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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/45

3:00 p.m., March 23, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	A. G. A. Faria, Temporary
	R. Comotto, Temporary
	D. A. Woodward, Temporary
	S. King, Temporary
	Jiang H.
C. H. Dallara	E. L. Walker, Temporary
	J. Prader
	E. V. Feldman
	A. M. Othman
	M. B. Chatah, Temporary
G. Grosche	B. Goos
J. E. Ismael	
A. Kafka	J. Hospedales
M. Massé	D. McCormack
	N. Toé, Temporary
	I. A. Al-Assaf
	L. Filardo
	C. Noriega, Temporary
J. Ovi	M. Fogelholm
	G. Pineau, Temporary
	G. P. J. Hogeweg
	I. Sliper, Temporary
G. Salehkhou	
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	S. Yoshikuni
S. Zecchini	S. Rebecchini, Temporary

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant
M. J. Miller, Assistant

Also Present

IBRD: P. Eigen, Latin America and the Caribbean Regional Office. Juan Candela, Director, Banco Central de Reserva del Perú; Marco Balarezo, Embassy of Peru. African Department: A. T. B. Taylor. European Department: P. Beaugrand. Exchange and Trade Relations Department: E. Brau, J. P. Pujol. External Relations Department: N. Worth. IMF Institute: O. B. Makalou. Legal Department: T. M. C. Asser, R. H. Munzberg, J. V. Surr. Research Department: A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; D. Folkerts-Landau, P. Isard, H. C. Kim, D. J. Mathieson. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; M. P. Blackwell, J. E. Blalock, P. J. Bradley, P. B. Clark, W. L. Coats, Jr., R. W. Furstenberg, D. Gupta, Y. Ozeki, O. Roncesvalles, B. von Numers. Western Hemisphere Department: J. Ferrán, Deputy Director; H. M. Flickenschild, M. E. Hardy, J. E. Leimone, R. K. Rennhack. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: P. E. Archibong, E. Ayales, K.-H. Kleine, R. Morales, A. Ouanes, P. D. Péroz, P. Péterfalvy, D. C. Templeman, J. E. Zeas. Assistants to Executive Directors: N. Adachi, J. R. N. Almeida, A. A. Badi, H. S. Binay, F. El Fiky, J. Gold, P. Gorjestani, S. Guribye, M. A. Hammoudi, C. L. Haynes, M. Hepp, G. K. Hodges, A. Iljas, K. Kpetigo, V. K. Malhotra, T. Morita, D. V. Nhien, A. Rieffel, S. Rouai, G. Schurr, C. C. A. van den Berg, D. A. Woodward.

1. SDR ALLOCATIONS - FURTHER CONSIDERATION

The Executive Directors continued from the previous meeting (EBM/88/44, 3/23/88) their consideration of a staff paper on the further consideration of an allocation of SDRs (SM/88/49, 2/24/88; and Cor. 1, 3/21/88). They also had before them a paper on the issue of resource transfers in the SDR system (SM/88/9, 1/7/88).

Mr. Jiang said that the important implications of and need for a new SDR allocation had been discussed extensively by the Executive Board on previous occasions and had been summarized at EBM/88/44 by speakers who favored an allocation. A new argument had been added in the latest staff papers, namely, that the SDR system could also facilitate the funding of a policy of coordinated exchange market intervention among major countries. Recent experience gave a good indication of the expanded role of the SDR in the international monetary system, and he hoped that that experience would help to reduce the resistance to a new allocation. An agreement on a new allocation had not yet been reached despite the increased global need for reserve supplementation and the existence of broad support for an allocation by a large number of member countries. He continued to favor a substantial allocation in the hope that agreement on an allocation would be reached as soon as possible.

Mr. Othman stated that the case for an SDR allocation had again been well made in the latest staff papers and by previous speakers. The staff papers clearly showed that the global ratios of non-gold reserves to imports, an important indicator of the demand for reserves, had increased from 17 percent in 1970 to about 27 percent in 1987, while the ratio of SDRs to imports had remained constant, at 1 percent, during the same period. Furthermore, the share of SDRs in non-gold reserves had dropped substantially, from 8.4 percent in 1972 to 4.3 percent at the end of 1987.

Those developments ran counter to the basic objectives of the Articles of Agreement, which called for making the SDR the principal reserve asset in the international monetary system, Mr. Othman continued. Unlike other forms of reserves, the SDR mechanism had not been activated in line with the increase in the global need for reserves.

Given the recent developments in the world demand for non-gold reserves, as reflected in the substantial increase in the ratio of non-gold reserves to imports shown in Table 1 in SM/88/49, and assuming that that trend would continue, a meaningful SDR allocation was called for, Mr. Othman considered. That conclusion was particularly true if the access of many countries to the financial markets was taken into consideration.

As SM/88/49 indicated, the developing countries that had access to private financial markets had to rely excessively on relatively unstable and costly borrowed resources in the absence of an SDR allocation, Mr. Othman noted. At the same time, developing countries that had limited access to private financial markets suffered from forgone domestic absorption because of the absence of SDR allocations.

At the same time, Mr. Othman went on, other groups of member countries might also have a need for allocations in the light of the most recent developments in the foreign exchange markets, in which SDRs had been used extensively. In addition, an allocation would not only reduce the cost of reserve accumulation through the increase in owned reserves resulting from the allocation, but would also reduce the deflationary effects of the adjustment policies being implemented by many member countries. Finally, an allocation could be combined with measures to strengthen incentives for holding SDRs, as was suggested in the staff paper, if such measures could be helpful in reaching a conclusion on an allocation.

Mr. Fogelholm commented that his chair had consistently favored a moderate and early allocation of SDRs during the fourth and fifth basic periods. He agreed with the staff's conclusions in SM/88/49; they warranted a resumption of SDR allocations.

A strengthened role for the SDR in the international monetary system should be sought on two levels, Mr. Fogelholm considered. First, new allocations would improve the efficiency and stability of the current reserve system, thereby improving the performance of the overall international monetary system. The ratio of past cumulative SDR allocations to total non-gold reserves had declined steadily since 1982; that trend should be reversed to ensure a larger role for the SDR as a reserve asset. A larger share of owned reserves would reduce the cost of reserve holdings, especially for member countries that had limited access to international financial markets.

Second, it was important to make the reserve characteristics of the SDR more attractive in order to increase the voluntary use of the asset, Mr. Fogelholm continued. Reducing the rigidity in SDR transactions would increase the flexibility and liquidity of the system and make the SDR generally more useful to member countries. That issue had been discussed by the Executive Board in 1987, and his chair continued to support all measures aimed at increasing the usefulness and attractiveness of the SDR.

In that connection, it was useful to note that, since the previous discussion on allocations, the Fund had negotiated and concluded SDR buying and selling arrangements with a number of member countries, including four members of his constituency, Mr. Fogelholm remarked. Those arrangements had considerably increased the flexibility in the use of the SDR, as evidenced by, inter alia, the fact that, for some time, there had been no need to use the Designation Plan. On another occasion, the staff could usefully provide additional information on those arrangements and, even more important, assess their implications for the designation system.

Mr. Hogeweg noted that no new views seemed to be emerging from the present discussion. The views of his chair on SDR allocations had not changed since the previous discussion of the matter. He continued to favor, in principle, annual allocations of a moderate magnitude as a contribution to the maintenance of the allocation mechanism with a view to dealing with possible future problems in the supply of reserves. The cost of holding reserves could not be used as an independent argument in favor of allocations. Of course, non-gold reserve holdings had increased sharply in 1987. In view of the requirement for an allocation of the existence of a long-term global need for reserve supplementation, allocations at the present stage would have to be small.

The staff had rightly stressed that it was desirable for countries to maintain a certain share of their reserves in SDRs, Mr. Hogeweg commented. In so doing, countries could fulfill their general obligations as participants in the SDR Department. Of course, that conclusion should not mean that an increase in other reserve assets--and, hence, a decline in the share of SDRs in global non-gold reserves--should be seen as an argument for new allocations to restore the share of SDRs to its previous level. Using that argument could lead to conclusions on the appropriateness of new allocations that were opposite to conclusions based on the global need for reserve supplementation.

The background paper on the issue of resource transfers in the SDR system was useful, Mr. Hogeweg commented. In that paper, the staff correctly noted that allocations would lead to permanent resource transfers only to the extent that the SDR interest rate was not competitive or required a risk premium. However, in his view, that line of reasoning applied to any kind of credit for which a rate of interest was paid. The creation of monetary reserve assets should be seen as an entirely separate issue from the issue of the extension of credit by one group of countries to another.

Mr. Pineau recalled that during the previous discussion on a possible allocation, his chair had made a long statement on the suitability of the SDR as a reserve asset in the context of the debt situation and on the need to ease some operational constraints with a view to enhancing the SDR's attractiveness. He wished to comment on a few recent developments that had strengthened the case for an allocation.

In 1987, non-gold reserve holdings had increased sharply, owing mainly to the active intervention policy of major industrial countries, Mr. Pineau continued. As a result, the ratio of reserves to imports for all member countries had increased to nearly 27 percent at the end of 1987. It was premature to conclude that that higher level of reserve holdings would prevail in the future. Nevertheless, the repeated commitment by major industrial countries to promoting greater exchange rate stability might well have a bearing on the desirable level of reserves. Accordingly, if nothing were done to enlarge the stock of SDRs, the share of that asset in total reserves would shrink even more rapidly than in the recent past. As a result, the function of the SDR in the international monetary system would become not only marginal, but also meaningless, something that would obviously be difficult for his authorities to accept.

A related argument in favor of allocations was based on the role that SDRs could play in facilitating the mobilization of resources for exchange market intervention, Mr. Pineau remarked. At the present stage, his authorities did not have a firm view on direct intervention with SDRs. However, they considered that reserve currency swaps funded through SDRs, along the lines of the recent agreement between the United States and Japan, could be helpful; in particular, the use of SDRs as a hedging mechanism could induce major industrial countries to further explore that kind of arrangement.

As to the question of the carrying cost of reserve holdings, the new estimate presented in the staff paper clearly illustrated the lasting inability of many member countries to recover normal access to financial markets, Mr. Pineau said. The recent growing instability of capital markets was likely to aggravate that trend and further complicate the adjustment process. In that connection, the protracted process of assembling financing packages and the emergence of arrears on a wide scale were significant developments. Of course, an allocation could not substitute for adequate conditional financing by commercial banks and multilateral institutions. Nonetheless, whether it was designed as a safety net or a buffer stock, an allocation could go a certain way toward restoring conditions conducive to a more orderly adjustment process.

SM/88/9 contained interesting views on the argument that the SDR system might imply a permanent transfer of resources, Mr. Pineau commented. The staff paper confirmed that the net use of SDRs carried a cost, and that net interest payments prevented any transfer of resources as long as they were market related. Therefore, the competitiveness of the SDR appeared to be an integral part of its reserve asset nature. The only factor that could involve some form of transfer of resources had to do with the risk of nonpayment of interest. He hoped that that category of arrears would be kept to the minimum, so that a risk premium would remain unwarranted. His authorities continued to support fully a resumption of SDR allocations.

Mr. Prader made the following statement:

> The systemic implications of the steep discounting of developing country debts in the secondary markets and of the general preference for more stable exchange relationships among the major currencies justify, from different angles, a reinforcement of the present reserve system, to which an allocation of SDRs could make a meaningful contribution. Therefore, I wish to propose two studies of the possibility of an allocation, first, as part of the ongoing search for complementary debt solutions and, second, as a means of supporting the SDR's role as the principal reserve currency in the system. As Mr. Kafka has noted, the objective of making the SDR the principal reserve currency is still stated in the Articles of Agreement.
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> Recent experience with debt conversion schemes shows that a country can approach banks with such schemes only if it has enough reserve resources either to buy back its debt at a discount, or, like Mexico, to collateralize its reconverted debt

obligations. An allocation of SDRs, which would permit countries to have access to such schemes with a lower threshold in terms of reserve constraints, could very well make such schemes more attractive and lead to their greater use. An allocation would thus help to end the stalemate under which the market value of sovereign debt falls ever lower without any prospect of correcting the situation through either debt accumulation or debt reduction. The benefits that the SDR could have for this situation would be considerably enhanced if an allocation were based on the principles of conditional SDR use; this approach would both increase the amount of SDRs available to the debtor countries, and link the Fund's support of debt conversion schemes to formal commitments on appropriate adjustment policies.

Even if interest in the pursuit of debt conversion does not continue to spread, larger and more stable reserve holdings by debtor countries are still greatly needed to bolster market confidence that outstanding debts will continue to be serviced, paving the way for the future resumption of financing flows. The tables in the staff paper show that, taking into account past dollar fluctuations, the reserve holdings of countries with recent debt problems are still 20-25 percent below their 1980 level, a gap that I do not expect can be narrowed soon if minimum growth and import levels are to be maintained. In other words, an allocation of SDRs could meaningfully contribute to breaking up the circular relationships now afflicting the debtor countries, in which the banks' unwillingness to lend additional money to these countries has caused a loss of confidence in their debt-servicing capacity owing to nonfulfillment of these initial financing conditions, which, in turn, has made the banks even less willing to lend to those countries.

In this context, SDR allocations offer compelling advantages over other, more radical debt problem solutions, as allocations involve limited costs and are injected into the system without requiring any substantial transfer of resources between groups of countries. As to the carrying costs of holding SDRs, I do not understand the contention discussed in the staff paper that the cost savings of holding SDRs would be offset by a higher cost of privately borrowed resources or a weakening of countries' adjustment efforts. The Board's latest seminar discussion on the debt strategy clearly showed that meaningful implementation of adjustment and restoration of creditworthiness under the present strategy of growing out of debt, both depend on additional financing. This condition, which is not being met at present, could be partly fulfilled through an SDR allocation that would support, not postpone, adjustment, and reduce--rather than increase--the cost of other sources of reserve supply.

The issue of resource transfers within the SDR system is especially relevant to the present debate on the merits of an international facility for debt conversion. All proposals to this end require the owners of the facility to make substantial resource transfers to be shared among creditor banks and debtor countries. The staff paper on this issue concludes that, unlike current debt relief solutions, the SDR system does not impose on its participants any significant permanent transfer of resources, a feature that could be further strengthened by improving the reserve asset characteristics of the SDR and by further developing voluntary transfers in SDRs.

