt appropriate measures to correct existing imbalances and a policy orientation which, in turn, could be supported by an external financial package.

As noted by the staff, in most cases member countries made substantial efforts to meet their financial obligations to the Fund, Mr. Fogelholm said. Thus, it was indeed questionable whether a further strengthening of the procedures was warranted. Apart from the preventive effect, the impact of the procedures implemented so far had proved to be limited and their further strengthening might not be the appropriate way to proceed. At the same time, more forceful procedures might be warranted in cases where member countries in arrears refused to cooperate with the Fund and address the problems appropriately. In those circumstances, a gradual introduction of penalty charges could be considered, based however on an objective indicator, for instance, a refusal by a member country to participate in the regular Article IV consultations. Nevertheless, it was important to avoid measures that could lead to a politicization of Fund policies. Another line of action that could be contemplated was direct and formal contact with other international financial institutions and major creditor countries. The contents of such communication should be of an informative nature and not request specific action.

Furthermore, Mr. Fogelholm stated, the Nordic countries felt that quota increases should not become effective for countries in arrears. As to the remaining proposals in the staff paper, like the staff itself, they were rather skeptical. Finally, they supported the staff proposal to amend the decisions on suspension of a member's right to use SDRs.

Mr. Fernando remarked that although the value of overdue obligations had increased sharply, the problem was not of a general nature. The Fund's efforts at tackling the problem by encouraging members to adopt appropriate adjustment programs thus seemed to be paying some dividend.

He wished to make three general points on the subject, Mr. Fernando continued. First, in recent months, there had been an intensification of efforts under initiatives taken by the Fund and World Bank to address the larger problem of high indebtedness among low-income countries that had received strong support from the international community.

His second point was that significant headway had been made in cooperation among the debtors, multilateral institutions, and official creditors in promoting sustained adjustment policies, Mr. Fernando commented. Many of the members with protracted payments problems were in that category. Uganda had become current, and a comprehensive economic program for Sierra Leone was in an advanced stage of preparation. It might also be recalled that since the emergence of arrears in 1981, Zambia, Somalia, and Sierra Leone, at the moment in protracted arrears, had become current at various times between 1981 and 1987. That experience was evidence of past willingness to settle overdue and recognition of the preferred creditor status of the Fund. In general, he perceived a greater willingness to formulate adjustment programs. In that context, his chair supported the idea that encouragement should be given, in selected cases to begin with, to countries to seek bridge financing on the basis of a comprehensive program of adjustment which could then facilitate access to the structural adjustment, the enhanced structural adjustment, or the extended Fund facilities, or a combination thereof.

His third general point was that the Board's recent decisions on the Special Contingent Account had strengthened the Fund's financial position, Mr. Fernando noted.

Against that background, his chair did not generally favor the imposition of punitive measures, Mr. Fernando continued. Having weighed the pros and cons of penalty charges, it was hard to see how they could be helpful. From among the other options mentioned on page 15 of EBS/87/252, it was unrealistic to consider instituting legal proceedings in members' national courts, and unnecessary to communicate formally with other institutions and major creditors for the reasons set out in the staff paper.

A further option related to quota increases, Mr. Fernando observed, but their use as a lever to encourage members with protracted overdue obligations to clear their positions was a subject that should more properly be discussed in the context of the Ninth General Review of Quotas. His chair would not favor any action along the lines mentioned in the staff paper.

In respect of technical assistance, in situations where limitations on or ineligibility to make use of the general resources of the Fund were in place, the provision of technical assistance might also be seen as use of Fund resources, Mr. Fernando remarked. However, technical assistance was of particular importance for a member to formulate economic adjustment programs and also strengthen its statistical base. Attention had been drawn frequently to the need to improve statistics in developing member countries so as to facilitate monitoring the path of adjustment and the design of programs. It could also be argued that good statistics helped Article IV consultations, which were an obligation that a country even in overdue status had to perform. Viewed from that broader angle, the interruption of technical assistance, except in an extreme situation, would be unhelpful.

On the two procedural matters raised in the staff report, Mr. Fernando said that the staff proposal relating to decisions to suspend the right to use SDRs was acceptable. As for overdue maintenance of value obligations, he agreed that the maintenance of value provisions and members' obligations thereunder were vital to the Fund's financial structure. But because the circumstances in which such obligations became a problem were far different from those leading to the emergence of overdue financial obligations, it was inappropriate to apply the general policies and procedures developed for dealing with overdue financial obligations to overdue maintenance of value obligations.

Mr. Mawakani made the following statement:

Like previous speakers, I note with some concern that overdue financial obligations to the Fund increased during the six months under review. However, it is encouraging to note that the average number of members in arrears to the Fund decreased and that the bulk of overdue financial obligations remains concentrated among a few countries.

I will organize my comments on the specific issues raised in the paper.

On preventive measures, the Fund should continue to monitor closely the financial situation of members in arrears and should provide technical assistance in the design of adjustment programs to help countries make timely payments to the Fund.

As for corrective actions, the difficult economic and financial situation of all countries in arrears make an adjustment program without adequate financing very difficult to implement. Therefore, our present procedures should be re-examined. Adjustment programs by themselves will not solve the problem. The Fund must take the initiative to assist the countries in arrears to find donors that can come up with much needed additional financial resources to support the adjustment program.

With respect to strengthening of the Fund's financial position, measures have already been taken and I believe we shall come back to this question during the midyear review of the Fund's income position. I think, therefore, that no modification should be made at the present time.

Concerning procedural matters, in an attempt to be accurate, I can support a more understandable form of the decision specifying that the member's right to use SDRs is suspended "until the member has become current in its obligations to the SDR Department, at which time the suspension will lapse." The decision as reformulated gets rid of any confusion relating to the situation of an ineligible member.

For overdue maintenance of value obligations, I do not think it is necessary to introduce any new remedial measure. The staff should continue the present practice of following up with active efforts to secure settlement of such adjustments.

On the suggestions for extending the Fund's policies and procedures, I would like to make the following remarks:

First, we continue to believe that penalty charges should not be imposed. Up to now, they have not influenced members' behavior with respect to improving their foreign exchange and reserve management policies, or their adjustment efforts.

Second, this chair has a deep concern about the suggestion of suspending technical assistance to a member because it fails to be current with the Fund. Doing so may be counterproductive and have harmful effects for the members as well as the Fund. We think that technical assistance programs should be continued.

Third, regarding the suggestion that the Fund should communicate formally with other international financial institutions and major creditor countries, I agree with the staff that the publicity attached to a declaration of ineligibility may provide sufficient notification of the member's credit standing in the Fund without the need for further announcement. Moreover, it would be worrisome if the Fund were to come under pressure from other institutions to take reciprocal action that would be contrary to the Fund's Articles of Agreement.

Mr. Enoch stated that he considered the Acting Chairman's remarks at the conclusion of the discussion on the Special Contingent Account to have been wholly appropriate. He also felt that continued references to the possibility of use of the enhanced structural adjustment facility for members in arrears was unhelpful at the present stage, first, because it might deter some potential contributors to the facility, and second, because it might raise unrealistic expectations on the part of some countries as to what the enhanced structural adjustment facility might be able to achieve on its own.

His only concern with the staff report, which provided a clear survey, was the delay in its discussion by the Board, Mr. Enoch commented. The data in the report were over four months old, and although the update that had been issued two days previously was helpful, it might be useful in future to schedule an earlier discussion or to delay the issuance of the basic report until closer to the time of its consideration by the Board.

There were no obvious steps available to the Fund that were likely to make a dramatic impact on the still increasing problem of arrears, as the staff report made clear, Mr. Enoch continued. Nevertheless, it was fair to say that the Fund staff had made positive, if modest, progress in

tackling the arrears situation by means of a number of developments: careful assessment of risk in new lending; the close monitoring of members' payments performance, and the provision of practical technical support. The inevitable question was whether further significant advance could be made upon that unglamorous but nevertheless valuable progress. The two basic problems highlighted in the staff paper were the recurrent and temporary delays in payments, and the hard core of protracted arrears. The former phenomenon was disturbingly widespread; the large amounts of recurrent and temporary overdues, and the dramatic increase in the first months of 1988, were of great concern. He would be interested in staff comment as to whether it expected that increase to be a temporary upsurge, possibly owing to a seasonal pattern, or whether protracted arrears were likely to increase as a result. Smaller members seemed from the staff report to be responsible for the bulk of those temporary arrears, and not necessarily those members that were more chronically in arrears. If that was so, the underlying problem might be largely one of administrative weakness, bringing the basic technical support that the staff could provide into its own. In that connection, he wished to highlight the reference on page 5 of EBS/87/252 to the assistance given to members in making appropriate arrangements to acquire SDRs and in general to reinforce the efficiency with which members made payments to the Fund. It would even more helpful if the staff's efforts were used earlier and more widely. He suggested therefore that future requests for the use of Fund resources should, in the section dealing with a member's ability to repurchase, include also an assessment of members' technical repayment capabilities and a detailed history of their past payments record, including recurrent but temporary payments delays. Where a problem was identified, remedial technical measures could be a condition for access to the Fund's resources.

