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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/157

10:00 a.m., November 18, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	Song G., Temporary
C. H. Dallara	M. K. Bush
J. de Groote	
	E. V. Feldman
M. Finaish	
G. Grosche	B. Goos
J. E. Ismael	J. Reddy
A. Kafka	J. Hospedales
T. P. Lankester	C. Enoch
M. Massé	
Mawakani Samba	
Y. A. Nimatallah	I. A. Al-Assaf
	A. Ouanes, Temporary
	L. Filardo
	V. J. Fernández, Temporary
J. Ovi	
H. Ploix	
G. A. Posthumus	
C. R. Rye	I. Sliper, Temporary
	O. Kabbaj
	L. E. N. Fernando
	N. Sugita
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant
S. Woolls, Assistant

Also Present

IBRD: J. B. Sokol, Latin America and the Caribbean Regional Office. African Department: A. D. Ouattara, Counsellor and Director; J. Artus. Asian Department: R. J. Hides. European Department: R. P. Hicks. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; S. J. Anjaria, E. Brau, S. Kanesa-Thasan, C. Puckahtikom. External Relations Department: D. M. Cheney, J. P. Newman. IMF Institute: O. B. Makalou. Legal Department: W. E. Holder, Deputy General Counsel; T. M. C. Asser, A. O. Liuksila, J. K. Oh. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; R. G. Alter, D. A. DeRosa, E. Hernández-Catá, N. M. Kaibni, H. C. Kim, M. S. Kumar, E. C. Meldau-Womack, P. R. Menon, A. Muttardy, R. Pownall, B. E. Rourke, H. H. Zee. Secretary's Department: C. Brachet, Deputy Secretary; B. J. Owen. Treasurer's Department: F. G. Laske, Director; K. Boese, S. I. Fawzi, D. Gupta. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director; M. Caiola, Deputy Director; D. L. Budhoo, L. A. Cardemil, J. Clark, E. Decarli, R. A. Elson, D. N. Lachman, S. C. de Sosa, S. J. Stephens. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, S. M. Hassan, A. R. Ismael, Khong K. N., K.-H. Kleine, J.-C. Obame, G. Pineau, D. C. Templeman, A. Vasudevan, K. Yao, J. E. Zeas. Assistants to Executive Directors: N. Adachi, A. A. Badi, H. S. Binay, R. Comotto, E. C. Demaestri, F. Di Mauro, W. N. Engert, S. K. Fayyad, S. Guribye, M. A. Hammoudi, C. L. Haynes, M. Hepp, Hon C.-W., L. Hubloue, A. Iljas, J. M. Jones, S. King, M. A. Kyhlberg, T. Morita, J. A. K. Munthali, C. Noriega, L. M. Piantini, S. Rouai, G. Schurr, B. Tamami, E. L. Walker, Wang X., D. A. Woodward.

1. COMPENSATORY FINANCING FACILITY - REVIEW

The Executive Directors continued from the previous meeting (EBM/87/156, 11/17/87) their consideration of a staff paper on the review of the compensatory financing facility and proposals for concessional compensatory financing and an external contingency facility (EBS/87/165, 7/28/87; and Sup. 1, 7/30/87).

The Director of the Research Department said that the staff had taken careful note of the various comments that had been made during the useful discussion on the compensatory financing facility. The issues and questions that had been raised and the suggestions for further work would provide helpful guidance in the continued review of the facility and in the analysis of possible broader treatment of external contingencies.

The staff had made a significant effort to reflect in the latest papers the various views that were expressed by Executive Directors during the previous discussion on the compensatory financing facility, on March 3, 1987, the Director remarked. During that discussion, there had been a wide range of views reflecting different positions on many aspects of the compensatory financing facility, including conditionality, access, phasing, determination of export shortfalls, and contingencies. The differences in emphasis on the various issues as well as the preliminary nature of the discussion had been highlighted in the summing up.

In formulating its latest proposals, the staff had looked for elements that might help to narrow or bridge Executive Directors' different views, the Director commented. In other words, the staff had been searching for a reasonable compromise. To that end, the staff had tried to include elements from the positions of Executive Directors who favored liberalizing the compensatory financing facility and those who favored some tightening of the facility. In that connection, it was useful to bear in mind several key features of the staff proposals. When a member country's balance of payments problem reflected only a reversible export shortfall, the member would be eligible for a maximum 83 percent of quota, without the need for a Fund-supported program and without phasing. That approach was consistent with the view--mentioned in the March 3, 1987 summing up--of Executive Directors who wished to preserve the existing characteristics of the compensatory financing facility, so that it could be used in a timely and appropriate way by all members facing reversible balance of payments problems.