In any event, I propose that the staff undertake further study of the prospects for creating an international debt facility. The study should give due consideration to the global benefits obtainable from an SDR allocation designed to support the continued improvement of countries' debt-servicing capacity at a limited and temporary cost to all participants in the system. Greater availability of SDRs would have the benefit of supporting the widespread preference for a more stable exchange relationship among the major countries, an issue that the staff appropriately relates to the steady decline in the ratio of non-gold reserves to the stock of external assets held by the commercial banking system and to the intensity of recent crises in the financial markets.

The need for periodic and coordinated intervention to support the stability of the emerging system requires no further demonstration and was recently officially endorsed by the standing arrangement between the United States and Japan to sell SDRs in order to finance symmetrical interventions. This arrangement, together with the arrangements that two members of this constituency and a growing number of other countries have concluded with the Fund, demonstrate how the liquidity of the SDR system can be considerably improved. Even more important, the arrangement between Japan and the United States sheds a brighter light on the global need, which the SDR could potentially meet, to support the principal reserve currency's role in the present system with prolonged financing and increased exchange stability. I noted that Mr. Templeman has interpreted the U.S. and Japanese standing arrangements in a somewhat different manner, but, over time, as economic circumstances change, the U.S. position might well be similar to ours.

The events of 1987 show that the present system is exposed to constant risks of market disturbances that, given their unpredictable turbulence and magnitude, fully justify a decision in favor of an allocation to demonstrate that the Fund is prepared to adopt any confidence-building measures that may be needed.

Mr. El Kogali said that the staff paper presented an entirely convincing case for a resumption of SDR allocations. Rather than restate the arguments in favor of allocations, he wished to highlight the obvious implications of failure to take positive action. There could be no dispute that the share of SDRs in non-gold reserves had declined markedly, to 4.3 percent at the end of 1987, compared with 6.5 percent at the end of the third basic period in 1981 and a peak of 8.7 percent in 1972. The staff had estimated that, in the absence of any further allocations, that share could decline to 3.9 percent by 1991, assuming that the relationship between non-gold reserves and imports was maintained at the average for the period 1973-87. As a result, and in the absence of countervailing action, the role of the SDR would be greatly reduced and was likely to become increasingly insignificant, an outcome that should be clearly spelled out for the coming meeting of the Interim Committee. In reporting matters to the Interim Committee, the Executive Board should explicitly recognize the fact that the original intentions and spirit of the Articles of Agreement were not being adhered to.

The Executive Board was obliged to reaffirm the spirit of the Articles of Agreement with respect to SDR allocations, Mr. El Kogali continued. Accordingly, attention should be focused on two areas. The first was the restoration of the historical relationship between cumulative SDR holdings and non-gold reserves. In other words, the Executive Board should recommend restoring the share of SDRs in non-gold reserves to the level that had prevailed at the end of the third basic period or to some other agreed level. Second, the Executive Board should ensure that, at a minimum, the prospective decline in the share of SDRs in non-gold reserves did not actually occur. That step would require some additional allocations as indicated by the staff.

In considering the question of allocations, it was useful to bear in mind the recommendations that had recently been made by the Institute of International Finance, whose members included the major international banks that were the principal participants in the global financial system, Mr. El Kogali said. The Institute had been forthright in its support of an allocation amounting to SDR 21.4 billion. The basis for that recommendation was similar to the arguments contained in the present staff paper. The Institute had shown that all participants stood to benefit from an allocation; there would be no adverse consequences for the global economy.

The Deputy Director of the Research Department said that the staff continued to believe that a satisfactory solution to the debt problem required, inter alia, sustained adjustment by debtor countries and appropriate amounts of conditional liquidity. In its paper, the staff had meant to stress that growth-oriented adjustment could be facilitated by an adequate mix of owned and borrowed reserves, and that adjustment could, in certain circumstances, be hampered by inadequate access to reserves as well as by excessive liquidity.

The staff fully agreed with Executive Directors who had stressed that greater stability in the international monetary system hinged principally on a reduction in the existing financial imbalances, particularly those among the largest countries, the Deputy Director of the Research Department commented. In that connection, the staff did not see an SDR allocation as a substitute for underlying adjustment, but rather as a complement to it. In other words, the staff had argued that the SDR could have a useful role to play in obtaining greater stability.

The staff representative from the Research Department recalled that the question had been raised whether the data in the staff paper on the cost of holding reserves were representative of market costs. In making its calculations, the staff had attempted to compare its estimates with other published sources--such as the OECD and the BIS--on interest rate spreads. The staff could provide additional information on a bilateral basis showing how the spreads were roughly comparable across all the reporting sources.

The Chairman made the following summing up:

> Even if we have not found sufficient support for a new SDR allocation, this was a useful exchange on the issues relating to SDR allocations during the remainder of the fifth basic period, which extends through 1991. The staff papers that have been considered today have argued that, in light of recent developments in the international monetary system, SDR allocations can yield benefits for all members, although the benefits accruing to individual countries would naturally differ. The staff, in addition to its analysis of global reserve developments, has also reflected on the broader systemic issues of whether the SDR system could be used to facilitate the efforts to achieve greater exchange rate stability, to limit the dependence of some countries on borrowed reserves in a period of increased asset price variability and financial market disturbances, and to reduce the high cost for certain countries of generating reserves through current account adjustments.
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> Executive Directors offered a number of views on the potential role of SDR allocations under current international monetary conditions. Many Directors favoring a resumption of SDR allocations argued that such allocations could improve the performance of the international monetary system by reducing the costs of acquiring reserves, reducing reliance on borrowed reserves, and facilitating the financing of exchange market intervention. They observed that much of the recent growth of reserve holdings has been concentrated in a few major industrial countries that have undertaken extensive exchange market intervention, and that many other countries have experienced much less growth and even declines in their reserves. In their view, such exchange market intervention is unlikely to provide a stable source of long-term reserve growth. Since a large number of countries still lack adequate access to international financial markets, it was also noted by a number of Directors that these countries have been forced to generate additional reserves through current account

adjustments, often involving import compression, that exceed the adjustments required to establish a sustainable balance of payments position. They were concerned that such adjustments would create a deflationary bias in the international economy. Furthermore, they argued that the international monetary system could be regarded as functioning well only when all groups of countries had adequate access to reserves.

In addition, SDR allocations were viewed by some Directors as a means of reducing the dependence of the reserve system on borrowed reserves. Events in major bond and equity markets during 1987 indicated both the growing integration of international financial markets and the speed at which major financial market disturbances can spread. An increase in the share of SDRs in non-gold reserves would raise the proportion of owned reserves in the system and thereby provide a "safety net" for a reserve system dependent on borrowed reserves. It was also suggested by some Directors that the SDR system could provide a nonmarket source of funding for coordinated exchange market interventions. Indeed, the recent swap arrangement between Japan and the United States was mentioned as an example of such a possibility. Reference was also made to SDR swap arrangements between the Fund and member countries.

Other Directors who did not favor a resumption of SDR allocations argued that the reserve system was generating adequate liquidity and that, as a result, there was no long-term global need for reserve supplementation. During 1987, holdings of non-gold reserves for all major country groups expanded, and ratios of reserves to imports reached or approached their highest values since 1970. Some of these Directors felt that existing resources for exchange market intervention were adequate and did not require augmentation via SDR allocation. Also, while some countries have not had access to borrowed reserves through financial markets, this was viewed as a problem of creditworthiness for particular countries that should be addressed through the use of conditional liquidity rather than the creation of unconditional global liquidity. Moreover, they argued that the liquidity needs of such countries are being incorporated into Fund-supported adjustment programs, which pay due attention to growth; as such, there would not in their view be any deflationary bias associated with reserve accumulation. In addition, they were concerned that prolonged net use of SDRs by some groups of the countries was inconsistent with the monetary character of the SDR. Some Directors also noted that, while the SDR system may be able to serve as a "safety net" for the reserve system, the issue of how such arrangements would be structured required further consideration.

Directors generally agreed with the analysis presented in the background paper, which argued that permanent resource transfers arise in the SDR system only to the extent that the SDR interest rate is uncompetitive or that holding SDRs is risky. Most Directors agreed that the SDR interest rate is broadly competitive with the yields on other reserve assets, and that holding SDRs does not involve significant risks. Several Directors expressed support for measures to enhance the liquidity and usability of the SDR. A few Directors also indicated a willingness to consider reintroducing a reconstitution requirement, although some others felt that this would counteract progress in improving the SDR's usability.

Most Executive Directors continue to favor a resumption of SDR allocations, and among that group I found broad support to restore, perhaps progressively, the share of SDRs in non-gold reserves. But I have not detected basic changes in the positions of those who oppose allocations. Thus, I will report to the Interim Committee that the broad support needed for an allocation to take place does not exist at the present time.

I now wish to add a few personal remarks.

In the present situation, I think that we all recognize that the international monetary and financial system is vulnerable. Allow me to highlight two aspects of this vulnerability.

First, speculation leading to disorderly conditions in exchange markets could start again. The immediate impact that such developments can have on stock markets is now well known. The experience of last fall is still fresh enough in our memories to make any further elaboration unnecessary. Instead of reopening at this stage the debate on the "long-term need for reserves," about which I recognize members have questions, should we not stand ready to act quickly and decisively to ensure that adequate exchange reserves are available, when needed, to counter these most dangerous developments?

Second, the situation of the heavily indebted countries adds to the pertinence of this kind of action. The argument that the international financial institutions and the markets are able to provide adequate exchange reserves to heavily indebted countries, while theoretically correct, is far from being confirmed by our day-to-day experience. Since 1981-82, impressive adjustment, equivalent to 8 percentage points of GDP, has been achieved on average by the heavily indebted middle-income countries, but still leaves a situation of perhaps greater vulnerability for these countries in their adjustment efforts because of the general withdrawal of commercial banks from voluntary lending. This is a structural change in the international financial system which makes it more difficult for many countries

> to finance reserve additions. Whether this is a permanent structural change only time will tell, but for the present, many countries are finding it more difficult to meet their growing need for reserves.
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> For these reasons, I consider that an immediate SDR allocation of, say, SDR 20-30 billion would certainly be in order, over the next two years. I would suggest--especially after the world economic outlook discussion we will have in a few days--that you put to your authorities a very pragmatic judgment on this question: not to set out to establish a new doctrine or criteria for the future, but to address a very specific immediate situation of uncertainty, if not danger.

Mr. Sengupta recalled that the G-10 report on the role of the Fund discussed the concept of the so-called safety net, which had been endorsed by all the industrial countries. The SDR could be used as a safety net, and the Chairman apparently was moving in the direction of favoring that approach. On another occasion, it would be interesting to learn the reaction of industrial countries to that concept of the safety net and the Chairman's proposal for allocations of SDR 20-30 billion.

The Chairman recalled that he had been impressed by the concept of a safety net as discussed during the preparation of the G-10 report in 1985. That concept could be further considered in coming months in discussions on the future of the international monetary system.

Mr. Goos said that he did not fully agree with some of the arguments that the Chairman had made in his summing up. The Chairman had referred to the recent exchange market turbulence and to the possible need in the future for additional liquidity to meet the intervention needs of member countries. However, during the recent exchange market turbulence, there had not been any great difficulty in mobilizing the liquidity needed for exchange market intervention. After all, swaps had been made; the United States had had recourse to its swap agreement with Japan that had included SDRs. But even that aspect of the arrangements that had been made had not been absolutely necessary. Therefore, he saw no compelling need for allocations on the grounds of providing liquidity for exchange market intervention. In any event, the need for liquidity for that purpose was not a problem of a global nature; it was concentrated in the major industrial countries.

In considering debt-servicing problems as a part of the rationale for new SDR allocations, it was important to bear in mind the particular problem of capital flight, Mr. Goos considered. Billions of dollars were held abroad by the nationals of debtor countries. Accordingly, it was clear that needed liquidity was available; the real need was to tap that liquidity. That need suggested that there might be something wrong with the adjustment efforts of the countries concerned; those efforts might have to be strengthened in order to reverse the capital flows and improve the liquidity situation of those countries.

His opposition to an allocation at the present stage was not based on a dogmatic interpretation of the relevant Articles of Agreement, Mr. Goos said. In considering the appropriateness of an allocation at the present stage, there were good reasons for concentrating on the question whether or not a global need for reserve supplementation existed, and he felt strongly that considerable reserves were available. He had not excluded the possibility that the situation might change, and he agreed that the establishment of a global need was to some extent a matter of judgment. The difficulty he had had in mind when making his earlier comments was that the additional arguments that were presented in the staff papers were not related to the question of the global need for reserve supplementation. His chair felt compelled to counter those arguments and, in so doing, it felt that it was perhaps being backed into a corner. Once his chair was in that position, and should its judgment regarding the need for reserve supplementation change, his chair might find it difficult to get out of that corner and might well wish to have some arguments at its disposal that had not been rejected previously. In the present situation, it did not help to have the staff continue pushing new arguments to show the advantage of an SDR allocation.

The Chairman remarked that he, like Mr. Goos, considered that the SDR was a monetary instrument. However, the efforts by debtor countries to undertake strong and successful adjustment efforts was a problem that was very difficult to deal with under the present system, as there was typically a gap between the undertaking of adjustment by members and the recovery of their creditworthiness. The reward for a successful adjustment of the restoration of creditworthiness frequently took a long time, and, in those cases, the role of the SDR as a monetary instrument could be of some help.

Mr. Comotto said that he agreed with Mr. Goos that a number of arguments advanced by the staff in favor of an allocation were not relevant to the criteria for an allocation that were set out in the Articles of Agreement. Other Directors had made the same point, particularly with regard to the cost and benefits of an allocation. That counterargument should be reflected in the summing up.

The Executive Directors concluded their discussion.

2. LIQUIDITY POSITION AND FINANCING NEEDS - REVIEW

The Executive Directors considered a staff paper reviewing the Fund's liquidity position and financing needs (EBS/88/49, 3/2/88).

The Deputy Treasurer stated that the staff's projection of uncommitted borrowed resources at end-1988 (of SDR 1.6 billion) included SDR 0.5 billion of investments of borrowed resources. That amount could, however, be on the high side, in particular because there would be no resources invested at end-1989 from borrowing under the short-term agreement with the Saudi Arabian Monetary Agency, which was to be fully repaid in November 1989. Nevertheless, the staff had tentatively assumed at the present time that there might be some investment of resources drawn under the 1986 borrowing agreement with Japan that would be available at end-1989 to finance enlarged access purchases. The figure of SDR 0.5 billion could also include some supplementary financing facility repurchases that will have been received and held by the Fund prior to making the corresponding repayments to lenders.