If recurrent but temporary payments delays posed a difficult problem, protracted arrears presented an even more troublesome one, Mr. Enoch continued. As the staff had convincingly argued, many proposed deterrents were likely only to exacerbate the situation. Of course, the difficulty inherent in the proposal for penalty charges could be resolved if it were possible to separate those that would not pay from those that could not pay. He was not fully convinced by the staff's arguments against such separate treatment, although he recognized the likely difficulties arising from attempts to distinguish the one group of countries from the other. One possible criterion might be to determine whether or not a debtor had attempted to make partial clearance of its arrears or had made payments to other institutions; and, of course, the debtor's reserve position could be evaluated.

In general, he could go along with the staff view against imposing penalty charges on members in arrears, although he saw a possible case for freezing a member's quota if that member was in arrears to the Fund, Mr. Enoch continued. That matter should be reconsidered when the Board resumed its discussion on the Ninth General Quota Review. But broadly speaking, a member's history of arrears should be a consideration in

assessing the advisability of increasing a member's use of the Fund's resources, and requiring exceptional safeguards in the form, for example, of significant prior policy actions.

Having said that, he shared the staff's doubts about attempting to recover arrears through national courts and about the advisability of advertising a member's arrears to other institutions, Mr. Enoch remarked. The first proposal was dangerous, and both approaches were likely to arouse unproductive hostility. He was also opposed to the withdrawal or refusal of technical assistance to a member in arrears, at least where that assistance was directed toward eliminating arrears. On the other hand, he saw no reason for maintaining resident representative posts in countries with protracted arrears.

On procedural matters, he supported the staff view on the desirability of maintaining the current case-by-case approach to the timing of declarations of ineligibility to use the Fund's resources, Mr. Enoch remarked. In particular, the Board's recent experience with Sierra Leone's overdue obligations had somewhat restored his belief in the value of flexibility, suggesting that greater automaticity might be unhelpful. He hoped that events did not cause him to revise his position on that matter.

The procedures involved in calculating maintenance of value obligations made it easy to sympathize with the numerous members that apparently experienced difficulties in observing them, Mr. Enoch remarked. Those procedures were in need of simplification.

While no effort should be spared to cope with the problem of existing arrears, those arrears were to a large extent spilt milk, Mr. Enoch added, and it was even more incumbent upon the Fund to be vigilant for the future. The call for the Fund to ensure that it only supported viable programs of adjustment could never become a cliché in that respect, particularly in view of the weakness of a number of recent programs, one of which had been brought to the Board despite the clear expectation of recurring arrears, which in fact materialized shortly after the program was approved. The Fund must not react to arrears by refinancing them through weak, unsustainable new programs.

Finally, Mr. Enoch said that he could support the staff's proposal with respect to decisions on overdue obligations in the SDR Department.

Mr. El Kogali made the following statement:

At the outset, I should like to note that today's discussion serves as yet another reminder of the severe economic and financial conditions which have made it difficult for many developing countries to grow out of their external debt problems. However, the situation regarding arrears to the Fund, although serious, cannot be described as desperate for a couple of reasons. In the first place, despite their rapid increase, we can take some comfort in the fact that the source of the increase is now

limited to a few core countries. The problem of arrears is, therefore, not widespread among the membership of the Fund. Second, although the situation pertaining to those countries still in arrears has been reported in somewhat pessimistic terms and is still uncertain, I believe there are some encouraging signs which could lead to the eventual resolution of the problem. In a number of these countries, serious efforts are being made to put in place strong and credible adjustment programs that should be able to attract international financial support to facilitate the regularization of relations with the Fund.

It is pertinent to note that the implementation of these adjustment programs has been the direct result of an effective dialogue that the Fund has maintained with its members. Though *slow in bearing results, these contacts with the authorities* have engendered an important rapport which should be encouraged and continued in order to further demonstrate the benefits that can be derived from initiating adjustment programs. In this connection, it is regrettable that the proposal for the Board to consider the modalities of access to Fund resources under the enhanced structural adjustment facility by countries in arrears was withdrawn. Without prejudice to the contents and proposals contained in that staff paper, this chair has all along maintained the position that there is need for the Fund to evolve solutions that are specifically focused on those limited core cases. Some measure of Fund involvement in the process of normalization of relations is inevitable since the size of each country's arrears precludes the use of traditional approaches to the liquidation of overdue financial obligations. Accordingly, the possible use of resources under the enhanced structural adjustment facility in combination with other sources of financing, both bilateral and multilateral, would provide a durable basis of economic recovery and eventual normalization of relations with the Fund.

I should add one footnote here by observing that the manner in which we, in the Board, have treated the whole question of arrears bears strong resemblance to those approaches designed to deal with short-term liquidity problems associated with external debt difficulties. In my view, it is clear that the countries facing protracted arrears, particularly those in my constituency, exhibit deep-seated problems of a long-term nature. As such, the solutions directed at resolving the question of arrears for these countries and remaining current thereafter would require full recognition of this reality. In other words, the Board should avoid adopting quick and easy solutions that are often merely punitive in character and ones that do not contribute toward the resolution of the problem.

On some of the specific issues raised by the staff, first, I am aware that the staff has gone beyond the compilation of relevant statistics on arrears and overall outstanding use of

Fund resources by assisting members in maintaining detailed information that has helped them to keep track of all obligations falling due to the Fund. All these data have been useful in providing an early warning mechanism. Thus, members that would otherwise have fallen behind in their payments have managed to remain current. I would, therefore, urge the staff to remain vigilant and maintain close communications with members on these and other matters. However, in its discussions with the authorities, the staff should avoid conveying the impression that the Fund is not concerned about the difficulties that their countries are facing and that it is only interested in ensuring repayment of its own credit. The staff should pay equal attention to the overall improvement of economic conditions if these countries are eventually to resume normal relations with the Fund and restore their creditworthiness.

On the question of maintenance of value adjustments, I am convinced that the existing procedures are reasonably adequate. Apart from the fact that arrears associated with maintenance of value adjustments are different from obligations that fall due, members' track record to date is not at all a bad one. They still manage to make the necessary adjustments and settlement has been made within the context of countries' laws.

While it is conceivable that penalty charges may act as an incentive to avoid incurring arrears in cases where borrowing countries have the resources, it is also clear that the imposition of these charges, as in the case of special charges, will not improve collectibility. The underlying assumption in applying penalty charges is that countries have a choice which can be influenced by, for example, raising the cost on their obligations to the Fund. On the contrary, these countries do not have any such choice for they do not have the ability to pay even for their basic needs. I have noticed that despite all the evidence to the contrary, the staff still considers and, indeed, proposes that penalty charges could be used as leverage by the Fund to force countries to liquidate their arrears.

In closing, it will be noted that I have not commented on a number of issues raised in the staff paper, mainly because the position of this chair has been made clear on a number of previous occasions, and to avoid the impression that I was being unnecessarily uncompromising. Furthermore, some of the issues, for instance, concerning the strengthening of the Fund's income position, were recently considered by the Board in relation to the Special Contingent Account. It is also my view that some of the proposed measures which have also been considered on previous occasions do not address the problem at hand. In many instances these proposals, as already pointed out, are punitive in character and would not, in my view, contribute toward resolving this problem. I am referring here to proposals such as depriving

members in arrears from benefiting from the forthcoming increase in quotas, and the proposed compulsory withdrawal from membership of the Fund. These and other measures could only lead to straining the Fund's relations with these members at a time when close relationships are most needed to encourage the adoption of strong adjustment programs. As already indicated, the problem is not unwillingness to pay, but lack of the ability to do so. Therefore, rather than withholding technical assistance, for example, an aspect which has fostered useful dialogue, I would appeal to the Board not to allow such contacts to be curtailed. I believe that active discussions with the authorities have improved the prospects for collectibility more than, say, the symbolic action of declaring members ineligible. I should like to suggest once again that, in the next six-monthly report, *attention should be focused on the problems of the core countries* and the proposal of some specific solutions. For our part, we are prepared to work with the staff on any specific proposals rather than treating the problem as a general one.

Finally, it is pertinent to note that the countries in my constituency are greatly concerned about the buildup of arrears, and their implications for the Fund and their own economies as well as those of other members. With this view in mind, my authorities continue to search actively for practical solutions to the problem that would lead to a speedy resolution of their outstanding obligations to the Fund.