The staff proposals envisaged a more flexible application of the guidelines on cooperation that would apply to the reduced lower tranche so that access to it would be eased; that approach was meant to be a response to the limited use of the lower tranche in recent years. At the same time, the staff had proposed that while the total access limit of 83 percent of quota would be left unchanged, the access under the lower tranche should be reduced to 33 percent. Accordingly, there was some trade-off between ease and amount of access. However, the aim was to facilitate access to the lower tranche for member countries that had a reversible export shortfall that was superimposed on a longer-term, irreversible balance of payments problem. Another important element of the staff proposals was the additional way in which a member country could qualify to use the compensatory financing facility: even if a member country did not have a calculated export shortfall, it could still be eligible for compensation if its export earnings were subject to deviations from the export trend that was assumed under a Fund-supported program, as long as the deviation was due to factors beyond the control of the member country.

It was important to note that, under the staff proposals, the treatment of contingencies was viewed as a supplement to, or a mechanism to be included in, existing arrangements, the Director went on. Contingent financing was not envisaged as a replacement for the more traditional use of the compensatory financing facility. It was also useful to remember that the staff proposal on the use of contingencies had been brought to the Executive Board's attention in a staff paper (EBS/87/165), which had been circulated on July 28, 1987.

The staff proposals also reflected the views of Executive Directors who wished to ensure that the compensatory financing facility would, in the words of the March 3, 1987 summing up, "not serve to weaken the incentive to adjust or contribute to future debt servicing difficulties, "the Director remarked. The staff proposal on phasing was meant to meet that concern. In sum, the staff's aim had been, and continued to be, to help to find ways to improve the compensatory financing facility that would, to the extent possible, meet the concerns that had been expressed by all Executive Directors.

As to the staff's guidelines for future work, there had clearly been strong endorsement for providing a comprehensive analysis of possible approaches to contingent use of Fund resources, the Director said. Some Executive Directors thought that it would be best to provide for an external contingency facility within existing facilities. Other Executive Directors considered that a new facility should be introduced. That issue would have to be the subject of further deliberation.

A critical difficulty on an analytical level was that the use of contingencies involved a kind of insurance principle to cover the possibility that, while on average, developments in the external payments would be satisfactory, there could be deviations from a desired path, the Director of the Research Department commented. Such an insurance principle involved in turn an element of symmetry. In addition, there was a continuing concern that a Fund-supported program should not be derailed by an unexpected external shock. In that context, one would have to examine whether the shock was permanent or transitory, whether or not program targets should be changed in the course of the program period, and for how long breathing space should be given in the event of an external shock that threatened to throw a program off track.

Further work would be needed on all those critical issues. Indeed, one of the main general conclusions that could clearly be drawn from the discussion was that there had been a strong call for serious study, at both the analytical and operational levels, of all the various possible features of a contingency. The staff would continue working on the analytical foundations of the various contingency elements as well as on the more operational implications. That effort would require significant staff time and resources.

The Deputy Director of the Research Department recalled that the question had been raised whether it would be helpful to include in a contingency mechanism an aggregate indicator, such as the current account, to examine changed financing needs, or, alternatively, whether it might be better to use a more disaggregated approach and consider a number of key components, such as import prices and export volumes, and interest rates. Among the advantages of the disaggregated approach was that it would probably be easier to establish that the problems facing a country had been caused by factors beyond its control and the relevant data would probably be available relatively soon. However, it was important to consider whether the structure of foreign exchange flows across different developing countries would be sufficiently similar to enable the Fund to use three or four variables in assessing the situation in a wide variety of member countries. The staff would have to look carefully at that matter, with a view to determining whether the variety of circumstances that could be covered would be sufficiently broad. Mr. de Groote had made the interesting suggestion that the world economic outlook forecast could be used as a baseline for a contingency mechanism, thereby preventing prolonged negotiations over the choice of the baseline. The staff would also wish to carefully consider that possibility. The world economic outlook would naturally provide some variables for assessing the global environment. Of course, some of the variables in a baseline would have to be more country specific--for example, import prices and export volumes. However, specifying the baseline scenario in advance could make the contingency exercise potentially less contentious.

Another interesting suggestion was that of Mr. Posthumus for possible ways of changing the adjustment and financing mix under a contingency mechanism when there were deviations from an expected path, the Deputy Director continued. In principle, of course, it was best to respond to temporary disturbances with financing, and to respond to more permanent disturbances with adjustments. In practice, there were difficult questions concerning how long a facility should provide protection against disturbances and precisely when adjustments should be made.