Mr. Prader made the following statement:

The staff's well-balanced assessment of the Fund's liquidity and financing needs points to the conclusion that for the time being, the overall liquidity situation of the Fund is quite comfortable, and may remain so in the near future. However, every member of the Board will agree that it is premature to seek a definitive conclusion, because much depends on the future role of the Fund in assisting its members.

The outcome of discussions under way concerning the revitalization of the extended Fund facility, a revised compensatory financing facility, and the incorporation into Fund-supported programs of external contingency mechanisms, could well increase the amount of resources required for the Fund to meet its members' demands for assistance until existing liquidity is exceeded by a sizable margin. This chair cannot share the views of those who would like to provide the additional resources needed to finance these programs out of borrowing operations by the Fund, not only because of the asymmetrical effect on member countries' resources, but also because my authorities have always regarded the Fund's external borrowing as a temporary expedient. Only a large quota increase could relieve the institution's financing needs, should additional financing be required.

I have two remarks on the staff paper. First, I would like to mention my authorities' concern about the 40 percent increase in overdue repurchases during the last six months. That problem has already been addressed by the Board in a separate meeting, but little progress has been made toward resolving it.

Second, the staff paper raises the issue of uncertainty over the usability of the currencies of a number of countries owing to balance of payments problems. The magnitude of the problem seems to be such that the staff had to revise downward the stock of usable currencies by one quarter, in a sense reflecting a trend in which favorable balance of payments positions are concentrated in fewer and fewer countries. So long as those countries are willing to take on a growing share of Fund financing, this situation seems to pose no threat to the Fund's financing operations. The ease with which operational budgets are approved by the Board, in particular, indicates that the Treasurer's concern is not shared.

I would be interested in the staff's views on the implications of that trend, and some clarification about the seriousness of the situation. Does the staff expect to encounter any difficulties in financing the operational budget.

Mr. Ismael made the following statement:

I fully share the staff's view, expressed on page 12 of EBS/88/49, that there are considerable uncertainties under the present circumstances about major factors which have a substantial impact on the Fund's liquidity position and financing needs. First, there are considerable uncertainties regarding the world economic outlook and the potential demand for Fund resources. The staff's projections in the past have tended to be generally more optimistic than the actual outcome. In addition, the assumptions surrounding the current world economic outlook projections are tenuous and contain considerable uncertainties. The second major area of uncertainties relates to the prospective changes in Fund policies with regard to the extended Fund facility and the special facilities. These changes would have direct effects on the demand for Fund resources, and the uncertainties make it difficult to judge clearly the adequacy of the Fund's liquidity.

The staff's projection of the demand for the Fund's resources shows that the introduction of the structural adjustment facility and the enhanced structural adjustment facility, which are better suited to members' needs, may lead to a considerable increase in the demand for resources from those facilities, and a shift away from the use of the Fund's general resources. A similar increase in the demand for the resources of the extended Fund facility and the special facilities, in my view, would also occur if changes were made with a view toward meeting the needs of prospective members. The staff papers on the extended Fund facility (EBS/88/7, 1/20/88) and on the external contingency mechanisms (EBS/88/30, 2/12/88) have indicated the range and magnitude of the needed additional resources. In the circumstances, the Fund's liquidity position would need to be strengthened by a substantial quota increase; otherwise, the Fund would be forced to make additional borrowings. It is unfortunate that today's discussion is being held without the Board having a better picture of the prospective changes regarding policies on the extended Fund facility and the special facilities, including their liquidity implications.

With regard to the supply of the Fund's resources, I note that the stock of both ordinary and borrowed resources is expected to decline substantially in the next two years. While the decline may be brought about in part by temporary factors, such as the need to finance the mismatch in repurchases under the enlarged access policy and the supplementary financing facility, it is important to keep the Fund's resources, especially ordinary resources, at a level compatible with the financing needs of its members. In this respect, I regret that despite the continued uncertain economic situation, especially for developing countries, outstanding Fund credit is expected to decline to less than SDR 26 billion by end-1989, compared to more than SDR 35 billion at the end of 1985. I continue to believe that the relatively low use of Fund resources in recent years has been attributable largely to tighter conditionality, and the conservative application of the guidelines on access.

With those observations, I support the staff's conclusion that in the next two years, the Fund's liquidity position would remain broadly adequate to accommodate members' requests for its resources under the policy on enlarged access, as well as under the special facilities. As pointed out by the staff, the projections should be revised in due course, taking into account the outcome of the Executive Board discussions on the revitalization of the extended Fund facility and the introduction of external contingency mechanisms.

Mr. Toé made the following statement:

I note from the staff paper that the Fund's liquidity position is broadly satisfactory and that it is likely to remain so, barring unforeseen adverse developments in the external positions of member countries. I note also that, on the assumption of the maintenance of the status quo with respect to Fund policies on the extended Fund facility and the special facilities, and to the present mixing ratios of ordinary and borrowed resources under credit tranche purchases, no new borrowing arrangement would be required to accommodate drawings on the Fund's resources through 1989.

However, the staff stresses the fragility of the projections, and highlights a number of uncertainties that have a bearing on the Fund's liquidity position. Those uncertainties pertain to the situation of countries whose external positions are currently deemed to be strong, to the ongoing reviews of the compensatory financing facility and the extended Fund facility, and to the discussions on the external contingency mechanisms. In the circumstances, I agree that the situation should be monitored closely in order to detect and prevent any adverse developments in the Fund's liquidity position that may impair the Fund's ability to meet members' requests for use of its resources. In that regard, I share the staff's view that revised projections based on the outcome of the Board discussions on the extended Fund facility and the external contingency mechanisms should be presented to the Board for information or consideration, if need be.

Beyond those uncertainties, the best way to ensure a long-lasting improvement in the Fund's liquidity position is to expand substantially its ordinary resources through a significant increase in quotas. As this Chair has stated on previous occasions, the fact that the Fund is, and should remain, essentially a quota-based institution should not be lost sight of.

A substantial increase in Fund quotas takes on added urgency in view of the large net transfers of resources that are scheduled to take place in 1988-89. According to staff projections, those transfers will amount to SDR 3 billion in that period. Even after taking into account the amount of assistance that can be provided under the structural adjustment facility and the enhanced structural adjustment facility, there will still be net transfers of about SDR 1 billion in 1988, and a matching only in 1989. Although the logic of the revolving character of Fund resources should be kept in mind, the transfer of resources from countries in dire need of financing in this less than hospitable financial environment will send a wrong signal to the financial community--a development which would ill serve the catalytic role of the Fund. A significant increase in quotas will enable the Fund to expand its financial assistance to these countries, and thus reverse the net transfer of resources that is taking place.

Mr. Hogeweg made the following statement:

My authorities agree with the staff appraisal that the Fund's liquidity position as it has developed since the Board's last review does not give rise to immediate concerns. However, the uncertainties surrounding the Fund's liquidity position in the coming period, which were already present at the last review, have only increased. It has to be recognized that the present favorable situation, in which the currencies of virtually all industrial countries are considered usable in the operational budget, will not last forever, especially in view of the balance of payments difficulties experienced by some of them, as reflected in the world economic outlook. Balance of payments difficulties may also affect the availability of borrowed resources. Furthermore, we have noted that the staff is now of the opinion that the level of arrears to the Fund is such that it has begun to exert a material impact on the Fund's liquidity. These concerns imply that there is no reason for complacency.

Furthermore, the staff projections of course do not take into account the possible impact on the Fund's liquidity position of the revitalization of the extended Fund facility and the creation of external contingency mechanisms, which are currently under discussion; the Chairman's recently issued statements provide some tentative indication in this respect. On this occasion, I would only like to stress that the effects of those issues on the Fund's liquidity should certainly be taken into account, in full detail, by the time final decisions on them are made.

We understand that the question of drawdowns under the agreement with the Saudi Arabian Monetary Agency will be further reviewed in the next six-monthly report. From what my authorities can judge now, they are open to the staff suggestion to limit further use of funds under that agreement, in view of the undesirability of financing the Fund through very short-term borrowings.

Mr. McCormack made the following statement:

This chair agrees with the staff assessment that at present and for the foreseeable future, the Fund's liquidity position is broadly satisfactory. The amount of resources available appears to easily accommodate the projected demand for the use of the Fund's resources under current lending policy practices. However, in light of the ongoing discussion on changing the Fund's lending policies, as well as the general high degree of risk in the current economic environment, my authorities perceive considerable uncertainty regarding the Fund's liquidity position as presented in the staff paper. There is a need, therefore, to keep the situation under close review.

The Fund's stock of usable ordinary resources has increased by SDR 2.1 billion since July 31, 1987, reflecting net reflows due to the large volume of repurchases, including early and advance repurchases by some members. As a result, the Fund's holdings of usable resources could be regarded as relatively high, and that the immediate prospect is for further large-scale inflows to the Fund resulting from the continuing high level of repurchases. Nevertheless, the stock of ordinary resources is expected to decline substantially in 1988 and 1989, largely owing to the use of ordinary resources to repay the Fund's borrowing.

Continued adjustment to the stock of usable currencies by a factor of one quarter to take into account the existing downside risks to those currencies seems appropriate. However, my authorities are somewhat concerned about the growing stock of overdue obligations, the treatment of which over the forecast period may not adequately capture the risk that they pose to the availability of the Fund's resources. Since the last liquidity review, overdue obligations have increased by SDR 0.4 billion, to a total of SDR 1.4 billion, an increase from 3.4 percent of adjusted usable ordinary resources to 4.5 percent. Furthermore, the forthcoming repurchase obligations of the members that at present have protracted overdue repurchases are about SDR 1.1 billion, of which more than half are coming due in 1988. My authorities note, however, that net outstanding repurchases are maintained at their current level of SDR 1.4 billion over the forecast period. While this chair is not suggesting that their treatment be necessarily altered, I would note that they represent an added element of risk that does not appear to be accounted for in the staff paper. My authorities agree with the staff that overdue repurchases have reached a magnitude that is material in relation to the Fund's stock of usable resources, and would like to emphasize that their significance may rapidly increase in the near future.

This chair notes with interest that the large net repurchases to the Fund that have taken place over 1987 are projected to decline substantially in 1988 and 1989, from SDR 4.6 billion in 1987, to SDR 1.7 billion and SDR 1.3 billion, respectively, in 1988 and 1989. The large net inflow of funds was a result of heavy borrowing by member countries in the early 1980s, and other factors outside of the Fund's control. Nevertheless, the reversal of that trend is welcome evidence that the Fund will continue to play an integral role in the international economy, by providing essential financial assistance and promoting much needed adjustment.

Mr. Hospedales made the following statement:

This chair continues to find the greatest difficulty in reconciling, on the one hand, the failure of debtor countries, and for that matter, many other developing countries, to reignite a process of sustainable and durable growth, with, on the other hand, the broadly satisfactory state of the Fund's liquidity position. What is more, a further improvement can be expected in the Fund's liquidity position owing to the prospective large-scale inflows to the Fund resulting from a continuing high level of repurchases, on the basis of the staff's analysis and assumptions. For that reason, my authorities cannot agree more with the Managing Director's statement on the extended Fund facility that such a position is not appropriate for the Fund at this juncture.

Hence, the Fund is now in a solid position to take appropriate steps to enhance its role in promoting the requisite adjustment policies among its members, through projected financing under the structural adjustment facility and the enhanced structural adjustment facility, the completion of the review of the compensatory financing facility and the extended Fund facility, and the possible establishment of an external contingency mechanism. The Fund is also in a good position to deal with the downside risk to higher levels of investment and growth stemming from the persistence of uncertainties in the world economic situation. However, to continue and to intensify the process of adjustment, completion of the Ninth Review of Quotas will become increasingly pressing and urgent, if recourse to further exceptional borrowing is to be avoided. It is therefore appropriate to initiate Fund policy action to facilitate the Fund's widely accepted objective of promoting growth-oriented adjustment, and supplementing domestic resources for productive investment.

That approach will surely enhance the willingness of a wide range of the Fund's membership, in particular the middle income members, to take early action to redress the present contractionary adjustment forces imposed on them by an adverse and inhospitable world economic environment. This contraction is evidenced in particular by the continuing high level of net transfer of resources from those countries. This chair looks forward, therefore, to continuing discussions on the review of Fund policies, including the present mixing ratios of ordinary and borrowed resources, so that the Interim Committee can agree, and, where necessary, provide appropriate guidance, on a framework of adjustment and financing broadly acceptable to the Fund's members.

Finally, current overdue financial obligations appear now to be exerting a material impact on the Fund's liquidity. This chair continues to regret that an overhaul of the Fund's procedures so as to resolve the adjustment problems of the small number of chronically overdue members has not yet begun. If such an overhaul of procedures is not achieved, the cooperative character of the Fund could be severely tested.

Mrs. Walker made the following statement:

It is clear from the staff report that the Fund's liquidity position, based on current policies, remains strong. In fact, the level of adjusted and uncommitted usable resources has increased since last July. My authorities are aware, however, that the specific liquidity outlook could change somewhat, depending on upcoming decisions by the Board on Fund lending policies, and that the liquidity implications of those decisions will need to be examined. However, even with those uncertainties, and with the stock of adjusted and uncommitted usable ordinary resources projected to decline marginally in the next two years, it certainly appears that the Fund has a broadly satisfactory liquidity position that will enable it to meet the needs of its members in the near term. While the total of the Fund's balance of payments financing may be less than total repayments in the near future, that is nothing to be ashamed of; rather, it is entirely natural, appropriate, and consistent with the revolving character of the Fund's resources, particularly in light of the heavy lending by the Fund in the 1980s, and because many of the Fund's borrowers in that period are not requesting further borrowings now.

As Directors have known for some time, the Fund will need to repay some borrowed resources with ordinary resources. That is unfortunate, and my authorities would have preferred an extension of the repayment schedule by the Saudi Arabian Monetary Agency (SAMA) to coincide with the extension of the drawdown period. In that regard, when the SAMA loan was last discussed, the Board was left with the impression that there might be scope for the Saudi authorities to further consider changing the repayment period. Does that still exist? If not, we support the staff's proposal regarding the further drawdown of that loan.