Mrs. Walker made the following statement:

Regrettably, this review of overdue financial obligations to the Fund is the seventh in a series and arrears have again increased substantially with the number of protracted arrears having reached higher levels as well. We do welcome the recent steps to enhance the financial position of the Fund through additions to the Special Contingent Account.

Regarding the procedural steps which we have taken to date to deal with this problem, we support such preventive measures as specific "prompting" of the debtor country before payments are due, the accumulation of SDRs in anticipation of payments, and the inclusion in medium-term balance of payments scenarios of data on repayments to the Fund. However, we also have some concerns with our procedures. First, while some progress has been made in assessing members' ability to repay the Fund, we do not feel that efforts thus far have been entirely satisfactory. In our view, we need to be more exact in this analysis. We raised this point in the recent discussion on Uganda's request for a compensatory financing purchase. Second, we are dissatisfied with the evolution of the handling of ineligibility cases. We recognize that these cases must be handled somewhat on a

case-by-case basis, but there does need to be some consistency in our overall approach as it applies to individual cases. We believe that we have lost some of this consistency, partly because the Board takes decisions on individual cases with no recommendation from management on the appropriate course of action based on previous cases. We recommend that management take a stronger role in recommending a course of action, based on precedents, for the Board to consider.

While the amount of arrears has continued to grow significantly since our last review, the largest amounts have remained concentrated in a relatively small number of countries which are chronically overdue. The costs of burden sharing on both debtors and creditors because of nonpayment in these protracted cases are also very large, and we would appreciate receiving specific data on them along the lines of Mr. Nimatallah's request. While the fact that the largest overdue payments are concentrated in a few countries does not mean that the problem has stabilized, it does indicate to us that we should be concentrating our efforts on finding new ways to deal with these particularly serious problems on a case-by-case basis.

One suggestion we have put forward in the past and would like to elaborate on today is for Executive Directors and management to meet informally to discuss ways of dealing with the arrears problem. While we raised the possibility of holding an informal meeting during our discussion of the work program, the staff paper does not mention this suggestion, and we would appreciate consideration of this idea. At such a meeting, we might consider creating small working groups consisting of management and Executive Directors to review individual members' arrears cases. For example, a small working group composed of the Director representing the debtor country in arrears, several Directors representing key creditors to that country, a regional neighbor of the country in arrears and other debtors as well could try to develop a scenario to encourage formulation of a comprehensive economic adjustment program and to explore potential sources of financing. This kind of informal approach has been initiated for Sudan, although further work is needed. We would suggest that an approach along the lines outlined above be taken with other chronic cases, and perhaps could include all members declared ineligible.

Regarding use of the resources of the enhanced structural adjustment facility by members in arrears, we support your summing up of the recent Board meeting on the Special Contingent Account. We believe that current procedures applying to use of Fund resources when a member is in arrears should apply to use of the enhanced facility, although the new facility may be able to figure in scenarios for economic adjustment leading to

resolution of arrears problems in some of these cases. We must be cautious, however, not to attempt to prejudge the way in which individual cases might develop.

Referring to the procedural matters on which the staff is seeking guidance, first, we agree with the proposed clarification of the decisions on a member's right to use SDRs. On overdue financial obligations with respect to maintenance of value adjustments, a description of developments relating to overdue payments of valuation adjustments should be included in requests for use of Fund resources and, in our view, payments should be made before additional Fund resources are disbursed, although we can support the staff proposal.

Regarding penalty charges, we believe that perhaps there is a role for them in cases where it might be determined that a member could pay, but chooses not to remain current with the Fund. We would also ask the staff in this connection to look at criteria for making a distinction between those members who could pay and those who really do not have the resources, and agree with Mr. Enoch's suggested criteria, including partial clearance of arrears, payments to other institutions, and level of reserves.

We do not believe that countries which have been declared ineligible to use Fund resources should be allowed to benefit from quota increases since they are not fulfilling their obligations to the Fund. As the staff suggests, this is a matter that we will have to consider at the appropriate time in connection with the Ninth General Review of Quotas.

We do not think that suspending technical assistance in the case of overdue members would be generally in the interest of the Fund, particularly if such assistance is designed to develop the economic adjustment program needed to restore normal debtor-creditor payments relationships. However, we should leave open the possibility of making decisions to suspend technical assistance on a case-by-case basis.

We can support formal notification to international financial institutions when Fund members are declared ineligible to use Fund resources. While it is clear that such information is readily available to other institutions, formally sending such communications could be useful. Such notifications would not, in our view, place undue pressure on the Fund or the other institutions to alter lending decisions to members in arrears, which the staff suggests would be counter to the Articles. It would merely provide a more official channel for information already being circulated, one that could bring about more awareness about arrears cases.

Finally, we believe that the arrears problem should be considered by Ministers at the Interim Committee meeting. We are giving thought to how our Governor can address the problem in his speeches at the meetings.

Mr. Donoso said that the continued increase in the volume of arrears to the Fund was very worrying. Part of the problem consisted of the large number of members that from time to time incurred overdue obligations which tended to be settled after a short delay. With respect to the more serious arrears that had persisted for a prolonged time, he favored a cautious approach. In the cases in question, countries had serious difficulties that had to be analyzed carefully. The Board had spent much time trying to understand better how to deal with the situation underlying the arrears problem. The issue was still not resolved, and the Board should act with great prudence to avoid precipitating developments contrary to the objectives sought.

His chair supported the current actions being taken by the Fund to prevent the emergence of new arrears as well as to reduce and eliminate existing overdue payments, Mr. Donoso continued. On the suggestions for extending the Fund's policies, he did not favor any system of penalty charges, because the buildup of arrears was in most cases the result of fundamental economic difficulties rather than of a marginal financial decision. The Fund's experience with a system of special charges on overdue financial obligations proved that the existence of additional charges might be irrelevant to decisions to settle existing arrears or even in preventing the emergence of new ones.

As for drawing a distinction between countries' incapacity or unwillingness to repay the Fund, such a distinction would involve only subjective judgments about the intention of members without helping to resolve the arrears problem, Mr. Donoso considered. His constituency also opposed other measures mentioned in the staff paper, such as the suspension of membership; recourse to the national courts of members; or not permitting an increase in quota to take effect before overdue obligations were settled. It would be particularly unfortunate to suspend technical assistance to members in arrears just when efforts to help them formulate adequate policies were an even more necessary part of the process of addressing such countries' difficulties.

Since almost all creditor countries were present in the Fund's Executive Board when a declaration of ineligibility was decided, further communication and publicity on the decision should be avoided, Mr. Donoso considered, so as not to affect the decisions of other creditors or financial institutions. On the contrary, his chair strongly supported the policy of close communication with the member country experiencing difficulties and of the Fund's cooperative approach, given the concentration and persistence of the arrears problem in a few cases. Any improvement in that policy approach would be a welcome step in the right direction. The Fund had a role to play by assisting members in addressing the severe

difficulties that they faced when they were in arrears, by supporting members' efforts to implement adequate economic policies and obtain the necessary financial resources. The enhanced structural adjustment facility was expected to play an important part in that role by improving the situation of low-income countries. He attached great importance to the prompt implementation of the enhanced facility.

Finally, on the two procedural matters raised in the staff paper, he could go along with the clarification suggested by the staff on the form of decisions to suspend members' right to use SDRs, Mr. Donoso concluded. Second, with respect to overdue maintenance of value obligations, the number of members and the amounts unpaid had been significantly reduced since September 1987. Therefore, he could fully support the staff's view, namely, to resolve the problem through a direct dialogue between the member and the staff, an approach that had proved its efficiency in the past.

Mr. Dai observed that the situation with respect to overdue financial obligations had been deteriorating in terms of absolute value and duration since the Board's review in March 1987. However, as the problem of overdues remained for the time being within the confines of the same few countries, he did not believe that it posed a serious threat to the financial position of the Fund.

He would not elaborate on the general problem of overdue financial obligations, but would concentrate instead on some of the important issues raised in the staff report, Mr. Dai continued.

First, on the matter of overdue currency valuation adjustments, he generally concurred with the staff reasons for not treating them as overdues, Mr. Dai said. As for adding an explanation for such overdue valuation adjustments in papers on requests for the use of Fund resources, he could go along with the staff proposal provided that such overdue valuation adjustments were not treated as overdue financial obligations and did not affect the Board's approval of requests for use of Fund resources by the member countries concerned.

The second issue he wished to focus on concerned the penalty charges that had been proposed by some Directors, Mr. Dai recalled. The experience so far with the special charges introduced by the Fund was that they did not provide a clear indication that the implementation of penalty charges would in fact achieve the desired result of improving the repayment performance of member countries in arrears. Therefore, he did not believe that penalty charges were desirable or effective tools for addressing the arrears problem.