In his comments on moral hazard, Mr. Dallara had made the point that a member's policy decisions were not as great a cause for concern when adverse developments were exogenous in nature, the Deputy Director said. He certainly sympathized with Mr. Dallara. However, the issue of moral hazard raised a number of questions. For example, while international interest rates could be regarded as being exogenous in nature, one would have to consider whether a country's decision on how much to borrow abroad would be affected by the existence of a facility that would compensate for part of an increase in the country's interest payments. Similarly, a lender's decision on making a loan and on the interest rate on the loan might be influenced by its knowledge that an increase in interest rate spreads might be covered by the contingency facility rather than by the borrowing country itself. The whole issue of moral hazard would have to be looked at further.

He agreed with Mr. Sengupta that the relationship between purchases under the compensatory financing facility, conditionality, and overdue financial obligations was largely empirical in nature and required considerable work, the Deputy Director of the Research Department remarked. Presumably one would wish to look at the independent influence of an increase or decrease in conditionality on overdue obligations, and a number of other factors could play a role--for example, the state of the world economy. One would also need to look at a period in which there had been compensatory financing purchases with and without Fund-supported programs. In recent years, relatively few compensatory financing purchases had been made by members that had also had an arrangement with the Fund, and the staff might well have to examine earlier periods. If the relationship between purchases, conditionality, and overdue financial obligations was to be determined essentially on the basis of relevant data, considerable work would have to be done.

Mr. Goos remarked that the staff and some Executive Directors seemed to prefer to base the coverage of a contingency mechanism on a set of selected indicators rather than on certain aggregated indicators, partly because the use of selected indicators was thought to make it easier to determine whether the problems facing a member country had been caused by factors beyond the authorities' control. Apparently that approach implied that the Fund would determine whether export and interest rate developments had deviated from the expected path and the Fund would then likely conclude that the deviation was beyond the control of the authorities and should be compensated. In his view, however, the criterion of beyond the control of the authorities should be broader. For example, if there appeared to be current account difficulties owing to developments in the indicators that had been selected, it would also be important to take into account developments in the capital account. If capital flows were found to be unchanged, it would be reasonable to ask whether the authorities should not have raised interest rates to more appropriate levels to encourage capital inflows, thereby obviating their need to receive compensation for the adverse developments in the current account and other external variables. If the application of the criterion of beyond the control of the authorities were to be taken seriously, there would have to be a comprehensive assessment of overall developments.

Mr. Kafka noted that in August 1987 the staff had provided him with a summary list of the opinions that had been expressed by Executive Directors during the previous discussion on the compensatory financing facility. The list had included the number of Executive Directors who had supported particular positions and the voting power of those Directors. His statement during the present discussion had been based largely on the information shown in that list.

The staff had noted the very strong support that had been expressed during the present discussion for introducing an element of contingency financing into the compensatory financing facility or into Fund arrangements with member countries, Mr. Kafka commented. In addition, strong support had been expressed for the idea that strengthening contingency financing should not be achieved at the expense of making compensatory financing more difficult for member countries to receive.

Mr. Sengupta recalled that in the Chairman's summing up of the previous discussion on the compensatory financing facility it was clearly stated that a member country need not have an arrangement with the Fund in order to meet the test of cooperation. Moreover, most Executive Directors had not called for any reduction in the access to the compensatory financing facility. Therefore, that summing up was not consistent with the staff proposal in its latest papers to reduce the first tranche from 50 percent to 33 percent; in addition, the staff had not clearly stated that the reduced tranche of 33 percent would be provided even in the absence of a financial arrangement with the Fund. The staff seemed to have suggested that the reduced tranche of 33 percent would be available only after the initiation of discussions on a financial arrangement, something that was clearly not consistent with the spirit of the Chairman's summing up of the previous discussion on the compensatory financing facility. Prior to 1985, the use of the first tranche under the compensatory financing facility had been practically automatic. The list of Executive Directors' positions to which Mr. Kafka had referred, clearly showed that the great majority of Executive Directors had not even suggested reducing the lower tranche of the compensatory financing facility.

An important issue with respect to a contingency facility was whether the contingencies would be specific to individual countries or would be based on a kind of general index along the line of the suggestion by Mr. de Groote, Mr. Sengupta remarked. As was proposed in the G-24 report, contingencies should be designed to help to protect the continued implementation of the policies under an arrangement with the Fund; an arrangement would typically include a baseline scenario for the balance of payments on the basis of which the financial program, including export earnings, other foreign exchange earnings and capital inflows, could be determined; the country concerned would then be able to calculate its credit requirements, and a ceiling on total government credit could be established, so that sufficient credit would be available for the private sector. Under present practices and procedures, the Fund had no way of ensuring that an arrangement could be continued in the event of adverse developments in exogenous variables. Accordingly, there should be a link between developments in exogenous variables and the possible need for additional financial resources in support of an arrangement. The exogenous variables in question would have to be agreed with the authorities in advance; accordingly, before the approval of any arrangement with the

Fund, there would have to be country-specific negotiations on which variables were within and beyond the control of a government. It would be agreed that a significant part of the deviation of the movement of selected variables from an expected path that adversely affected foreign exchange earnings would lead to the provision of compensatory financing.