It also appears that the stock of ordinary resources is being drawn down in part owing to the failure of members to make repurchases to the Fund as scheduled. In that regard, I was interested in Mr. McCormack's point about the assumptions made in the Fund's financial statements about repurchases coming due. Furthermore, overdue repurchases doubled in amount in 1986 and 1987, and the staff believes that they are now at a level that is material in relation to the Fund's stock of usable resources. That makes the recent decision to add to the Special Contingent Account all the more important, and emphasizes the need to assure that the amounts in that Account reflect the underlying situation.

Mr. Al-Assaf said that the Saudi Arabian Monetary Agency had indicated that if Saudi Arabia's balance of payments position had improved, an extension of the repayment period might have been possible. Such an improvement seemed unlikely in the foreseeable future. On a related point, the Saudi Arabian Monetary Agency had no difficulty with the staff suggestion that the Fund make no further use of the loan after the end of 1988, provided it was informed of the Fund's intentions sufficiently in advance.

Mr. Salehkhou made the following statement:

The Fund's financial position is satisfactory, and is expected to remain comfortable through 1989. I am not sure how pleased we should be with that conclusion, which I feel is in sharp contrast to the severe financial constraints facing many developing member countries. An examination of the Fund's liquidity and the staff's projections regarding financing needs reveals a continuous decline in the outstanding volume of Fund credit resulting from net repurchases. Given the current effective access limits, averaging somewhat below 40 percent of quota on an annual basis, the familiar trend of net repurchases which commenced in 1986 is now projected to persist through 1989, at a time, ironically, when member countries will continue to face exceptional financing needs. One could thus easily succumb to the temptation of reaffirming that no major changes are needed with regard to the Fund's stance in balance of payments financing.

It is disquieting to note the staff's favorable projections regarding the Fund's liquidity position in the medium term. Such projections are based on the assumptions of unchanged quotas and unchanged policies with respect to access to various Fund facilities. I believe that any assessment of the adequacy of the Fund's liquidity, without due regard for the adaptation of the Fund's instruments and resources to members' genuine resource needs, would be meaningless.

If preliminary discussions on the ongoing reviews of the extended Fund facility, the compensatory financing facility, and the consideration of external contingency mechanisms in Fund arrangements, as well as the Ninth General Review of Quotas, are to be any indication, any reversal of the trend of net repurchases would seem next to impossible any time soon. Furthermore, it appears from the Board's preliminary discussions on the extended Fund facility and the external contingency mechanisms that the various proposals which have been presented are not likely to lead to any sizable overall increase in access to the Fund's resources, but at best to "more generous" financing under current access limits. Without any addition to the Fund's resources, the only possible implication is that tighter conditionality will be attached to Fund programs. I continue to believe that a substantial increase in quotas is vital if the Fund is to discharge its responsibilities effectively, and given the persistence of the debt problem and the existing uncertainties in members' external payments positions which might increase the demand for Fund credit.

I note from the staff paper that the decline in the Fund's ordinary resources in 1988 and 1989 will result mainly from their use in repaying the Fund's borrowing, which is expected to decline over that period. To the extent that the Fund would thus be required to rely more on its own ordinary resources, the repayment of borrowed resources is welcome. In that respect, an increase in quotas will contribute to restoring quotas as the primary source of the Fund's financing, and reduce recourse to borrowing, which should become the exception rather than the rule, in the Fund's operations. Increasing the Fund's reliance on ordinary resources would also contribute to the restoration of more appropriate lending terms for borrowing members.

Mr. Fernando made the following statement:

I have noted that the Fund's liquidity position continues to be satisfactory, and that no risk is perceived in the foreseeable future. On balance, my authorities think that the liquidity position is even better than the statistics show, as demand factors in the use of Fund resources are influenced by many variables. Therefore, for reasons of prudence, a high projection for the use of Fund resources is made, while the projections with respect to the supply factors are based on more certain assumptions, and thus are less likely to change. For instance, my authorities doubt that the drawings envisaged for 1988 and 1989 under the compensatory financing facility will actually be made. The recent recovery of primary commodity prices from historical lows, as well as the medium-term scenarios in the world economic outlook concerning world output, suggest that reduced demand for drawings under that facility could be expected.

On the basis of the current review of the extended Fund facility, the compensatory financing facility, and external contingency mechanisms, an adequate amount of finance would be in question were members to develop Fund-supported adjustment programs based on the attractiveness and usefulness of those facilities. This chair does not envisage a sudden and sharp increase in the demand for Fund credit because of those initiatives that would strain the Fund's liquidity position over the medium term. My authorities believe that quota-based resources should be the principal means of financing those facilities. The terms and conditions for facilities which are designed to address structural issues should be attractive, and, in that context, continued use of borrowed resources is unsuitable.

While a satisfactory liquidity position is a necessary condition for an international financial institution, maintaining a satisfactory liquidity position cannot be the objective in and of itself. Rather, the point is whether the Fund is meeting its obligation to provide balance of payments assistance on the required scale. As we feel that there is room for improvement in that respect, we have on previous occasions urged that average annual access under stand-by arrangements be increased, and that access limits be restored to their pre-1984 levels. An overliquid position, and continuing net inflows to the Fund, coexisting with the widespread payments imbalances of a large number of its members, might impair confidence in the Fund.

Mr. King stated that his chair judged that the Fund's liquidity position was comfortable, partly reflecting the normal cyclical pattern in the Fund's finances, as well as the growing importance of concessional financing through the structural adjustment facility and the enhanced structural adjustment facility. The discussions taking place on the various aspects of the Fund's lending policies could have implications for the liquidity outlook, but it was difficult to know what they would be until those discussions were at a more advanced stage. In that light, he would not address the issue of the mixing ratios, which would be dealt with in another context. He had, however, noted the staff's suggestions that there might be a case, in order to avoid exacerbating the mismatch problem, for making greater use of borrowed resources available on longer-term maturities. He was in favor of returning to that subject in the next review of the Fund's liquidity.

He noted that the staff's forecasts conventionally assumed no further rise in the level of arrears, Mr. King continued. The issue of arrears had arisen in the past during discussions of the Fund's income position before the introduction of burden sharing, and he believed that in that context the staff had assumed for forecasting purposes that countries which had been in arrears for more than a given period--say, six months--would continue to fail to meet their forthcoming obligations. That assumption might be the more plausible one for forecasting the Fund's liquidity position as well.

Mr. Goos stated that he shared the staff's conclusion that, given the Fund's present policies, the Fund's liquidity position remained broadly satisfactory. However, the standard assumption in the staff paper that present Fund lending policies would continue, severely limited the value of the liquidity analysis. The staff's proposal to present revised projections based on the outcome of the ongoing discussions on the Fund's facilities and policies was appropriate. However, before taking definitive decisions on those facilities and policies, it would be more important to get a clear sense of their possible liquidity implications, than to have the liquidity projections retroactively revised. The staff had provided some indications of those implications, but he wondered whether the proposals for the extended Fund facility and the external contingency mechanisms--particularly the latter--could be supplemented with more detailed information on the potential liquidity effects. That information ought to have been provided in the detailed framework of the statistical tables and liquidity ratios as presented in the annex to the staff paper.

As Mr. Hogeweg and other Directors had remarked, an increase in the use of Fund resources should be allowed only if the liquidity implications of such an increase had been established with a reasonable degree of accuracy, and if financing was firmly assured, Mr. Goos went on. In that context, it appeared that the scope for changing existing Fund facilities was severely constrained by the projected decline in the level of uncommitted borrowed resources. He was somewhat surprised by the indication in the Managing Director's statement on the extended Fund facility that even under current policies, there might be a need to consider an increase in Fund borrowing, especially if the 1984 short-term borrowing agreement with the Saudi Arabian Monetary Agency was not fully utilized; that indication differed from the staff's presentation. The issue would need to be decided at a later stage, but the need for further Fund borrowing ought to be assessed in the context of the outcome of the Ninth General Review of

Quotas, and also in the light of future decisions on the enlarged access limits. He believed that any consideration of increasing access to the Fund's resources should be guided by the principle that Fund lending would normally be based on quota resources.

He was seriously concerned about the substantial impact of existing overdue financial obligations on the Fund's liquidity position, Mr. Goos remarked, because it clearly underlined the critical importance of dealing effectively with arrears, and wherever possible, of strengthening the procedures for doing so. He welcomed the intention of the Ministers to discuss that subject at the forthcoming Interim Committee meeting.

Mr. Yoshikuni stated that the staff's estimates of the Fund's liquidity position for the period through end-1989 seemed reasonable and broadly appropriate. As the staff had pointed out, prospects for the Fund's liquidity position were more uncertain than usual, as those prospects were influenced, among other things, by the future evolution of the balance of payments positions of indebted countries. Moreover, the unknown outcome of the comprehensive review of the Fund's policy on the use of its resources under various facilities currently being undertaken, could also be considered to have added to the uncertainty. Should there be any change in the Fund's lending policy or in the world economic situation, the outlook for the Fund's liquidity position might well be different; that needed to be borne in mind, and in his view an optimistic attitude was thus inappropriate. Because of those uncertainties, his authorities believed that it would be advisable to accelerate the discussions on the Ninth General Review of Quotas, to the extent possible within the timeframe the Board had agreed on March 18, 1988 (Committee of the Whole on Review of Quotas Meeting 88/5, 3/18/88). His authorities believed that the Fund's resources should come from quota subscriptions.

Mrs. Filardo noted that the staff had concluded that the Fund's liquidity position was satisfactory, a conclusion with which many of her colleagues disagreed. The Fund's current financial position could be seen as somewhat paradoxical, given the limited access to capital markets some developing countries had encountered, especially those with high debt levels. It had been broadly recognized that commercial bank lending for balance of payments purposes had halted, and that the growth in the level of debt during 1987 was the result of the depreciation of the U.S. dollar, and of only a marginal increase in credit by other multilateral institutions; notably, only negative flows had been recorded from the Fund since 1986. While the staff recognized the uncertainty attached to the future use of Fund resources, they had projected that the amount of financing to be provided by the Fund over the period 1988-1989 would remain unchanged, even after considering the probable access to resources under the structural adjustment facility and the enhanced structural adjustment facility. Even though the volume of repurchases would continue to be large, ordinary resources would decline, as the repayment of borrowed resources was effected. In her view, the staff was thus being overoptimistic in assessing the Fund's liquidity position as satisfactory, especially at a time when the Board was making efforts to re-evaluate and enhance the debt strategy and the Fund's role in it.

As her chair had stated on various occasions, Mrs. Filardo continued, the key issue that remained was the constraint of access limits, and the self-imposed continuation of the guidelines and limitations on access to the Fund's resources. The Fund had thus chosen to rely on a restricted mix of ordinary and borrowed resources, without giving consideration to the need for an adequate quota increase. In that respect, she agreed with previous speakers that the Fund should be financed chiefly through quota-based resources.

As the Fund was still in the process of defining its role in the debt strategy, and as there was so much uncertainty with respect to the compensatory financing facility, the extended Fund facility, and external contingency mechanisms, it was premature to determine the adequacy of Fund liquidity at that juncture, Mrs. Filardo went on. In her view, it was contradictory to advise Governors that the Fund's liquidity was adequate, while concurrently pursuing an increase in quotas under the Ninth General Review. It might therefore be advisable to reserve a final judgment on the adequacy of the Fund's liquidity position until decisions on the Fund's facilities and lending policies had been agreed. Her authorities did not wish to send the wrong signals to Governors, or to give them the impression that the Fund had sufficient resources in the context of the current economic framework. Overdue financial obligations to the Fund were an indication of the problems of severe adjustment that some developing countries were facing.

Mr. Faria made the following statement:

> Along with other Directors, this chair finds that the level of the Fund's resources for 1988 and 1989 as projected in the staff paper is broadly satisfactory. In the short run, the total of adjusted usable currencies and SDRs in the General Resources Account (as of January 31, 1988), at SDR 31.3 billion, exceeds last year's level. At the same time, Table 1 of the Annex to the staff paper projects uncommitted ordinary resources (adjusted) at SDR 27.3 billion by the end of the year. However, I fully agree with the staff observation that projections this year are subject to a greater degree of uncertainty due to potential demand for resources related to the enhanced structural adjustment facility, the review of the compensatory financing and the extended Fund facility, and the introduction of external contingency mechanisms. I have also noted that the evolution of borrowed resources has been in line with expectations, but that they may also need to be re-examined as the end of the borrowing agreement with the Saudi Arabian Monetary Agency is approached, and in light of the development of new facilities. The liquidity and financing situation of the Fund at present appears to be adequate, but could be characterized, nevertheless, as cautious, because any substantive impact of the new facilities would be

brought to the attention of the Board only in the forthcoming liquidity projections in September 1988.

With the available resources, the Fund could play a much more effective role in assisting low-income countries facing severe financing difficulties. This chair is concerned that, during a period in which developing countries find themselves with unparalleled financial and debt problems, the Fund has assumed the role of net recipient of financial resources from them, contrary to its established role, while it is continuing to urge official and private creditors to increase their net capital flows to low-income countries. Table 3 of the Annex shows that the net use of Fund credit by developing countries was SDR -4.6 billion in 1987, and is projected to be SDR -1.7 billion in 1988 and SDR -1.3 billion in 1989, a substantial proportion coming from African countries.

That unsatisfactory situation has come about despite the maintenance of enlarged access policies during recent years. This chair had consistently argued that the Fund must do more if it is to be in a position to assist its low income-members, and in this connection, has emphasized that it is the implementation of guidelines on enlarged access by the staff, rather than the limits on access per se, that has constituted the bottleneck; that point was illustrated by the reduction in actual access from an average of 60 percent of quota in 1984, to an average of 43 percent in 1987, despite the maintenance of the enlarged access policy.

I am in broad agreement with the considerations put forward in the Managing Director's well reasoned statement on the discussion on the extended Fund facility, geared to expanding access to that facility. Likewise, I hope that the review of the compensatory financing facility, the establishment of external contingency mechanisms, and the activation of the enhanced structural adjustment facility, will begin to address in a serious manner the deep-rooted problems of developing countries, and immediately start to reverse the outflow of financial resources from them. But I must emphasize that the policy must be implemented in the same spirit as it was established.

The members of my constituency have stressed on previous occasions that the new facilities should not become a substitute for countries' access to existing facilities of the Fund. Were this to happen, there would be little addition to the flow of financial resources, but unfortunately the staff gives the impression, on page 5 of its paper, that it has projected lower gross disbursements under existing facilities in 1988 and 1989 because of prospective drawings under the enhanced structural adjustment facility. This chair would welcome some clarification of that point by the staff, as well as on the implicit reduction resulting from prospective drawings under the structural adjustment facility.