Third, with respect to other proposals such as the suspension of membership, nonapproval of quota increases, and limiting technical assistance to members with overdues, Mr. Dai said that he did not believe such measures were generally appropriate for solving the problems confronted by the Fund. Sight should not be lost of the fact that the problem of overdue

obligations was part of the world debt crisis. Against that background, his authorities maintained that the fundamental solution to the problem lay in the successful implementation of a world debt strategy. Present conditions required the Fund to give strong assistance to countries to carry out effective economic structural adjustment within the general framework of the overall debt strategy. In addition, assistance could also be provided by other members in a position to do so. In sum, without an improvement in the current debt situation, it was unrealistic to expect the intensification of sanctions and pressures to improve the present situation.

Mr. Rebecchini made the following statement:

Overdue financial obligations remain a cause of concern, particularly their increasing concentration among a few "hard-case" countries. We continue to believe, however, that the present strategy for coping with overdue obligations remains valid. Specifically, a more lenient approach does not appear warranted at this stage. However, the strategy needs to be improved in order to cope more effectively with the group of hard-case countries, especially those that manifest a clear unwillingness to cooperate with the Fund, and in order to help those that are willing to cooperate with the Fund to eliminate their arrears.

Improving the present strategy requires, in our opinion, first and foremost, a strengthening of cooperation among the Fund, the countries in arrears, and the donor countries. A lasting solution to the problem of overdue obligations will depend on increased efforts on the part of each of these three actors.

On the part of the debtor, cooperation requires an increased readiness to adopt adequate economic and financial policies. It should be stressed that in the absence of a strong adjustment program it is difficult if not impossible to initiate any cooperative action. On the part of the donor countries, cooperation requires stepping up the flow of concessional financing, on a bilateral and/or multilateral basis, to those countries that are embarking on significant adjustment programs. The enhancement of the structural adjustment facility provides a very useful opportunity to expand the role of donors in this context. And on the part of the Fund, cooperation requires providing surveillance and technical assistance in order to detect potential difficulties at an early stage, determine the most appropriate adjustment measures, and thereby facilitate the repayment of arrears.

On the more specific approaches to deal with overdue obligations presented in the staff paper, we see very limited scope for the use of penalty charges; we believe that penalty

charges would have little impact on the behavior of hard-case countries. Charges levied on these countries have remained unpaid, and raising charges might therefore ultimately result only in an increase of the Fund's exposure to these countries. The reason is that most of the countries incurring protracted overdue obligations are actually unaffected by considerations of financial incentive because they are constrained by the availability of resources. The lasting solution to their financial problems, including repayment to the Fund, depends on the social and political commitment to adopt adequate adjustment programs. In these circumstances, penalty charges would, at best, be irrelevant and might even make it more difficult for the Fund to operate in such a way as to bring about such commitment. Penalty charges might, however, be justified if a case can be made that a country is not facing a resource constraint and might be withholding payments to the Fund on the basis of portfolio decisions. In this respect, while we realize that the issue of unwillingness versus inability does not lend itself to clear-cut solutions, we believe that some case could be made out of the issue, particularly if it is handled pragmatically and on a case-by-case basis. Therefore, we wish to join previous speakers in requesting the staff to pursue this issue further.

Serious consideration should be given to the proposal for suspending the carrying out of a quota increase for countries in arrears, until they have become current with the Fund. It would be contradictory to raise the voting power of a member at the same time that it is violating the Articles of Agreement and consequently the rights of other members.

As for technical assistance, the Fund should closely cooperate with countries in arrears so as to provide them with the necessary support in their effort to meet their financial obligations. However, some scope might exist for limiting the provision of technical assistance to those issues that are strictly instrumental to the rapid repayment of arrears. In this respect, it will be necessary to be flexible and take decisions on a case-by-case basis.

On the suspension of membership, we feel that such action could harm the cooperative nature of this institution at the current delicate juncture. Therefore, we would be reluctant to pursue this approach any further at this time.

Finally, on the issue of overdue obligations arising from the maintenance of value obligations, we can agree to the continuation of present policies since we share the staff arguments. We can also support the change in language proposed by the staff for decisions pertaining to the suspension of a member's right to use SDRs.

Mr. Zaidi made the following statement:

The Fund has implemented a number of measures to increase the likelihood that members will be in a position to make repurchases and pay charges on schedule, and the declining trend since the first quarter of 1986 in the average number of members in arrears to the Fund provides some evidence that these preventive efforts have been effective, at least to some extent. Measures such as assessment of debt-servicing capacity of members making use of Fund resources, introduction of improved cash flow management techniques, and close monitoring of a member's forthcoming obligations to the Fund during the period when a member has outstanding obligations have all helped in this regard.

While we understand the need for certain preventive measures, we feel that the introduction of penalty charges would not provide an effective incentive for members to become and remain current with the Fund. As has been indicated in earlier discussions, in most cases obligations to the Fund are settled promptly on their due dates, despite the fact that from a purely financial point of view it may be advantageous for members to delay settlement, and there is little evidence that the level of charges has influenced members' performance in meeting their obligations to the Fund. The problem of overdue obligations arises for the most part not from the unwillingness on the part of certain countries to pay, but rather from their inability to pay. These countries have accumulated arrears not only to the Fund, but also to other creditors, and the imposition of penalty charges could be counterproductive; because the accumulation of such charges over time would impose an additional financial burden on members and could complicate domestic and international efforts to resolve their problems. While in theory penalty charges applied only in those cases where there is an unwillingness to pay could be justified, it would be difficult in practice to make the judgment as to whether a particular member is unwilling or unable to pay.

The members in arrears are mostly those who are facing difficult economic situations caused by factors beyond their control. An important reason for the emergence and accumulation of overdue obligations by some countries has been their inability to strengthen their external payments position because of the slow expansion of world trade. The prospects for the solution of the arrears problem depend upon joint efforts by the Fund and the whole membership, including the countries concerned as well as the creditor countries. The cooperation by donors and creditors needs to be strengthened to assist the adjustment

efforts of members in arrears. Since the adjustment and supportive measures will take time, the Fund should continue to play an important role in creating an appropriate international environment conducive to rapid adjustment.

We are of the view that the withholding of technical assistance from a member in arrears would be counterproductive, because it would undermine the Fund's efforts toward helping the country formulate policies to strengthen its external position. We recognize that the issue of quotas will be discussed again in the future, but at the present time we have some reservations about the suggestion that an individual member's quota increase subscription not be payable until the member had eliminated its overdue obligations to the Fund.

In light of the considerations mentioned in the staff paper, we have difficulties with the suggestion that the Fund should communicate formally with other international financial institutions and major creditor countries, requesting that they take into account an individual country's arrears to the Fund in their relationship with the country concerned. If the purpose of such communication was to serve as a notification to other creditors that the country in question was not meeting its financial obligations to the Fund, then that did not seem to be necessary as the information is presumably already known since most international financial institutions have common shareholders and almost all creditor countries are members of the Executive Board. On the other hand, if the purpose of such communication was to influence decisions of other institutions, then it could lead to such undesirable effects as bringing the Fund under pressure from other institutions to take reciprocal action in other cases.

Finally, with respect to the question whether the Fund could pursue the collection of overdue obligations of members in the national courts of other members, we agree with the staff that even if national courts were to assume jurisdiction and decide the Fund's claim on its merits, the Fund would be exposed to several risks. The staff has pointed out some of these risks, and it seems to us that these are not risks that the Fund should be willing to take in light of the costs involved. As the staff has noted, the Fund's bringing suit against a particular member in the national courts of other members could cast doubt on the Fund's impartiality. In addition, different national courts might reach different conclusions in applying the Fund's law, or even reach conclusions that differ from the Fund's own interpretation of its Articles and decisions.

Mr. Hogeweg said that he wished to associate himself with the remarks made by Mr. Enoch, Mr. Fogelholm, Mr. Goos, and by Mrs. Walker as well on

the appropriateness of the Acting Chairman's summing up of the discussion on the Special Contingent Account with respect to the use of the resources of the enhanced structural adjustment facility.

On the issue before the Board, he too was concerned about the rising arrears, and he hoped that the updated figures in Table 1 of the supplement to the staff report would remain compatible with the diagnosis that the protracted arrears problem was contained to a few member countries, Mr. Hogeweg continued. The nature of the arrears problem was such that it could not be solved by changes in administrative procedures by the Fund once the arrears had occurred. The approach must be preventive: adherence to conditionality and care in approving programs. Certainly, the current problem could be solved only with major effort by all parties concerned.

He was grateful for the material presented in the staff report, and for the information in an earlier staff paper on the legal background to the suspension of membership (SM/87/229, 8/25/87), Mr. Hogeweg said. Nevertheless, it would not be helpful to move in that particular direction. As for the matter of quota payments by countries in arrears, that issue should be discussed during the current quota review.

Finally, Mr. Hogeweg said that he agreed with the staff view on the two procedural matters set out in the staff paper for the Board's consideration.

The Deputy Treasurer noted that as shown in Table 1 in both EBS/87/252 and in the supplement, there was a certain seasonality to the increase in the number of members with overdue obligations. A period for the payment of charges ended with the calendar year and with the Fund's financial quarters, and some members were late in making payments largely for administrative reasons. On average, 61 members made late payments in 1987. A slight increase in the number of countries overdue at the beginning of 1988 was thought to be temporary. In fact, as of February 5, only 20 members were overdue, and payments were expected from another 5 or 6 members in the coming days. At the same time, it should be noted that 2 of the 30 members overdue at the end of January had not formerly been listed as regularly being overdue; they were middle-income countries and the evolution of their payments to the Fund would have to be watched carefully.

The increase in the number of members that would be overdue by three years or more was an inevitable consequence of the schedule of their repurchases and the timing of their overdue obligations, and to the absence of particular efforts to reduce those obligations, the Deputy Treasurer continued. The number of members with protracted overdue obligations was expected to rise to six--the equivalent of the number of members that were currently ineligible. The hard core of members with overdue obligations consisted of those six countries, which were also responsible for the bulk of the obligations, and three other members against which complaints were outstanding. Depending on the outcome with respect to the newly emerging arrears of less than one month's duration for some middle-income countries,

it would be complacent to believe that the problem had been completely contained. However, there did not seem at present to be a systemic spread of overdue obligations among the membership beyond those that had protracted overdue obligations.

As for the difficult question of distinguishing between members that would not and members that could not repay the Fund, the Deputy Treasurer observed, it was fair to say that no member had stated that it would not pay. In fact, every member with overdue obligations had reiterated, in both public and private communications with the Managing Director, willingness to pay as circumstances permitted. There had been no renunciation of any kind of overdue obligations to the Fund. If all members with overdue obligations were considered to be in the category of inability to pay, the issue would seem to be one of priority. A large number of members in considerably worse circumstances than the six countries that had been declared ineligible did manage to make regular payments and maintain current status with the Fund. It was difficult to drive home the point, which the Fund nevertheless always insisted on making, that those members should change their priorities. It was interesting to note that the six countries claiming inability to pay were among the eight countries unable to repay the World Bank. Difficult as it would be to draw operational distinctions between the members that could not and would not pay, the staff would make an effort to do so in the subsequent six-monthly report. To impose penalty charges on members that could not pay would however involve a fine distinction, more of politics and priorities than of differences in ability as defined, for instance, by net reserve levels, which would in most cases be highly negative.

Mr. Nimatallah remarked that the distinction could of course be drawn much more easily if a member stated that it was not willing to repay the Fund. However, he wondered how a country's decision to limit its payments to, say, 10 percent of its export receipts would be interpreted; would that member be considered unwilling to pay? It seemed to him that criteria could be developed, including those mentioned during the discussion.

The Deputy Treasurer responded that such a decision to limit payments could also be considered a matter of priority.

On another issue raised by Mr. Nimatallah and other Executive Directors, namely, the cost to creditors and lenders to the Fund of overdue obligations, the Deputy Treasurer explained that the information was supplied in Table 8 of the supplement to the six-monthly report and also in the quarterly reports dealing with the adjustments to the remuneration coefficient and the rate of charge on the use of ordinary resources. The amount of deferred income that was being financed under the burden sharing decision was slightly over SDR 300 million. In terms of the Fund's cost recovery system, unpaid special charges were of the order of SDR 22 million. To meet the cost of deferred income, the discount on the remuneration coefficient and the adjustment of the rate of charge had averaged about 50 basis points. The increase in reserves and balances held in the Special Contingent Account resulted in further adjustments to the rate of charge

of about 8 basis points and 16 basis points to the rate of remuneration. Clearly, the costs of financing deferred income and additions to the Fund's reserves were not negligible. The fact that repurchases were not made was a cost element to the Fund because reserve tranche positions were different from what they otherwise would have been. It was difficult to demonstrate the distribution of the costs with the exception of the special charges and the related cost recovery package.

With respect to the quite large number of administrative measures that were being taken by the staff to follow up developments with respect to payments due to the Fund, the Deputy Treasurer recalled that the Special Operations Division which had been set up 18 months previously dealt largely with overdue obligations, and also with the operation of the enhanced structural adjustment facility, although there was no connection between the two activities. That Division was in close touch with area departments and the Exchange and Trade Relations Department. In the various briefing papers that were prepared for discussions with members' authorities, and in other formal and informal contacts of members with the Fund, the staff tended to press such issues as acquiring SDRs ahead of need, having a foreign exchange cash budget, and of generally putting the Fund higher on their list of priorities than might otherwise have been the case. By pressing such advice on operational authorities in member countries some success was being achieved; the Fund's pleas were beginning to be taken more seriously.

Mrs. Walker said that she supported Mr. Nimatallah's point with respect to criteria for distinguishing between countries that could not and would not make payments to the Fund. Distinctions could also be drawn between countries that gave priority to payments to the Fund and those that stated that they did not do so. Despite the fact that that distinction was one of policy, it would be helpful to find a way to identify it.

Mr. Donoso remarked that as explained by the Deputy Treasurer, it was a question of whether or not there were economic or technical elements to define a member's willingness or inability to pay the Fund. There were no grounds for technical judgments in that respect, and any such analysis would not have a good basis in economics, either.

The Acting Chairman made the following summing up:

Let me make some general comments first, saying that Directors again expressed their deep concern about the continuing increase in the amounts of overdue financial obligations to the Fund, noting that at the end of January 1988 those amounts totaled over SDR 2 billion. In particular, disappointment was expressed at the lack of progress in resolving those relatively few cases of members with very large and prolonged arrears. In this context, it was emphasized again by Directors that the resolution of these very difficult cases will require considerable efforts on the part of the countries involved in undertaking adjustment programs, but also on the part of creditors and

donors in participating in the formulation of external financial support of strong adjustment programs and, in that way, creating the basis for the potential resumption of Fund lending. From one side, we will explore every means of trying to achieve that cooperation in individual cases when those elements, particularly the existence of a strong program, are in place. A number of Directors also stressed the importance of preventive measures and of finding ways to help member countries remain current and intensifying our efforts in that regard. Some Directors also again re-emphasized the importance of including in staff papers assessments of members' repayment capacity, especially when new use of Fund resources is involved.

On some of the more specific issues that have been raised in the staff paper, first, on the question of making a clear distinction between the two types of suspension of a member's right to use SDRs, not all spoke on the matter, but those who did supported the introduction of the language as proposed by the staff.

Second, Directors also agreed that the present practice, whereby the general policies and procedures relating to overdue financial obligations to the Fund are not applied to overdue maintenance of value adjustments, should be continued. Again, it was emphasized that prompt settlement of these adjustments constitutes an essential element of members' financial obligation to the Fund, and the staff was encouraged to follow up actively in cases of overdue valuation adjustments in order to achieve a more speedy settlement and to report periodically to the Board in the context of staff papers on individual members.

Third, with respect to penalty charges, the Board does not generally favor the introduction of penalty charges at this time, although some Directors feel that there may be circumstances when they might be appropriate, particularly when a member appeared to be unwilling to cooperate with the Fund on finding a solution to its problem of overdue obligations.

Fourth, with respect to technical assistance to members in arrears, the sentiment among Directors was that technical assistance, when provided, should be directly related to overcoming the problems which have led to the emergence of arrears and should be used productively by the member concerned in a manner to enable it to become current with the Fund. This has been the established practice of the staff when making judgments on whether technical assistance should be provided to member countries in arrears.

Fifth, with respect to communications with other institutions, although there were some Directors who supported the idea, as a general proposition the Board did not endorse sending

formal communications regarding members with overdue financial obligations to other international institutions and major creditor countries.

Those Directors who spoke on the issue of quota increases for members in arrears felt that the matter should be examined in the context of the discussion in the Committee of the Whole on the Ninth General Quota Review. However, a number of Directors expressed already at this time the sentiment that the discharge of overdue obligations to the Fund should take priority over subscription payments for quota increases.