Mr. Al-Assaf made the following statement:

I concur with the staff assessment that the Fund's liquidity position appears broadly satisfactory. However, it is clear that changes in policies with respect to the mix of resources, access limits, and the introduction of a new facility could change the situation.

With respect to the trend in repurchases presented in the staff paper, I recognize that repurchases have exceeded purchases over the past two years, and that further such net reflows are in prospect. That trend is a natural outcome of the Fund's lending policy cycle, as Mr. McCormack and Mrs. Walker have pointed out; it is a function of the sharp and temporary increase in Fund lending in response to the 1982 debt crisis. But while the overall trend is for a reduction in net Fund credit, a net increase in Fund credit for a number of members will be experienced. For example, about one quarter of all members with outstanding Fund credit are projected to receive net financing from the Fund in the two-year period ahead. If disbursements under the structural adjustment facility and enhanced structural adjustment facility and Trust Fund repayments are taken into account, the number of members receiving net financing from the Fund could rise to approximately fifty.

A notable feature on the supply side is the significant decline in uncommitted borrowed resources. According to staff projections, by end-1989 the balance of uncommitted borrowed resources will be very small, and will consist entirely of the credit available under the 1986 borrowing agreement with Japan. While that does not indicate a need for further borrowing by the Fund, it would underscore the need to adopt a cautious stance with respect to changes in Fund policies until the issue of the quota increase has been resolved, and until a decision is made concerning overall Fund borrowing requirements in the years ahead.

Another notable feature on the supply side is the fact that an increasing number of industrial countries and other creditors that hold reserve tranche positions are expected to be in current account deficit positions in 1988. That has an important implication for the volume of usable currencies, as considerable uncertainties are introduced into the present situation regarding the continued usability of the currencies of a relatively long list of countries.

A third feature of the supply of resources is that overdue obligations have now exceeded the level of SDR 2.0 billion, and arrears are now beginning to exert a strong impact on the Fund's liquidity.

While the present situation seems broadly satisfactory, there are considerable uncertainties arising from the usability of some members' currencies, the scale and pace of the resolution of the problem of overdue financial obligations, and the likely outcome of the Ninth General Review of Quotas. There are also considerable uncertainties relating to the external environment and the demand for Fund resources, and it is therefore important that the Fund's liquidity position be gauged in the light of those considerations. I support Mr. Goos's proposal for conducting a detailed analysis of the impact on the Fund's liquidity of the proposals for the extended Fund facility and external contingency mechanisms.

In response to Mrs. Walker's question, it is correct that at the time of the extension of the withdrawal period of the 1984 borrowing agreement with the Saudi Arabian Monetary Agency there was the understanding that the Saudi Arabian Monetary Agency would be willing to extend the maturity period as well, if Saudi Arabia's balance of payments situation improved. I do not think that the prospect is bright for an improvement in the next two years. My authorities have no difficulties with the suggestion that the Fund make no further calls on the borrowing agreement with the Saudi Arabian Monetary Agency after end-1988.

Mr. Zecchini said that he agreed with the staff assessment that the Fund's liquidity position up to the end of 1989 appeared to be satisfactory. The uncertainties which surrounded that assessment were no greater than in the previous two years. In particular, the payments imbalances of countries whose currencies were included in the list of usable currencies were expected to decline, according to the last world economic outlook projections, and the economic conditions that would indicate a strong increase in the demand for Fund credit in the next two years were not apparent. Rather, greater use of resources under the structural adjustment facility and the enhanced structural adjustment facility could be expected, and those resources were not provided by the Fund per se, but by contributing countries, with little or no risk for the Fund itself.

The enhancement of facilities such as the extended Fund facility, and the compensatory financing facility, and the establishment of external contingency mechanisms, represented a new source of uncertainty in the liquidity projections, Mr. Zecchini continued. It was, however, premature to predict a liquidity squeeze arising from such enhancements, as there were no indications of a large pent-up demand for export or contingency compensation, or for extensive structural reforms that might be financed through the extended Fund facility. The liquidity issue should be framed in the context of the Ninth General Review of Quotas; a substantial increase in quotas could not reasonably be expected to be delayed beyond 1989, but if it were delayed, serious doubts would arise not so much about the Fund's liquidity position, but rather about the Fund's ability to carry out its mandate under normal economic conditions and on the basis of the cooperative spirit which should inspire its operations, which was a more important issue, in his view.

Mr. Sliper stated that he agreed with the emphasis in the staff paper on the uncertainties that surrounded the current liquidity projections. It was generally accepted that the current position was reasonably comfortable, but various factors could change the forecast quite substantively in the near future, especially the forthcoming discussion of the extended Fund facility. In particular, he believed that the assumptions about the impact on liquidity of the extended Fund facility that the Managing Director had outlined in his statement had been rather optimistic. The second element of uncertainty was the prospect of an increase in the number of members in arrears, as a number of Directors had already remarked. A third element was the balance of payments position of some industrial countries. All of those elements emphasized the importance of keeping the liquidity situation under close review, particularly when decisions were taken on changes to the Fund's facilities. Like Mr. Goos, he had been a little surprised at the implication in the staff paper, and in the Managing Director's statement on the extended Fund facility, that the Fund might have to increase the amount of its borrowed resources. His chair had been firmly of the view that the Fund should be primarily a quota-based institution, and that borrowing should only be resorted to in exceptional circumstances.

Mr. Feldman stated that he agreed that the Fund's liquidity position as described in the staff paper appeared to be satisfactory, but that that position ought to be reassessed in the light of the evolving decisions reshaping the Fund's facilities, in particular, the revitalization of the extended Fund facility, the redefinition of the compensatory financing facility, and the introduction of external contingency mechanisms. A substantial increase in quotas would be the most reasonable way of assuring that the demand for financial resources would be matched by adequate supply. The demand already existed with respect to countries that had embarked on growth-oriented adjustment programs and were encountering severe difficulties in gaining access to the voluntary credit markets. He also would like the staff to confirm the treatment given to arrears in the projections.

Mr. Chatah stated that the information provided by the staff indicated that the Fund's liquidity position was broadly satisfactory, despite elements of uncertainty. He had noted that repurchases would continue to exceed purchases in the following two years. Given a normal cyclical pattern of demand for Fund resources, periods of net repayment following periods of net lending might be expected. Fund resources should be made available to members in case of need, with the necessary safeguards, and taking into account the Fund's liquidity position. Over time, the Fund would be a recipient of net flows, but that should be a result of improved global economic conditions and a genuine decline in the need for Fund resources.

Mr. Fogelholm stated that he was in broad agreement with the overall staff assessment of the Fund's liquidity position, which he also found to be comfortable, at least in the short run. Of course, the current situation was clouded with many uncertainties, both with regard to the difficult external financial positions of many member countries, and to the potential changes in Fund policies presently under discussion. He trusted that the staff would follow those developments carefully. If warranted, a revised projection of the Fund's liquidity position should be presented to the Board, even before the next regular review of the Fund's liquidity. His chair believed that the Fund's liquidity should increasingly be based on ordinary resources, implying the need for a substantial and early increase in quotas.

Mr. Pineau stated that the Fund's liquidity position continued to be satisfactory, at least from a financial point of view; from an economic perspective, developments in 1987 had been less welcome. The Fund's financial withdrawal from the world economy had accelerated significantly, with a decline of SDR 4.6 billion in total outstanding credit, largely attributable to a bunching of repayments. At the same time, however, gross purchases had continued to decline, which was more worrying, to the extent that it represented a lessening of the Fund's financial involvement. In that connection, purchases projected for 1988 and 1989 seemed to be at the upper end of the range, with a forecast increase of 50 percent compared with 1987. That increase seemed to be on the high side, including as it did the potential impact of enactment of the enhanced structural adjustment facility. However, the projection did not take into account additional demand for Fund credit that might result from the current review of Fund facilities. Like Mr. Faria, he would be interested in any additional information that the staff might have on the impact on the Fund's liquidity of the enhanced structural adjustment facility. In order to assess better the uncertainty surrounding those projections, it might be useful if the original estimates, along with the actual results for purchases and repurchases, were included in the same statistical table in the future.

The Deputy Treasurer stated that, in presenting the paper on the Fund's liquidity position to the Board before the review of the Fund's facilities had been completed, the staff had believed that useful background would be provided on the Fund's liquidity position prior to the discussion on changes in the Fund's lending facilities, in particular, the extended Fund facility and the external contingency mechanism. The Managing Director had presented very preliminary estimates of the liquidity impact of the external contingency mechanism in his recent statement on that topic (Buff 88/57, 3/18/88). The estimates of the demand for resources that had been presented might be regarded as somewhat on the high side, as they incorporated assumptions about the timing of, and commitments for, arrangements that were above the average. For example, additional amounts under the external contingency mechanism for 1988 were estimated to be on the order of from SDR 1 to 3 billion, and for the extended Fund facility, of from SDR 2.5 to 4 billion (for ordinary resources) and from SDR 2.5 to 5.5 billion (for borrowed resources). From a sample of eight fairly large quota countries, the staff had assumed that each country would enter into arrangements under the extended Fund facility shortly, and for the maximum amounts available, which was perhaps not realistic, since it would take some time to put together a policy for a three-year program, and not all countries would receive assistance at the limits. Therefore, the impression that there would be a sudden and immediate impact on the Fund's liquidity in the event that the proposals for the extended Fund facility and the external contingency mechanism were implemented in new policies was a worst-case scenario. The staff had further assumed that borrowed resources would be an element in financing any revitalization of the extended Fund facility, because it was assumed that the enlarged access policy would continue. The mixing ratios between ordinary and borrowed resources could be changed to a certain extent, but after a certain point borrowing would become necessary. A totally different set of assumptions would have been necessary if it were assumed that borrowed resources would not be used in financing a revitalized extended facility.

A number of Directors had referred to the uncertainties underlying the staff's estimates, the Deputy Treasurer continued, especially regarding the supply of usable resources. He wished to stress that in the staff's view the uncertainties themselves did not imply that there would be a squeeze on the Fund's liquidity in the immediate future. Those uncertainties chiefly concerned the evolution of members' balance of payments and reserve positions over a more extended period. For example, one Director had raised the issue of whether the currencies of some countries might no longer be usable by the Fund and thus would be removed from the operational budget, and whether the 25 percent downward adjustment to the Fund's holdings of usable currencies was not relatively large. The downward adjustment to the level of usable currencies was a traditional and conservative practice of the Fund, and such a downward adjustment seemed reasonable because three important uncertainties were thereby taken into account. The first uncertainty was in connection with the deteriorating balance of payments on current account positions of members who had not however indicated to the Fund that they intended to draw on their reserve tranche or would request the Fund to stop using their currency, because of those balance of payments developments. Although no country with such a balance of payments situation currently in the operational budget had indicated to the Fund a possibility that it might request that its involvement in Fund financing be discontinued, provision needed to be made for such an eventuality in any case. The second uncertainty concerned the Fund's need to maintain working balances, at around 10 percent of quota, or the amount of currency that the Fund would need to pay the member in remuneration in the event that the member chose to take remuneration in the form of its own currency. The aggregate amount for that purpose was substantial. The third uncertainty was the margin for reserve tranche drawings, placed at SDR 1 billion, which appeared to be a bit on the high side in the light of recent experience. If the amounts reserved with respect to any one of those three uncertainties could be reduced, then there was the possibility of adjusting the amount of usable currencies upward, although he did not see any substantive reasons to do so at the present time.

Some Executive Directors had pointed to the apparent anomaly of the Fund's currently comfortable liquidity position, while the Fund was pursuing a substantial increase in quotas, the Deputy Treasurer went on. In the staff's view, there was no anomaly. While the Fund's liquidity position was currently adequate, it would deteriorate in the near future, given the projected demands on the Fund's resources and the rising volume of disbursements, especially because of the large-scale repayments of short-term borrowing that were due to be made with ordinary resources in the period ahead. The demand for Fund resources seemed at present to be on an upswing, as evidenced by the number of arrangements, as well as the volume of disbursements, which later would amount to SDR 5 billion in 1988, and was expected to be SDR 5 billion in 1989 as well, compared with SDR 3.3 billion in 1987. Furthermore, the current estimates of demand for Fund resources for 1989 were on the low side, as some countries could not indicate to the area departments what their intentions would be with regard to Fund financing in 1989. Furthermore, the need for a quota increase needed to be looked at over the medium term and not over the next year or so, and in the light of many factors, such as the role of the Fund in the 1990s. Under normal circumstances, had the quota review been completed by March 1988, the payments for the increases in quotas would normally be expected to flow to the Fund, beginning early in 1989, so that any emerging strain on the Fund's liquidity, which normally occurred late in the quota cycle, could be eased by the inflow of quota payments. However, as it was proposed to extend the quota review until April 1989, it was consequently unlikely that payments for increases in quotas could be made before the end of 1989. With the development of new lending facilities, and in light of the projections for an increase in the use of Fund resources in any case, the necessity of bolstering the Fund's liquidity position through a quota increase became compelling for the medium term. The Fund could not for long sustain a relatively high rate of lending and make substantial loan repayments without weakening its liquidity position over the next few years.

The Fund had not yet decided whether to stop drawing under the borrowing arrangement with the Saudi Arabian Monetary Agency by the end of 1988, the Deputy Treasurer continued. In terms of timing and maturity, there was perhaps a very good case to be made for not using the outstanding balances under the loan after end-1988 because it would provide financing only for a short period. However, circumstances might suggest that it would be useful to use the loan for part of the last year of its life, as a bridge to the resources that might be expected from the increases in quotas at the end of 1989. The staff would examine the matter further and would inform the Saudi Arabian Monetary Agency of its intentions in due course.

Several Directors had asked how the staff had treated overdue financial obligations to the Fund for the purposes of the liquidity review, the

Deputy Treasurer recalled. The staff had made the assumption that the volume of overdue obligations in the review period would not rise; unfortunately, they had risen, but the assumption was that they would not continue to do so. The staff believed that it was important to maintain that position, and consequently was reluctant to include projections for members with repurchases overdue for six months or more. All delayed repurchases affected the Fund's liquidity, regardless of the length of the overdue period. A total of SDR 1.4 billion in overdue repurchases, which should have been supplementing the Fund's liquidity, had rather been removed from the Fund's use, and had also exposed the Fund's liquidity in the form of higher reserve tranches than would otherwise have been the case. And there was a substantial amount of credit outstanding, but not yet overdue, to countries with overdue obligations.