Finally, on the issue of trying to distinguish between inability and unwillingness to settle overdue obligations, some Executive Directors have asked the staff to develop possible criteria that could be used to draw such a distinction, and have made some suggestions in that respect. As the staff mentioned, such a distinction is a matter of judgment, which is difficult to make. Having attended many meetings with visiting delegations from all countries that are in arrears to the Fund, I have not come across any that have not expressed great earnestness and desire to clear up arrears to the Fund. It is very difficult in those circumstances to say that countries are not willing to repay the Fund, but we do stress the importance of giving priority to doing so. We will keep working on this matter to see if we can come up with some criteria.

2. LAO PEOPLE'S DEMOCRATIC REPUBLIC - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with the Lao People's Democratic Republic (SM/88/23, 2/3/88). They also had before them a background paper on recent economic developments in the Lao People's Democratic Republic (SM/88/26, 1/25/88).

Mr. Reddy made the following statement:

The Lao People's Democratic Republic is one of the world's poorest countries (per capita income of SDR 140), which is in the process of making a transition from a centrally planned economy to a more decentralized and mixed economy where market forces will have a more important role to play in the production and distribution process. A number of important steps have already been taken toward this end, and many more reform measures are expected in the coming months.

The economic performance of The Lao People's Democratic Republic in 1987 was mixed because of adverse weather conditions. Agricultural production and electricity generation both declined, due to a severe drought. As a result, real GDP declined by 3 percent after increasing by an average of over 7 percent in the

previous three years. In spite of the adverse consequences of the drought on agricultural food production, inflation was reduced to 6 percent in 1987 from 35 percent in 1986 and 115 percent in 1985. The favorable price performance was a direct result of improved supplies arising from the liberalization of domestic trade and higher imports of consumer goods. The balance of payments situation remained fragile, with reduced sales of electricity in 1987. While the trade deficit widened, it is important to note that this reflected in part the absorption of larger external assistance. It is estimated that around 45 percent of total imports is aid related. The external debt service ratio (13 percent in 1987) has remained moderate so far, although the burden is likely to increase in the future. The authorities have met all their external debt service obligations. External reserves equivalent to eight weeks of imports are adequate at present although it may become inadequate, as imports increase partly as a result of the liberalization process and accelerated investment under the new Plan.

The role of macroeconomic policies was not so important in the past since decisions on production, pricing, distribution, imports, and exports were largely centrally determined. However, macroeconomic policies will have a more important role to play in a liberalized system.

The budgetary position showed considerable improvement in 1986-87, though budgetary analysis is made difficult by a number of shortcomings in the fiscal account. The central government budget had no access to domestic financing, and the deficit was financed from foreign assistance. The improvement in the budgetary position is attributable mainly to an increase in revenues and a decline in the expenditure/GDP ratio. It is important to note that the deficit to GDP ratio for the Lao People's Democratic Republic is not comparable to other countries since foreign grants are treated as part of the financing item; and therefore, a somewhat larger deficit is necessary to absorb foreign aid.

Monetary policy will have to pay greater attention to controlling inflation. Financial programming at this stage of the Lao economy is likely to be difficult, since a number of structural changes are taking place. For example, there are considerable uncertainties surrounding the effect on the demand for money of greater price stability, the increased domestic trade, and the replacement of barter trade with cash transactions. However, as the economy is transformed, the authorities will need to devise effective instruments to control credit and liquidity growth.

The Second Five-Year Plan (1986-90) approved since the last Article IV discussions has four main objectives--to raise and

diversify agricultural production, to promote manufacturing production, to improve domestic and international transportation, and to raise the level of education. The initiation of the New System of Economic Management (NSEM), and the government budget allocations, will be the key instruments for achieving the plan objectives.

The key elements of the new strategy are: greater reliance on market mechanism for price determination, exchange rate reform, the decentralization of decision making, and liberalization of trade. The following are among some of the measures already introduced to achieve these objectives:

1. Pricing reforms

In June 1987, a fundamental pricing reform was introduced. Under the reform, prices of all commodities are to be market determined. Regional differences in prices would be allowed. Prices are to be negotiated freely between the different parties to the transaction without any official interference. However, some prices will remain under price control until such time as public sector salaries are adjusted upward. Agricultural procurement is now reformed, not only to allow market pricing but also to replace barter with cash procurement.

2. Exchange rates

As part of the general pricing reforms, the authorities have also decided to adopt more realistic exchange rates. In September 1987, the authorities decided to reduce the number of official exchange rates from seven to four as a step toward eventual unification of exchange rates. In addition, a more realistic exchange rate of KN 370 per US\$1 is now applied for inward remittances and part of imports and exports. As a result of these actions, some 15-20 percent of official transactions with the convertible area now take place at market-related rates. The kip has appreciated in the parallel market from KN 450 per US\$1 in July 1986 to KN 390 per US\$1 in October 1987, reflecting stronger confidence related to lower inflation and economic liberalization.

3. Decentralized decision making

Under the NSEM, public enterprises are accorded much greater autonomy to make decisions on production, investment, employment, salaries, and pricing. Annual production plans are drawn up by the enterprises themselves. The enterprises are now expected to arrange financing for their own operations, and their operating surpluses will be subject to profits tax. Enterprises which make losses over extended periods will either be wound up or will undergo management change. At the end of 1987, some 75 percent

of state enterprises were granted autonomy, and it is expected that the scheme will be extended to all public enterprises by the end of this year.

4. Tax reform

In order to mobilize resources, a far-reaching tax reform has been introduced. The new tax system will tax the profits of public enterprises in the same way as private sector profits. The turnover tax for the services sector has been modified, and tax on logging has been introduced. The authorities have indicated their willingness to implement a number of suggestions by the staff, including suggestions for export taxes for absorbing windfall gains and to impose personal income tax on public sector employees. The Lao authorities intend to keep the tax system under review so as to make further improvements.

5. Trade liberalization

Reforms were introduced in 1987 to facilitate interregional trade and to achieve greater involvement of the private sector and cooperatives in domestic and international trade. Prices of traded goods are freely negotiated, and restrictions of domestic movements of goods were abolished. Cooperatives and private traders can now freely transport and trade in goods not contracted by state enterprises. Domestic trade has increased substantially as a result of this reform, and there is improved supplies in all regions of the country, with the result that the inflation rate has come down considerably from the previous years.

The reforms introduced by the Lao authorities have been bold and far-reaching, since these changes involve major deviation from the socialist system of economic management. Much more remains to be done. The authorities intend to monitor and review the results of the initiatives already undertaken, with a view to making further changes. In their efforts to improve economic efficiency through major structural changes, my authorities are seeking Fund assistance under the structural adjustment facility. Such assistance could not only strengthen the adjustment efforts under way in the Lao People's Democratic Republic, but it could underpin such efforts with adequate resources, so that reasonable growth can also be achieved during the period of adjustment.

Finally, I wish to join my authorities in commending the staff for the excellent report with which my authorities are in broad agreement. In a country like the Lao People's Democratic Republic, Article IV missions also serve a technical assistance role, and my authorities are appreciative of the staff's recommendations for reform in various areas.

Mr. Marcel said that as Mr. Reddy had recalled, the Lao People's Democratic Republic was one of the poorest countries of the membership. At the present juncture, the country deserved the Board's attention and encouragement, as the authorities were taking promising first steps to modernize and open up the economy. As noted by the staff, the reforms introduced in the tax system and the public enterprise sector needed to be followed through and consolidated. Likewise, more decisive actions remained to be carried out in respect of the price mechanism and the exchange rate regime.

Nevertheless, he shared the staff's view that recent developments pointed in the right direction, Mr. Marcel added. The prospect of a structural adjustment or enhanced structural adjustment arrangement could now be considered more seriously, along with the necessary technical assistance that would facilitate the continuation of structural reforms. He looked forward to a closer relationship between the member and the Fund, and would appreciate any staff comment on the status of the forthcoming Fund mission, scheduled for March.

Mrs. Walker made the following statement:

It is clear from the report before us as well as from Mr. Reddy's statement that the authorities of the Lao People's Democratic Republic have taken some steps in the direction of liberalizing their economy during the past year. Such steps are important in the process of improving the medium-term economic outlook for the country as well as removing some of the obstacles to economic development. In particular, the reforms in the price system, the public enterprise sector, and the exchange rate are notable steps in the direction of a more market-oriented and thus responsive economy. We welcome these reforms as a first step in an evolving process of change in the economic management of the economy.

Continuing progress on a number of fronts will be necessary if the economy is to improve fundamentally. First, we believe that the New System of Economic Management remains an important process that should be developed further and all of its provisions adopted. In this context, we welcome the inclusion of all state enterprises in this system, but look forward to the resolution of the remaining key issues. I would highlight the need to examine the role and process of economic planning and the rehabilitation or closing of loss-making enterprises.

We welcome the reorganization and liberalization of the domestic trading system, particularly the fact that trade is based on price and volumes negotiated between trading organizations, and that prices for procurement are negotiated freely. The liberalization of prices in general is a very positive development; however, subsidies remain, particularly on commodities sold to civil servants, as does an unrealistic exchange

rate, both of which, in our view, continue to hinder rational pricing. Therefore, we urge the authorities to make needed changes in these policies to complement the price liberalization.

The budget for 1988 will be another critical area for attention. It will be interesting to learn about the full impact of the tax reform. In addition, we note the problems with the tax reform and we hope that the authorities might consider in making in their review some revisions along the lines suggested by the staff. It is unfortunate that current expenditure is expected to increase owing to salary increases for civil servants. In this connection, efforts to reduce the size of the civil service will be increasingly important.

Monetary policy must be tightened as well, specifically through a reduction in credit allocation to the public sector enterprises. We welcome the plans to strengthen the banking system, although no specific mention is made of what action is being taken. We also agree that monetary policy should be part of a well-designed financial program, but understand that this may be difficult in light of the inadequate information available for such an analysis. Therefore, we urge the authorities to develop the necessary statistics.

We noted that the staff found the Second Five-Year Plan's targets for growth and domestically financed investment to be somewhat unrealistic. In addition, it is troublesome that the World Bank had such problems with the particular emphasis of the investment program, and we encourage the authorities to take Bank views into consideration when reformulating priorities for domestic investment.

The simplification of the exchange system that has taken place since January 1988 is welcome. However, we also agree with the staff that a unified exchange rate for all foreign trade transactions, with all transactions channeled through the Bank for Foreign Trade, combined with a liberal import system, will be critical to achieve overall improvements in the economy.

Overall, we recognize that while the authorities of the Lao People's Democratic Republic have taken a number of important steps toward economic liberalization, the economy clearly remains controlled in a variety of ways. Such controls must be lessened, the public sector reduced, and further liberalization must take place before the economy can begin to benefit from even the measures taken thus far. In particular, this would include additional pricing reforms, including a unification of the exchange rate, further export diversification, liberalization of the foreign trade regime, and removal of obstacles to foreign investment. We would expect to see movement in all of these areas.

Mr. Vasudevan made the following statement:

We are in general agreement with the main thrust of the staff appraisal and can therefore go along with the proposed decisions.

From the staff report as well as Mr. Reddy's statement, one is bound to be struck by the range as well as the depth of the policy measures that the Lao authorities undertook in the course of 1986-87. We commend them for moving toward greater liberalization of prices and trade, improving the management of state enterprises, and changing the tax and exchange systems, in spite of the setback received in the form of the decline in real GDP in 1987. We would encourage the authorities to persevere in these reform efforts so that the improvement in economic efficiency that would occur as a result helps to attract larger inflows of capital from abroad for financing long-term plans of economic diversification. From Mr. Reddy's statement, it appears that the process of reform will continue, together with reviews and monitoring of the results of the several initiatives that the authorities have already undertaken.

Considerable improvements have already been made in fiscal policy in the past year, notwithstanding the shortcomings in the fiscal accounts. The authorities' open-mindedness in viewing fiscal issues is well documented in the report. We welcome the indication that the staff's suggestion about export taxes and exemptions from personal income tax will be adopted immediately; one would expect them to find a place in the 1988 budget. The authorities are also prepared to consider, in their future reviews of the tax system, the staff's other suggestions for a flat profit tax rate, together with accompanying commodity and excise taxes, and simplified import tariffs. These two suggestions may not be so readily included in the 1988 budget, in light of the absence of any clear view about their revenue and resource allocation implications vis-à-vis those of the authorities' proposed differential profit taxes and import taxes. It is important to note that the authorities want to keep their expenditures under control and scrutiny and to abstain from use of bank credit to finance the budget deficit.

It is in the areas of money and credit that the authorities are likely to face major challenges, given the introduction of the New System of Economic Management (NSEM), the liberalization of prices and trade, and the depreciation of the official exchange rates for some transactions. The gradual replacement of barter by cash transactions in procurement would be an additional factor contributing to an increase in monetization. In these circumstances, both the authorities and the staff see, rightly indeed, the need to control credit demand, especially from state enterprises, in order to keep inflation under check. While this

general objective is definitely worth pursuing, the specifics should have been spelt out in the report, because this is an area in which the authorities' experience--as one can expect in any centralized system of decision making--would be relatively limited. It is possible that technical assistance may need to be provided in this respect by the Fund, if the authorities so desire. The present situation also suggests that, given the lack of historical behavioral relationships, the Fund staff should be flexible in negotiations concerning the macroeconomic and structural adjustment program as part of the structural adjustment facility.

Concerning the external sector, it is important to recognize that external financing needs would go up sharply, in view of the liberalization of prices and trade and in view of the large planned increase in public investments in 1988-90. It is not clear how far the medium-term scenarios have considered the effects of the liberalization measures that have already been undertaken and that are being considered. In any case, the current account deficits in respect of the convertible area would rise sharply from \$14 million in 1986 to an annual average of \$37 million in the period 1988-90. If the impact of liberalization is sharper than presently expected, there would be a need to provide for a cushion in the form of a buildup of reserves. This point may need to be considered in future negotiations on the structural adjustment arrangement.

Finally, we would support the authorities' moves to seek Fund assistance under the structural adjustment facility, not only because of the ongoing reform process but also because reasonable economic growth and diversification would be rendered possible only through structural adjustment, with large external financial support.

Mr. Yamazaki made the following statement:

Since 1986, the Lao authorities have introduced a number of policy measures to reduce some of the deep-rooted rigidities and distortions that have accumulated in the economy. The positive development in the policy area encompasses the fundamental structural reform of the domestic price and fiscal system as well as reorientation of the exchange rate policy. As Mr. Reddy stated, the authorities' effort to move toward a market-oriented and liberal system is commendable; nevertheless, the vulnerability of the economy and the weakness of the external situation underscore the need for further implementation of structural measures complementary to the ongoing reform. In this context, I am in broad agreement with the thrust of the staff appraisal,

which incorporates appropriate recommendations to the authorities. Therefore, I will limit myself to touching upon several aspects for emphasis.

First, although the initial objective of the Second Five-Year Plan to promote agricultural production seems to have been formulated adequately, I agree with the Bank staff's view that priority should be given to transportation projects rather than to irrigation projects under the present circumstances of the increase in rice production. I would also like to associate myself with the staff view that the growth objective of the Second Five-Year Plan should be reviewed and that the financing strategy in the Plan should be revised.

Second, the increased autonomy of state enterprises will no doubt contribute to the efficient allocation of resources. In this respect, I welcome the authorities' decision of introducing the New System of Economic Management to every state enterprise. To underpin the new policy, managerial skills and accounting practices should be improved. More restricted credit policy for state enterprises would also buttress the success of the NSEM.

Third, with respect to fiscal policy, there is a clear need for reform on both the revenue and expenditure sides. In this regard, the proposal for the new tax system is a welcome first step, although I would like to endorse the staff's suggestions for the attainment of a more adequate revenue structure. On the expenditure side, I would like to urge the authorities to reduce the remaining subsidies not only for purposes of fiscal consolidation, but also for the efficient mobilization of domestic resources. In this respect, I would be interested in any new information on the 1988 budget that the staff might have obtained after the consultation discussion.

Fourth, the favorable price developments stemming from the liberalized trade policy should be maintained. For this purpose, the banking sector has to play a more active role and the interest rate needs to be raised so as to send state enterprises proper signals on the scarcity of resources.

Fifth, on the exchange rate policy, I welcome the partial elimination of multiple exchange rate practices. While this is not a major breakthrough, the authorities are moving in the right direction and are encouraged to take bolder steps. In this connection, I would like to urge the authorities to rectify the unrealistic representative rate with the Fund and would welcome the staff's comments on the progress made in the discussions with the authorities, who have indicated their intention to propose a new rate.

Sixth, the authorities will certainly benefit by improving their financial data, particularly on balance of payments, government finance, and monetary statistics. I would encourage the staff to continue to provide technical assistance in that area.

Finally, this chair will support the authorities' request for a structural adjustment arrangement, provided that the authorities embark on a structural adjustment program strong enough to achieve a viable balance of payments situation.

With these remarks, I would like to support the proposed decision.

Mr. Comotto said that he joined in welcoming the reforms that had been undertaken by the Lao authorities, particularly the liberalization of domestic trade and prices, and the start in introducing a tax system and in reforming the parastatal sector.