The existence of the structural adjustment facility and the enhanced structural adjustment facility did not in principle imply a reduction in the use of Fund credit, the Deputy Treasurer remarked. However, there were members entering into arrangements under the structural adjustment facility and the enhanced structural adjustment facility instead of under standard Fund facilities; that ipso facto affected the character of commitments and disbursements from the Fund's general resources. There were some countries with both stand-by arrangements and arrangements under the structural adjustment facility, so that in principle, balance of payments need permitting, there would be no reason why there would be a substitution of one type of Fund-supported program for another over the medium term.

Mrs. Walker stated that although her chair had refrained from bringing up the matter of the Fund's comfortable liquidity position at the time of the discussion of the Ninth General Review of Quotas, she wished to stress that, in the light of that position, her chair did not believe that the Fund would find that its liquidity position would be in any way inadequate in the period until the coming into effect of the next increases in quotas. The Fund's liquidity position was strong, and was projected to remain so into the near future.

The Deputy Treasurer stated that although he did not disagree with that point of view, if the demand for Fund credit increased as projected, and taking into account heavy loan repayments by the Fund, and if there were no imminent prospect of new resources from a quota increase, he believed that the Board would not feel so easy about the Fund's liquidity position in, say, two years' time. The need for an injection of usable resources would increase with the passage of time, and the present comfortable position could not be projected to continue for a long period ahead.

The Chairman then made the following summing up:

> There seems to be broad agreement with the staff assessment that the Fund's liquidity position is generally satisfactory at present. You have noted that in 1988/89 our stock of uncommitted usable ordinary resources will decline, partly as a result of the repayment of Fund borrowing for enlarged access resources and

supplementary Fund financing, ahead of schedule, as well as the diminishing volume of repurchases, which will reach a peak this year. Many of you have rightly noted that there is considerable uncertainty in the world economic outlook and in the consequent demand for use of Fund resources, and expressed your growing concern about the impact of arrears on Fund liquidity. You have noted the timing of this review in the context of our ongoing discussion on the extended Fund facility and contingency financing facility external contingency mechanisms; the potential impact on the Fund's liquidity must be taken fully into account in making basic decisions on the use of these mechanisms, but in designing the revitalized or modified facilities we have been careful that the Fund's liquidity position would not be unduly affected, having taken into account the coming into effect of the next increase in quotas.

A number of Directors have called attention to the impact of the use of enhanced structural adjustment facility resources by eligible countries on the demand for the Fund's general resources, and this is indeed an important point. Many of you have expressed regret at the recent and projected rather low level of use of Fund resources by countries which not only need those resources, but which might be wise to use them.

I fully share and support your calls for an early increase in quotas, and you have certainly noted Mr. Williams's remarks on the relationship between the Fund's liquidity position and the timing of the completion of the review of Fund quotas. We are late in this process, and I hope you will join me in trying to convey to your governments a sense of urgency now in making decisions; we have offered them a prolonged period for considering this decision, but hopefully the time will have been well used to accelerate the decision-making process so that an increase in quotas can come into effect as early as possible.

3. PERU - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the further review of Peru's overdue financial obligations to the Fund following the declaration of Peru's ineligibility to use the Fund's general resources effective August 15, 1986 (EBS/88/64, 3/21/88).

Mr. Juan Candela, Director of the Central Reserve Bank of Peru, represented Peru.

Mr. Candela stated that the Board had last met to discuss the development of relations with Peru in the context of the 1987 Article IV consultation (EBM/87/161, 11/25/87). An open and frank discussion had resulted, which had contributed to an environment of mutual understanding that was vital to the process of resolving common problems. At that meeting, the Peruvian Government had expressed its commitment to make appropriate efforts, through intensification of its dialogue with the Fund, toward resolving the difficulties in Peru's relationship with the Fund. Peru's relations with the international institutions were very important, as the international organizations were viewed as partners in Peru's economic development. Therefore, the economic difficulties of the Peruvian people had been explained at that Board meeting, along with the foundations and objectives of economic policy adopted by the Peruvian authorities over the past two years, and the challenges facing them for the future. A detailed description of the economic program to be implemented in the medium term had also been provided. During those Article IV consultation discussions, the Peruvian representative had stated that considerable economic growth had been achieved over the previous two years, after about a decade of excessively slow economic performance, with very clear signs of recession in some years, which had exacerbated the economic and social problems. The growth target was consequently indispensable and could not be delayed. Growth would restore confidence on the part of economic agents in Peru's future and secure their cooperation, so that the gradual process of economic recovery could be begun, and the poorest segment of the society thus be assisted. However, the search for economic growth had been accompanied by problems in other areas of fundamental importance, impinging upon the continuity of the economic recovery process. Social problems had been in evidence since November 1987, and certain economic difficulties had become more acute, principally seen in negative developments in the external sector. International reserves had declined because of the industrial sector's structurally high dependence on imported inputs and the growth in overall demand and inflation had resurfaced.

The Government of Peru was aware that its objective of sustained economic growth needed to be formulated with a focus on satisfying the fundamental needs of the lowest income segments of the population, Mr. Candela observed. Economic growth of that kind called for the correction of remaining disequilibria. If gains were to be permanent, a restructuring of overall demand would be required, both in the external sector, which would need to play a more dynamic role, and in the domestic sector, where the consumption requirements of the Peruvian people would need to be met with goods and services with less import content, both direct and indirect. The need to change consumption patterns and the structure of production in the economy was the fundamental axis of the Government's medium- and long-term development strategy. Economic measures that would contribute to a correction of those disequilibria had thus been adopted over the past four months, including a change in relative prices in favor of goods and services of domestic origin, and in the structure of income distribution in favor of the less fortunate. External sector disequilibria had caused the international reserves of the Central Reserve Bank to fall to a low level.

The Government had been implementing since December 1987 the economic measures set forth in the context of the three-year economic program, which was seeking to correct the existing internal and external disequilibria, Mr. Candela continued. Those measures had included a considerable depreciation of the inti, of about 50 percent vis-à-vis the U.S. dollar. Early in March 1988, the Central Reserve Bank had introduced additional corrective measures, after an implicit devaluation of 25 percent for those imports that are covered by the Central Reserve Bank. With the continuation of the policy of monthly devaluations, which had been announced in December 1987, the exchange rate for exports was being devalued so as to increase their competitiveness. The Government was committed to adjusting the rate each month in light of the inflation rate; the exchange rate for imports would also continue to be appropriately adjusted periodically.

Concerning the fiscal sector, Mr. Candela stated that the Congress had approved the 1988 budget, which included authorizations for new taxes, an increase in rates of existing taxes, and an elimination of tax exemptions. A net personal worth tax had been introduced, and the general sales tax had been increased less than two weeks previously to 10 percent, including 1 1/2 percent for local governments. There had also been a substantial increase in the rate of the selective consumer tax on certain nonpriority goods, which in some cases was about 300 percent. The price of gasoline, which incorporated an important tax element, had been raised by 50 percent, so that the deficit of the Peruvian State Petroleum Enterprise could be reduced.

Both major subsidy reductions and fiscal austerity measures had been announced on the expenditure side, Mr. Candela noted. Prices of basic foodstuffs, charges for public services such as water and electricity, communications, and public transport, had all been drastically increased. Prices for foodstuffs had been increased by up to 70 percent, and for some public services, such as public transport, for example, by 100 percent; additional price corrections were to be made in the following four months. Furthermore, severe restrictions on foreign travel would be introduced for public employees, and public enterprises would be subject to more stringent supervision, including written submission of performance results. All those measures were intended to progressively reduce the fiscal deficit, and demonstrated the Government's determination to correct sectoral disequilibria. Finally, the decision to sell a group of low priority public enterprises had recently been made public.

With regard to the monetary aggregates, considerable efforts had been made with respect to interest rates, Mr. Candela observed. Lending rates had been increased, with short-term rates having been raised by 50 percent. Savings rates, such as those on savings deposits, had been increased by 100 percent. Those measures represented an attempt to reduce the highly negative real interest rate and to establish interest rates as an effective mechanism for the strengthening of financial intermediation and the promotion of savings.

The Peruvian authorities were well aware of the magnitude of the disequilibria they faced, Mr. Candela went on. They were also aware of the seriousness of the Peruvian social situation, especially the effects of terrorism and their impact on the Government. The fight against terrorism absorbed significant fiscal resources. Because of the precarious social situation, the Government had felt it necessary to compensate for the adjustment measures by increases in the minimum legal salary, so that the deterioration in real income would be lessened. The salary increase would be directed to teachers, doctors, and nurses.

The Peruvian authorities were confident that the economic measures that had been adopted to correct the disequilibria, together with the measures to stimulate growth, would have positive results, Mr. Candela concluded. The objectives they had put forth at the previous meeting were still clearly viable, in his view; the implementation of the three-year economic program would represent a continued forward movement. There was no question that efforts to increase exports and achieve a favorable external trade balance would be necessary to meet Peru's commitments not only to its people, but to the international financial community as well. However, the achievement of external and internal equilibrium would not be done overnight; persistence, patience, and strong action would be necessary. The authorities were continuing a constructive dialogue with the World Bank in hopes of reaching common agreement; new agreements with some banks, suppliers, and governments had also been reached. The Government wished to maintain an open and frank dialogue with the international financial community, which it considered necessary to strengthen its relations and make progress for economic development. However, the economic adjustments that had been made needed to be seen against the backdrop of a daily testing of Peru's democracy by drug trafficking and by one of the most difficult and subversive terrorist movements in all of Latin America. Thus, Peru pleaded for the understanding and support of the international community.

Mr. Dallara made the following statement:

> First, let me thank Mr. Candela for the extensive and informative remarks he has made this afternoon concerning the Peruvian economy, and Peru's attitude and plans with respect to its obligations to this institution.
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> It is discouraging to be reminded that this is the fourth review of Peru's overdue financial obligations to the Fund since the declaration of ineligibility roughly a year and a half ago. Since that time, unfortunately, no significant payments have been made, and arrears have risen just since our last meeting by nearly SDR 50 million, to over SDR 410 million.
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> At the Board's November meeting (EBM/87/161, 11/25/87), the General Manager of the Central Reserve Bank said in his statement that "Our government is willing to reassume during 1988 and in a significant way Peru's financial obligations to the Fund, depending upon the development of our economic program." Unfortunately, in the ensuing four months only a little over SDR 1 million has been received in settlement of Peru's arrears to the Fund, a

development which can hardly be considered a significant step toward meeting Peru's obligations to the Fund.

In the informative statement which the Executive Board has just heard, I certainly welcome the intention of the Peruvian authorities to intensify the process of dialogue, as Mr. Candela stated it, and the desire to move to an export position which will enable Peru to meet its obligations to the Peruvian people and to the international financial community. Unfortunately, in those general statements of intentions, no clear articulation of immediate plans could be heard, as might have been hoped, to meet financial obligations to the Fund, a matter of growing urgency.

During our earlier reviews of the Peruvian case, this chair has expressed concern at what it perceived to be, unfortunately, deliberate discrimination against the Fund in the allocation of repayments on Peru's foreign obligations. The new staff paper suggests that in a sense this is continuing, although here I would welcome any clarification that Mr. Candela can offer. The staff indicates on page 6 of EBS/88/64 that available resources for debt service are allocated among creditors by giving priority to those creditors from whom a positive net flow of resources is expected. My authorities have interpreted that in the past to suggest that, since there is no immediate prospect of flows from the Fund, Peru has not attached high priority to meeting its obligations to the Fund.

In light of the very long and extensive record of close support by the Fund for Peru's efforts, and indeed Peru's collaboration with the Fund over many years, the matter of payment priority is one that is particularly difficult for my authorities to accept. At the same time, this chair recognizes that in recent months Peru's external situation has deteriorated to a point where even meeting its clearing obligations within Latin America has become difficult. Nevertheless, I would underscore that the notion that, because the Fund does not find itself in a position to provide new resources to Peru, a reduction in the priority attached to Peru's obligations to the Fund is warranted, simply cannot be accepted.

During the Board's most recent six-month review of overdue payments, there was a discussion of the issue of trying to distinguish between inability and unwillingness to settle obligations to the Fund. The Chairman noted in his summing up that such a differentiation is difficult. To a degree, that is a judgmental matter. But it was agreed, and captured in that summing up, that the staff would work further in an effort to develop criteria that might be useful in the Board's effort to reach the difficult judgment of whether the Board is facing cases of inability or unwillingness to repay the Fund. I would be interested in hearing from the staff the progress that has been made in that effort, because this chair would consider such a determination to be particularly relevant in the case of Peru.

In previous meetings this chair, and a number of others, has also called attention to the financial burden placed on the entire membership by the arrears problems. Therefore, this chair urges the staff, in future reports on the Peruvian problem--should there be a need for future reports--as well as in other arrears reports, to provide specific data on the implications and the effects of the arrears problem on other members of the institution. Perhaps that procedure should be restricted to those members whose arrears are of a certain magnitude, or who have been declared ineligible to use Fund resources, or on the basis of a similar criterion.

This chair has also suggested in recent discussions that consideration be given to formal notifications by the Chairman, on behalf of the Fund, to other international financial institutions of the status of certain arrears cases, in particular, those which have gone beyond the point of a declaration of ineligibility. During the Board's last general discussion, that suggestion did not find majority support among Directors; however, my authorities wish to raise it again today, because they feel that it is important that the Fund ensure that the severity of the arrears problem be appreciated broadly in the international financial community.

I would also recall another suggestion which my authorities have made earlier, which has not met with considerable support, but which my authorities continue to believe merits further consideration, and indeed merits consideration in this case. That suggestion was that a direct communication from the Chairman be sent to all Fund Governors informing them of a case of arrears. It could be said, of course, that Governors are already fully and properly informed; indeed, Directors have an obligation to ensure that. But in the real world, given the demands placed on everyone, including Fund Governors, a particularly precise and direct communication from the Chairman might be of some merit in externalizing the seriousness of the arrears problem.