However, it was something of an understatement to say that there was a long way to go; indeed, it was unclear how far the steps taken already went, Mr. Comotto continued. Important exceptions had been made to price liberalization, and the price system continued to be distorted by subsidies. Exchange arrangements remained complicated, and the predominant exchange rate continued to be seriously misaligned. The staff noted that the extent of the reform of state enterprises under the New System of Economic Management was unclear and that many of the new system's provisions had to be put into practice. The reform of fiscal policy, however commendable in itself, was in danger of merely formalizing existing practice or at least only remonetizing it. Monetary policy had yet to be defined and its absence threatened to destabilize the policy of liberalization in other areas by allowing an unconstrained expansion and misallocation of credit. Finally, with the helpful exception of the greater role played by the "sociétés mixtes," external policies remained highly restrictive.

The selective nature of the reforms that had been observed so far, on balance, left some doubt in his mind that the Lao authorities were entirely convinced of the need for a fundamental and comprehensive recasting of economic policy, Mr. Comotto remarked. In many ways, they seemed to be merely trying to patch up their somewhat idiosyncratic economic system at whatever points it was in danger of imminent collapse. As a result, he feared that they were likely to suffer the worst of both worlds.

He was also concerned that despite the authorities' apparent enthusiasm for maintaining a comprehensive economic administration, they were unable to compile much in the way of reliable data, Mr. Comotto said. Such a deficiency was likely to derail even the most committed attempts at reform. In that respect, it was particularly important to remember the need to construct a well articulated and reliable medium-term framework within which to operate a program to be supported under the structural adjustment

facility. A certain level of available statistical information was also an obligation of Fund membership, and the statistical issues outlined in the staff report were therefore a matter of concern in their own right. Similar concerns extended to the failure to settle overdue maintenance of value obligations to the Fund and to set a more realistic representative exchange rate for the kip. There was a very long way to go before an acceptable structural adjustment arrangement could be negotiated. Therefore, he supported the staff view that, if use of Fund resources was contemplated, the Lao People's Democratic Republic should revert to the standard 12-month consultation cycle.

In conclusion, Mr. Comotto urged the authorities to broaden and deepen the scope of their economic initiatives. He welcomed their interest in technical assistance from the Fund, particularly given their receptiveness to some of the suggestions made by the recent staff mission.

Mr. Wenzel said that he agreed with the staff appraisal. The only comment that he wished to make was to note that the adoption by the authorities of a new economic strategy held out the promise of substantial improvements in overall performance. At the same time, he encouraged them to vigorously pursue their reform objectives and to adopt the additional steps recommended by the staff. In that respect, he underlined especially the need to supplement reform measures with sufficiently restrictive financial policies because domestic and external stability were critical to sustainable and successful liberalization.

In conclusion, Mr. Wenzel stressed that the adoption of the staff's recommendations would make an important contribution to facilitating discussions on the use of Fund resources by the Lao People's Democratic Republic and the eventual approval by the Board of an arrangement under the structural adjustment facility.

The staff representative from the Asian Department said that although firm dates had not yet been established, it was intended that a staff mission should visit the Lao People's Democratic Republic in March for further discussion on a structural adjustment program.

The salary increases contemplated for 1988 were not of any significant magnitude in real terms, the staff representative added. They were basically intended to offset any reduction of subsidies introduced as part of the 1988 budget. No details were yet available on the 1988 budget.

As for the reform of the banking system, the authorities were thinking along the broad lines of a split of the existing state bank into a central bank and a commercial bank, the staff representative noted. In the view of the authorities, such a system would help strengthen monetary control. In that connection, the difficulties associated with financial programming at a time of significant structural change and rapid monetization of the economy could not be belittled. At the same time, however, the authorities'

track record over the years indicated clearly that monetary control needed to be tightened, and tightened substantially. The state bank needed to be given the power to control credit and to use that power.

The medium-term balance of payments projections in the staff report had been based on a preliminary assessment of the liberalization efforts that had been made so far, the staff representative said. Those efforts were of too short a duration to permit a firmer assessment. However, even on present assumptions, the medium-term scenario showed that there would be a large financing need and also a need for substantial debt relief from the nonconvertible currency area.

The issue of the representative rate had featured in the discussions with the authorities, the staff representative noted. In November 1987, the authorities indicated that they would be ready to cooperate with the Fund in order to establish a new representative rate and settle the overdue kip obligations in respect of the maintenance of value obligations. However, both those issues were matters for decision by the Council of Ministers, which had not yet reached a decision.

In conclusion, although a start had been made in reforming the Lao economy, much more needed to be done, the staff representative said. As pointed out in the staff report, the needed action would be the focus of the forthcoming round of discussions with the authorities.

Mr. Reddy said that he welcomed the general recognition that the steps taken by the authorities were in the right direction and that they were important steps. He had taken note of the comments with respect to areas in which further reforms had been suggested as being required. As Mr. Yamazaki had observed, the vulnerability of the economy did in fact increase the urgency of additional reform.

The Acting Chairman made the following summing up:

Directors welcomed the first steps made toward a more liberal and market-oriented system and noted, in particular, the liberalization of many prices and the freeing of domestic trade, the provision of greater autonomy to state enterprises, the introduction of a new tax system, and also the partial reform of the exchange system. These steps would need to be fully implemented and supplemented by additional measures aimed at further improving the tax system, increasing financial discipline of the public enterprises, controlling credit expansion, reducing price distortions, and establishing a rational exchange system. Directors noted that such policy measures would figure among the main issues in further discussions with the authorities toward the development of a program that could eventually qualify for Fund support under the structural adjustment facility. Progress in the area of economic policy would need also to be accompanied by substantial improvements in the coverage and quality of economic statistics.

With regard to fiscal policy, Directors expressed the view that the new tax system represented considerable progress, but that a number of its elements required further adaptation, along the line suggested by the Fund staff, to reduce distortions and also to simplify the system. There is also an urgent need to restrain expenditures and in this context to remove subsidies and reform the civil service. Concerning monetary policy, Directors voiced concern about the persistent rapid expansion of credit, including especially to state enterprises, and expressed the view that the monetary authorities should be empowered to implement an appropriate financial program and that this should be supported by a more flexible interest rate policy. With respect to pricing and exchange rate policy, Directors stressed the need for a reduction of the large subsidies and urged the authorities to adopt a realistic and uniform exchange rate for all foreign exchange transactions.

Directors also advocated the rapid development of the export sector through reorientation of plan expenditures and investments in line with the World Bank's recommendations. They also noted that the need for external financing, debt relief, and concessional assistance was likely to increase as a result of the economic reform policies.

Directors urged the authorities to eliminate the existing multiple currency practices and to cooperate with the Fund in establishing a more realistic representative exchange rate.

For the time being, it is expected that the next Article IV consultation with the Lao People's Democratic Republic will be held on the bicyclic procedure.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to the exchange measures of the Lao People's Democratic Republic subject to Article VIII, Sections 2(a) and 3, and in concluding the 1987 Article XIV consultation with the Lao People's Democratic Republic, in the light of the 1987 Article IV consultation with the Lao People's Democratic Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Lao People's Democratic Republic continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV, as described in SM/88/26 except for the multiple currency practices and the exchange restrictions arising from bilateral payments agreements with Fund members, which are subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund

encourages the authorities of the Lao People's Democratic Republic to simplify the exchange system, and in particular to eliminate the multiple currency practices as well as the restrictive features of the bilateral payments arrangements with Fund members.

Decision No. 8791-(88/19), adopted
February 10, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/18 (2/8/88) and EBM/88/19 (2/10/88).

3. NEPAL - TECHNICAL ASSISTANCE

In response to a request from the Nepalese authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/88/51 (2/5/88).

Adopted February 10, 1988

4. EXECUTIVE DIRECTORS - SECRETARIAL ASSISTANTS - GRADING

The Executive Board approves the recommendation for amendments to the rules for the grading of Secretarial Assistants to Executive Directors as set forth in EBAP/88/32 (2/8/88).

Adopted February 10, 1988

5. EXECUTIVE DIRECTOR - REPATRIATION

The Executive Board approves the recommendation concerning repatriation benefits for Mr. Romuáldez as set forth in EBAP/88/33 (2/8/88).

Adopted February 10, 1988

6. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 87/107 (7/23/87), are approved.

Adopted February 8, 1988

5. EXECUTIVE DIRECTOR - REPATRIATION

The Executive Board approves the recommendation concerning repatriation benefits for Mr. Romuáldez as set forth in EBAP/88/33 (2/8/88).

Adopted February 10, 1988

6. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 87/107 (7/23/87), are approved.

Adopted February 8, 1988

7. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/88/31 (2/8/88) is approved.

8. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/88/35 (2/9/88) is approved.

APPROVED: October 26, 1988

LEO VAN HOUTVEN
Secretary

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