In the meantime, this chair had also considered whether it might be useful in this particular case, and perhaps in others, for the Fund to send a mission to conduct a special consultation with Peru. The purpose of such a consultation would be to follow up on the recent Article IV consultation, and to review Peru's balance of payments with a view toward exploring with the Peruvian authorities the prospects for immediate steps to be taken toward elimination of Peru's arrears to the Fund. This chair was in fact heartened by Mr. Candela's comments, which suggested a desire to move in the direction of a closer dialogue with the

Fund. In fact, I think he used the words "intensifying the process of dialogue, willingness to cooperate and consult in an effort to find a solution." Indeed, a willingness to conduct such a consultation would be a clear signal of the Peruvian authorities' desire to engage in a closer dialogue with the Fund, in the view of this chair. Under Peru's last stand-by arrangement with the Fund, in 1984, a standard clause appeared which provided for the possibility of consultation and indeed indicated the Government's agreement to consult with the Fund, as follows: "During periods while Peru has outstanding purchases in the upper credit tranches under the stand-by arrangement to consult with the Fund from time to time at the initiative of the Government or at the request of the Managing Director concerning Peru's balance of payments policies." The recent changes in Peru's economic policies, which have been summarized by Mr. Candela and noted in the staff paper, would also suggest that it may be particularly timely to follow up on the earlier consultations. Therefore, my authorities suggest that efforts to plan such a consultation be initiated very shortly.

In consideration of the staff paper and Mr. Candela's remarks, I would like to acknowledge that a number of steps have been taken in Peru's economic policies which my chair believes go in the right direction. However, the overall stance of economic policy remains inadequate to the task required of it. The steady growth of arrears to the Fund cannot but affect adversely the attitude of Peru's creditors. That cannot serve the objective of restoring a strong external position for Peru which has been outlined.

In concluding, I would first suggest in paragraph 2 of the draft decision the inserting after the words "General Resources Account" a clause reading "and notes the financial burden placed upon other members by these arrears." The remaining clause would then become a new sentence. This wording would be consistent with that used in the case of Somalia. I would also suggest that the date in the bracket in paragraph 4 be "not later than May 23, 1988," which would be two months from today. Such a relatively brief period is fully justified in light of the seriousness and size of this particular problem, and in light of the lack of an effort on the part of Peru to make substantial payments to the Fund. Lastly, I would hope that, if there were interest in pursuing the notion of a very early consultation, that could be captured in the wording of the draft decision.

Mr. Sengupta made the following statement:

During the Board's previous discussion on Peru, this chair stressed three points. First, my authorities welcomed the reestablishment of normal relations between the Fund and the

Peruvian authorities; second, the settlement on time of net SDR charges as of November 1987 was also welcomed; and third, this chair observed that the Peruvian authorities had indeed recognized the need to take comprehensive measures to reverse the economic trends in their country. My authorities are aware of the problems Peru faces, particularly the problem of overdue financial obligations and the implications of overdue financial obligations for the Fund and other member countries.

This chair is glad to note that the authorities continue to move in the same positive direction. The channels of communication with the Fund and the Bank are open, and in that context I welcome the presence of the Director of the Central Reserve Bank of Peru. Peru has made yet another payment in settlement of net SDR charges, thereby becoming current in the SDR Department, and, as the staff paper notes, has recently taken a number of wage, price, fiscal, and exchange rate measures. The impact of those measures on a developing country like Peru has been substantial, and the Board should not fail to recognize that. Although the staff has said that those measures fall short of the comprehensive adjustment program recommended by them earlier, I would suggest further interaction between the staff and the Peruvian authorities, so that the character of the measures undertaken can be assessed in greater detail, and a firmer conclusion reached as to their adequacy and impact. If that requires a special consultation mission by the Fund staff, I do not object, but it would depend entirely upon the view of the Peruvian authorities and upon how they would interpret such a mission. Interaction between the Fund staff and the Peruvian authorities is further necessitated by the fact that during the last Article IV consultation discussions, there were substantial differences in perception between them in terms of the magnitude and character of the policy changes. Meanwhile, the authorities should continue their adjustment efforts with greater vigor, with the added assurance that if they do so, the Fund and the international community would support them.

I note from the staff paper that Peru's available resources for debt service are allocated among creditors with priority given to those from which a positive net flow of resources is expected. In the "realpolitik" of the world, that is quite understandable, especially when the level of reserves is so low, but this chair would strongly urge the authorities, in keeping with the Articles of Agreement to appreciate the constraints those overdue obligations place on the Fund's operations, and to resume payments to the Fund as soon as possible. That would be a further step toward a fuller normalization of relations with the Fund, and would make available assistance from other creditor and donor countries, as well. My authorities cannot support any proposal to bring pressure to bear on any other institution, including the World Bank, which is trying to come to terms with

Peru. The cause of Mr. Dallara's anguish is understood, but the way to help Peru resolve its problems is not the way he suggested.

In paragraph 3 of the draft decision, since the full details or impact of the measures taken in the last few months are not yet known, I suggest that instead of urging the Peruvian authorities to adopt "the comprehensive economic adjustment program," they be urged to adopt a more suitable or appropriate adjustment program that is required in Peru's circumstances; or as an alternative, it could be mentioned that Peru will adopt a comprehensive adjustment program. Urging them to adopt the comprehensive adjustment program would in effect mean making a judgment that what the staff has recommended is the panacea. That would not be in keeping with the repeated assertions of the Managing Director and the Board that the program should be one which is prepared by the country itself, and should not even appear to be imposed. Of course, the authorities could certainly discuss that with the Fund, and draw on the Fund's experience and expertise in various areas.

With respect to paragraph 4 of the draft decision, I would suggest giving the authorities at least a six-month period before the next review, because the period of four months given in November 1987 has not enabled the Board to acquire a better idea of developments in the Peruvian economy. Besides, as relations between the Fund and Peru are moving toward normalcy, it may be inadvisable to rush the authorities too much.

Mr. Noriega made the following statement:

The matter of Peru's overdue financial obligations was last reviewed at the time of the conclusion of the first Article IV consultation with Peru since 1984. At that time, the resumption of a dialogue with the authorities was noted, and the Board expressed the hope that a new period of fruitful relations would ensue. Today this chair welcomes the presence of the Director of the Central Reserve Bank as a gesture of the continuity of the dialogue, as he has just acknowledged, and reiterates the expectation that relations with the Fund may be fully normalized in the near future.

The staff paper indicates that the economic situation has worsened at an increasing pace since the Board's last discussion, and in particular that the Central Reserve Bank has been losing foreign reserves in substantial amounts. Those developments diminish the authorities' degree of freedom in launching a comprehensive program which might reverse the ongoing economic, and apparently social, deterioration, and restore sustainable growth. The likelihood that Peru will clear its financial obligations to its creditors is consequently much less. In that connection, the previous administration's experience of carrying out adjustment measures, without attracting the support of the international financial community, reflects badly on the advice the Fund may provide to the Government.

It is in that context that this chair strongly supports the measures adopted since the end of 1987 on various fronts, with a special commendation for the overall adjustment of the exchange rate system and trade and payments restrictions. The fact that the measures were enacted only recently prevents the staff from fully assessing their impact, although it is recognized that the thrust of those measures is adequate and in line with staff suggestions, and that they should contribute to alleviating the internal and external disequilibria; however, the measures seem insufficient to eliminate those disequilibria, understandably, given the lack of adequate external support. Yet, in order to rally such support, the authorities need to give a very clear indication of their cooperative stance with foreign creditors. That is precisely what this chair calls on the authorities to do, by committing themselves to a comprehensive and credible adjustment program.

The support of the Fund is crucial in that endeavor. Mr. Candela's opening remarks are in accord with that view. Thus, even if it may be more advantageous in the short term for Peru to service the debt of those of its creditors from which an increase in the flow of resources can be expected, in the medium term the Fund's active involvement may turn out to be more supportive of domestic efforts, while recognizing Peru's pressing circumstances, which are preventing prompt clearance of arrears to the Fund. This chair would be grateful if Mr. Candela could convey that message to his authorities.

With respect to the proposed decision, my authorities fail to see any advantages, either to the Fund or to the Peruvian authorities, in conducting the next review ahead of the six-month period. I support Mr. Sengupta's proposal for modifying paragraph 3.

Mr. Kafka remarked that he also welcomed the presence of the Director of the Central Reserve Bank at the meeting, and the statement he had made. Peru's situation, and its impact on the Fund, was extremely serious. His chair had frequently suggested that a more flexible attitude on the part of the Fund with respect to repurchases, which would yet be compatible with the Articles of Agreement would increase the likelihood that arrears to the Fund would be eliminated. Nevertheless, there was no question that Peru must be expected to do its utmost to settle its arrears at the earliest opportunity, as the authorities had declared was their intention. The Fund, as part of its responsibility to a member, should be prepared to assist Peru with advice, and perhaps in other ways, to garner the financial support of other creditors in order to deal with the arrears problem. At the same time, Peru needed to take the necessary economic measures and adopt the programs that would enable it to become current in its payments to the Fund.

He did not think that special communications to international institutions or to Fund Governors about the arrears situation would be helpful, Mr. Kafka went on. A special consultation would, however, be helpful if it were to be accepted by the Peruvian authorities.

With respect to the proposed decision, Mr. Kafka commented that some of the changes proposed could be helpful. In paragraph 3, it could be said that Peru should be asked to adopt a comprehensive economic adjustment program, and he suggested adding "as is required in Peru's circumstances." Advancing the date for the next review of Peru's overdue obligations would not be helpful, in his view. Rather, if possible, constant communications should be maintained with Peru, such as by way of a special consultation mission, so as to follow the authorities' efforts to improve Peru's economic situation.

Mr. Prader stated that during the previous review of Peru's overdue financial obligations, his chair had expressed understanding and sympathy for the authorities in their attempts to deal with the country's plight, and for their objectives of adjusting with due consideration for social objectives, such as income redistribution. However, in assessing the country's controversial economic and financial policies, the impression could not be avoided that Peru's discriminatory approach vis-à-vis its external creditors had reached a stage where all the possibilities for action had been exhausted; with growth and foreign exchange reserves declining, there was no longer any room to maneuver.

It had become evident that the authorities' spectacular foreign exchange policies, rather than increasing the country's policy margin, had instead excluded the country from prospects for financing that went beyond the present financing options, Mr. Prader went on. The staff's alternative scenario illustrated the point well. Furthermore, if Peru settled its arrears to the Fund, the way would be cleared for access to other Fund resources. In that context, could not the Peruvian authorities give consideration to the notion that "giving priority to those countries from which a positive net flow of resources is expected" be interpreted in a way which favored repaying the Fund?

Peru had given signs of rapprochement toward the Fund recently, in the form of a resumption of Article IV consultations, Mr. Prader noted. Also, Peru had gone some way toward adjustment, by introducing measures on exchange rates, interest rates, prices and wages since late 1987. But even in the field of adjustment policies, the adoption of separate exchange rates for exports and imports did not seem to be a viable policy option.

The question therefore was why Peru was not really consistent in the revision of its policies toward external creditors, in particular toward the Fund, Mr. Prader said. His impression was that the country's policies fell short of their potential. He urged the Peruvian authorities to rethink their external debt policy. He certainly welcomed the willingness expressed by Mr. Candela to engage in a policy dialogue with the Fund. However, in the absence of any practical step toward making significant payments to the Fund, he must support the proposed decision. He endorsed Mr. Dallara's proposal to have a special consultation with Peru on the nature of its arrears to the Fund. He also agreed with the proposal to mention in the decision the burden on other countries of Peru's arrears to the Fund, provided that the same mention was made in future decisions on countries in arrears to the Fund.

Mr. Goos said that he interpreted Mr. Candela's presence at the meeting as an indication that the Peruvian authorities wished to improve their relations with the Fund and with the international financial community. Nevertheless, he concurred with the concern expressed by other speakers on Peru's continuing nonsettlement of its arrears to the Fund, and shared Mr. Dallara's disappointment that a specific timetable on the elimination of the arrears appeared to be lacking. He also did not believe that Peru attached a high priority to the settlement of its obligations, which was a matter of serious concern. Those concerns were underlined by the fact that the deterioration in Peru's economic situation had reached the crisis stage, as clearly exemplified by the alarming acceleration in inflation, the accumulation of arrears to other creditors--amounting to close to $7 billion--and the virtual exhaustion of liquid reserve holdings.

Against that background, Mr. Goos continued, he, like others, welcomed the authorities' policy intentions, as well as the steps that had already been taken. But judging from the alternative scenario presented in the staff paper, those steps appeared to have fallen short of what was required. Therefore, the staff's advice that the Board urge Peru to adopt a comprehensive economic adjustment program and reiterate its deep regret at Peru's continuing failure to fulfill its financial obligations to the Fund was well taken; he therefore fully supported the proposed decision.

As to the amendments that had been proposed, he supported Mr. Dallara's reformulation of paragraph 2, Mr. Goos said. The same formulation should be included in similar decisions as a matter of general policy in the future. He also supported Mr. Sengupta's change to the third paragraph, which appeared especially appropriate as there seemed to be some uncertainty as to whether the staff had really taken into account all the steps that had been taken and that were being envisaged by the authorities. With respect to the review period specified in the last paragraph, although he fully understood Mr. Dallara's desire to see the Board deal with Peru's arrears as soon as possible so as to express its sense of urgency on the matter, he was not certain that a two-month period would be appropriate; perhaps a compromise could be reached between those Directors who preferred to retain the period of six months as drafted, and those who preferred a shorter period--perhaps a period of three months, he suggested.

A special consultation with the Peruvian authorities might be helpful, Mr. Goos considered. The readiness of the authorities to accept such a mission would certainly attest to their willingness to improve their relationship with the Fund and to come to grips with their problems. A letter from the Managing Director to the Governors apprising them of the seriousness of arrears in certain cases, as Mr. Dallara had suggested, would also be an idea worth pursuing.

Mr. Fogelholm made the following statement:

During the Board's discussion in November 1987 of economic developments in Peru, and of the country's overdue financial obligations to the Fund, the Board was informed of the Government's program, aimed at a reorientation of economic policies. Like other Directors, I welcome the measures undertaken since then, especially the steps taken to reduce the present multiple currency practices, and the increased flexibility in foreign exchange policy.

I note, however, that in the staff's view those measures fall far short of the comprehensive adjustment program that was recommended by the Fund last November. The huge imbalances that have developed in Peru's economy, which are due to a large extent to inappropriate economic policies, can only be solved by adopting a strong economic adjustment program over the medium term. Such a program should aim, in particular, at restoring Peru's competitiveness, and at promoting the efficient use of the country's productive resources.

Peru continues to treat its external creditors in a discriminatory way. I reiterate this chair's strong disapproval of this unilateral external debt-servicing policy. The discrimination against the Fund and the World Bank is especially worrisome. These institutions are based upon international, intergovernmental cooperation, and should be treated by their members on the basis of that cooperation. I hope that the Peruvian authorities will change their attitude in that respect, so that Peru's relations with all its external creditors can be normalized soon. In that connection, I welcome the statement of the Director of the Central Reserve Bank that the authorities are willing to intensify the dialogue with the Fund.

I also note that Peru has made only minimal payments to the Fund since the last review, causing the amount of outstanding arrears to increase rapidly. Given the concerns which have been expressed over developments in Peru, a review in less than six months' time would seem to be appropriate. Regarding the exact choice of a period of time, like Mr. Goos, my position remains a flexible one, particularly if the special consultation proposed by Mr. Dallara, which I support, can take place in the near future. I also support Mr. Dallara's idea that the financial burden on other members of arrears to the Fund be calculated and explained, but I agree with Mr. Prader that that should be done for all countries with arrears to the Fund, and in a nondiscriminatory way.

With respect to the proposed decision, I support Mr. Dallara's formulation of paragraph 2, and Mr. Sengupta's amendment to paragraph 3.

The Chairman suggested that were Mr. Dallara's reformulation of paragraph 2 to be accepted, the Board should agree to apply it to all future decisions on overdue financial obligations of a member; furthermore, he suggested that Mr. Sengupta's proposal to amend paragraph 3 be accepted.

Mr. McCormack said that like previous speakers, he welcomed the Director of the Central Reserve Bank to the meeting, and stressed the importance of keeping lines of communication open in that way. However, he regretted the fact that Peru had made only a very small payment since the Board's last review.

In November, when the staff report for the Article IV consultation with Peru was discussed, there was unanimity that Peru urgently needed to develop and implement a comprehensive adjustment program, Mr. McCormack continued. Since then, there had been a number of policy developments, reported in the staff paper, some of which were indeed welcome--for instance, the currency devaluations in October and December 1987, which brought the real effective exchange rate index back to the level of two years ago. However, those exchange rate measures, welcome as they were, still fell short of the required unification of the exchange rate. Moreover, there had since been a weighted average appreciation in real effective terms of some 8-10 percent. Also of concern was the failure to bring the level of interest rates more closely in line with the high and accelerating rate of inflation. In sum, the measures undertaken seemed to fall significantly short of the sort of comprehensive adjustment program that would inspire the confidence of the international community. Mr. Dallara's suggestion of a special mission to examine recent measures was a constructive one, and he would be interested in Mr. Candela's reaction. Regarding Mr. Dallara's other suggestion, he supported measures to bring peer pressure to bear on countries with persistent arrears, but had reservations about notification to other international financial institutions.

On the draft decision, delaying a further review for six months--the maximum period allowable--would in his view run the risk that the Board would lose touch with the evolving situation, Mr. McCormack concluded. Two months seemed far too short a period, and he would be guided by pragmatic considerations as to the best period. He supported Mr. Dallara's proposed reformulation of paragraph 2 of the proposed decision.

Mr. Hogeweg said that he joined other speakers in welcoming the Director of the Central Reserve Bank to the Board's discussion, and in expressing appreciation for his presentation. As was also the case at last November's Board meeting on Peru, it was clear that the Peruvian authorities were willing to maintain contact with the international financial institutions. However, he gravely regretted Peru's continuing and rising arrears to the Fund, as he had said before. He noted that new measures had been taken, but also that in the staff's view those measures did not constitute the required comprehensive program. He was especially concerned about the discrimination in favor of creditors from which a positive flow of resources in the short term could be expected, which was detrimental to the authorities' cause, in his view.

Consequently, Mr. Hogeweg stated, he supported Mr. Dallara's proposal for a special consultation to be conducted shortly. Such a consultation should be acceptable to the Peruvian authorities in view of the statement of their intentions which the Director had just delivered. He believed it would be very useful to delineate the burden on other member countries of arrears to the Fund, and he agreed that Mr. Dallara's reformulation of the second paragraph, if accepted by the Board, ought to be made a matter of general policy with respect to decisions on overdue financial obligations of a member. He had reservations about dispatching formal communications from the Managing Director to other international institutions and to Fund Governors informing them of the seriousness of arrears in certain cases, but he did not rule out the possibility that such a policy might be useful at a later stage.

Mr. Al-Assaf stated that he too wished to thank the Director of the Central Reserve Bank for his comprehensive presentation of the policies Peru had undertaken so far, and hoped that his presence reflected the authorities' willingness to keep open the dialogue with the Fund. He shared Mr. Dallara's view that the situation was not improving; in the final analysis, Peru's problems emphasized the fact that the country's unwillingness to settle its obligations had in general led to its inability to do so, as reflected in the deterioration of its reserve position.

Turning to Mr. Dallara's proposals, Mr. Al-Assaf said that he supported the proposal of sending a special consultation mission to Peru to discuss the matter of arrears with the authorities, provided, of course, that the approval of the authorities was first obtained. He also supported the proposal to include in the next staff report a delineation and calculation of the burden on other members of Peru's arrears to the Fund.

With respect to the timing of the next review, he was in favor of a shorter interval than the one proposed in the draft decision, Mr. Al-Assaf went on. However, in view of the authorities' recent endeavors, which the Director had described, he would be willing to consider an alternative solution. He proposed that the date remain as had been suggested in the decision, namely, six months, but that in the event Peru's arrears to the Fund were higher in two or three months than currently, the Executive Board would at that time automatically conduct the review.

Mr. Yoshikuni stated that he welcomed the presence of the Director of the Central Reserve Bank and appreciated his comprehensive statements on the Peruvian economy. However, he shared the views of Mr. Dallara, Mr. Goos, and others concerning the seriousness of Peru's economic problems, and urged the authorities to accept the comprehensive economic measures the Fund had proposed.

With respect to Mr. Dallara's proposal, he had reservations about a formal notification by the Managing Director to Governors of the Fund and to other international institutions describing the seriousness of arrears in certain cases, Mr. Yoshikuni said. He considered that such an action in Peru's case would undermine the relationship existing between Peru and the Fund. Concerning surveillance, special consultation might be a positive action in view of the seriousness of the problem. He also supported Mr. Dallara's proposal that the impact on other members of arrears to the Fund be analyzed and delineated in reports concerning the overdue financial obligations of a member. Mr. Dallara's reformulation of the second paragraph of the proposed decision was acceptable to him, but he remained open on the period before the next review of Peru's overdue obligations was to take place, and hoped that a compromise could be reached on that point.

Mr. Rebecchini said that he welcomed the presence of the Director of the Central Reserve Bank. He joined other speakers in expressing concern over Peru's continued buildup of arrears to the Fund. While he welcomed the recent payments made to the Fund in the SDR Department, as he saw it there was a fundamental incompatibility between the existence of overdue financial obligations and the cooperative nature of the institution. He therefore urged the Peruvian authorities to intensify their efforts to improve cooperation and to promptly settle their remaining overdue financial obligations. He had taken note of the numerous economic measures that had been adopted recently, but believed that they fell short of what would be required to effectively address the country's domestic and external problems.

He supported Mr. Dallara's proposal to include in future staff papers concerning overdue financial obligations of a member, an analysis and delineation of the burden on other members of arrears to the Fund, Mr. Rebecchini concluded, along with the proposal that the staff expedite its development of criteria to differentiate an unwillingness to repay from the inability to repay. He also supported Mr. Dallara's reformulation of paragraph 2 of the proposed decision, as well as Mr. Sengupta's amendment to paragraph 3.

Mr. Jiang stated that he welcomed the presence of the Director of the Central Reserve Bank, as well as the continuation of the dialogue between the Fund and Peru. As Peru had made some payments to the Fund and was now current in the SDR Department, and as it had taken a number of economic measures to improve its economic performance--although they needed to be strengthened--he supported the proposed decision, including a date for the next review to be set no later than six months from the date of the decision.

Mr. Pineau stated that in November 1987 the Board had stressed the need for a comprehensive program aimed at tackling the protracted difficulties of the Peruvian economy. His chair had been disappointed by the somewhat piecemeal approach to addressing the serious imbalances in the economy the Peruvian authorities had been following. Although some encouraging steps had been taken on the external front, especially with respect to exchange rate policy, the necessary adjustment process was still at a very early stage; in his view the authorities needed to display stronger determination. Close monitoring of economic policies appeared to be necessary. A review of the arrears situation within a four-month period therefore seemed appropriate. As an alternative, he could support a special consultation if that was acceptable to the authorities. He supported Mr. Sengupta's amendment to paragraph 3 of the proposed decision.

Mr. Woodward stated that he joined other speakers in welcoming the presence of the Director of the Central Reserve Bank. However, it was most regrettable that Peru continued to accumulate arrears to the Fund and had made no more than a token payment since the last review. Peru's external situation was becoming increasingly intractable as arrears accumulated, and prompt and effective action to redress the arrears was urgently required.

At least some of the recent policy changes represented a welcome first step, Mr. Woodward continued, particularly the tax increases and the major devaluations undertaken in late 1987. However, there was a long way to go, as he saw it. Regarding relations with creditors, the current discussions with the World Bank were to be welcomed, but progress toward reconciliation with other creditors appeared to have been extremely limited. He would welcome any further information on the discussions with the World Bank and the form any agreement might take.

In light of those considerations, Mr. Woodward said, he strongly urged the Peruvian authorities to adopt a full and comprehensive adjustment program, to reconsider their current highly counterproductive policy toward external creditors, and to make every effort to settle their overdue financial obligations to the Fund as quickly as possible. He supported Mr. Dallara's amendments to the proposed decision, as well as the idea of a special consultation with Peru and the inclusion in future staff papers on members' overdue financial obligations of a calculation of the impact of the arrears on other Fund members.

Mr. Candela stated that he would convey Directors' concerns to his Government. Concerning the possibility of carrying out a special consultation mission with the Peruvian Government, a suggestion which undoubtedly reflected the Board's concern over Peru's situation, his authorities maintained that there was a need to keep the dialogue open, and in that context he wished to draw the Board's attention to the fact that the Article IV consultations with Peru had only recently been concluded. In principle, the Peruvian authorities welcomed the possibility of a special consultation. However, he was not in a position to give a definite answer, as the matter needed to be decided by the Peruvian Government. There were, however, some problems of a practical nature, as Peru was currently meeting with a World Bank mission; some of the measures included in the World Bank program were already being implemented--some only a few days ago--and an assessment of the measures might be premature. Nevertheless, he would discuss the possibility of a special consultation with his authorities.

Finally, Mr. Candela requested the Board to show patience in dealing with countries with as difficult a set of circumstances as Peru faced, and asked that the period until the next review be maintained at six months, as the staff had proposed.

The Chairman said that the presence of the Director of the Central Reserve Bank was welcome, and that he had been most impressed by his opening statement. He had taken note in particular of the wish of the Peruvian authorities that the Fund be a partner in Peru's development. He was certain that the Executive Board shared that wish.

In the same vein of open and trustful discourse, the Chairman continued, he wished to emphasize that the spirit of partnership and cooperation was a key ingredient in any cooperative organization like the Fund. In relation to Peru's overdue financial obligations, the money that Peru owed the Fund did not belong only to the Fund's creditors; in a cooperative organization like the Fund, it belonged to all the member countries. The Fund membership included those countries with serious economic problems which had a pressing, and perhaps the most legitimate, need for the Fund's resources, and which could be the most seriously and adversely affected by the constraints and added costs placed on the use of Fund resources because of the impact of arrears on the Fund's financial position. Accordingly, in the spirit of partnership to which the Director had alluded, the Peruvian authorities should bear in mind the consequences of their arrears, and the responsibilities placed upon all members by the cooperative structure of the Fund.

The decision to embark on a special consultation with Peru was a decision for management, the Chairman remarked. Although he would consider such a consultation positively, he would first need to judge that it would be productive. He would begin to discuss the matter with the Peruvian authorities in the following days.

Communications to other international financial institutions on arrears, as proposed by Mr. Dallara, did not seem advisable, the Chairman considered. With respect to communicating with Fund Governors--without referring specifically to Peru--he would take the opportunity of the forthcoming Interim Committee meeting to call the attention of the Governors to the very difficult and worrying problems that arrears were creating. Governors needed to be conscious of the magnitude of the general problem of the overall level of arrears.

Turning to the proposed decision, the Chairman noted that Executive Directors had generally accepted Mr. Dallara's proposal to reformulate paragraph 2, as long as the reference to the burden on other members of arrears to the Fund was included in future decisions on members' overdue financial obligations. He further noted that Executive Directors had generally accepted the amendment to paragraph 3 proposed by Mr. Sengupta. In his view, it was important that Peru be seen to be taking the initiative with respect to the design of such a program. With respect to paragraph 4 and the timing of the next review, he had noted the proposals of Mr. Sengupta and Mr. Dallara, the desire of other Directors for a compromise, and Mr. Candela's request that the review take place after six months. In his view, the timing of the review would depend greatly on whether there was a special consultation; if so, even three months appeared inadequate. In a spirit of compromise, he suggested a date of July 23, 1988--four months.

Mr. Candela said that he could go along with the date of July 23, 1988 as the date for the next review.

Mr. Dallara stated that he would have preferred a somewhat shorter period because of the urgency of the problem, but that he could support a period of four months. With respect to the matter of consultations, he respected management's prerogative in the matter of deciding on the dispatch of a mission, but he hoped that the wide level of support in the Board for a special consultation might be taken into account. Finally, he wished to stress that under an earlier arrangement concluded with Peru in 1984, a consultation with the Fund from time to time had been an obligation.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Peru's continuing failure to fulfill its financial obligations to the Fund in the General Resources Account.

2. The Fund deeply regrets the continuing failure by Peru to fulfill its financial obligations to the Fund in the General Resources Account, and notes the financial burden placed upon other members by those arrears. The Fund again urges Peru to make full and prompt settlement of those obligations.

3. The Fund notes the economic measures implemented recently by Peru and urges Peru to adopt a comprehensive economic adjustment program as is required in Peru's circumstances.

4. The Fund will review the matter of Peru's overdue financial obligations to the Fund again not later than July 23, 1988.

Decision No. 8822-(88/45), adopted
March 23, 1988

APPROVED: November 15, 1988

LEO VAN HOUTVEN
Secretary