Mrs. Filardo commented that some of the staff's positions in EBS/87/165 seemed to be inconsistent with statements by the staff in EBS/87/165, Supplement 1. For example, the supplementary paper contained arguments in favor of making no changes in the compensatory financing facility; in particular, the staff had argued that phasing would not be convenient, but phasing was proposed in EBS/87/165. Further clarification of the staff's proposals would be helpful.

The staff representative from the Research Department commented on the interpretation that some Directors had given to the results of an analysis of phasing of compensatory financing purchases in the supplement to EBS/87/165. Some Directors thought that that phasing experiment was directly comparable to the tranching proposal in the main paper and thus interpreted the tranching proposal as likely to result in a diminution of the stabilizing role of the compensatory financing facility. The tranching proposal in EBS/87/165, however, emphasized that a compensatory financing purchase would be assessed in relation to the existence of a shortfall at each phase of disbursement. With shortfalls typically lasting for periods up to two years, the linking of each tranche to a shortfall would make for a better synchronization of compensatory finance purchases and shortfalls and in this respect the stabilizing property of the facility would likely be enhanced. In the supplement, the staff had experimented with the phasing of compensatory financing purchases but without reference as to whether each disbursement was associated with a shortfall. For a given shortfall, the staff had simply compared the effect on instability of an unphased purchase associated with a contemporaneous shortfall--which was essentially the same as the tranching proposal--and a purchase phased over four or eight quarterly disbursements without a link between disbursements and shortfalls. The exercise had shown that that particular form of phasing lessened the stabilizing influence of compensatory financing assistance.

The list of Executive Directors' positions at the March 3, 1987 discussion, to which Mr. Kafka had referred, was very tentative and was meant to serve only as a guide for the staff in its efforts to adhere to Executive Directors' views in the next papers on the compensatory financing facility, the staff representative said. A wide variety of views had been expressed during the March 3, 1987 discussion; there had been no clear majority with respect to any of the various issues that the Executive Board had considered or the proposals that had been made during the March 3, 1987 discussion. The staff had taken that outcome to mean that its task should be to try to bridge the differences in views on the various issues that had been aired during the March 3, 1987 discussion.

The suggestion made during the March 3, 1987 discussion to reduce the lower tranche under the compensatory financing facility to 33 percent had been made by Mr. Posthumus, the staff representative recalled. He had further suggested eliminating the conditionality on the lower tranche of 33 percent, so that access to it would be automatic. As the staff had noted in its paper, and as speakers had mentioned during the present discussion, the lower tranche of the facility had been used only infrequently in the recent past. An important objective of the staff proposal was to make the use of the lower tranche of the facility more active. The 1983 guidelines continued to serve the staff in making judgments about the cooperation requirement for the lower and upper tranches of the compensatory financing facility. The staff proposal was intended to interpret those guidelines for the lower tranche in a way that would make that tranche more acceptable. Under the staff proposal, access to the lower tranche would not be automatic. It remained to be seen, if the staff proposal were adopted, how the lower tranche could be made more accessible and at what stage of the adjustment process it would be considered suitable to release the first tranche. The staff's intention clearly was to make a trade-off between a reduction in the access to the lower tranche and an increase in the accessibility to that tranche.

It should be clearly understood that, in accordance with the 1983 guidelines, there was not necessarily a link between a stand-by arrangement and the release of the upper tranche of the compensatory financing facility, the staff representative from the Research Department said. Whether a member country chose to enter into a stand-by arrangement with the Fund was a matter for discussion and was ultimately a matter of choice for the country itself. The 1983 guidelines underscored the need for a member country that was to use the upper tranche of the compensatory financing facility to make needed policy corrections.

Mr. Sengupta stated that he continued to feel that the staff proposals were not consistent with the positions of Executive Directors as reflected in the Chairman's summing up of the discussion on March 3, 1987. It was true that Mr. Posthumus had suggested reducing the lower tranche of the compensatory financing facility, but he had also suggested eliminating the conditionality applicable to that tranche, and the staff had chosen to take up only one part of Mr. Posthumus's proposal. Moreover, he agreed with Mrs. Filardo that the staff papers contained conflicting statements. The study undertaken by the staff on purchases under the compensatory financing facility clearly showed that phasing undermined the facility's stabilizing role. The staff had concluded that "phasing could be considered to run counter to the one central objective of the facility, that is, that the compensation should take place as closely as possible in time to the shortfall to which it relates."

Mrs. Filardo added that on page 13 of EBS/87/165, Supplement 1, it was stated that "this suggests that there may well be a trade-off in phasing--it may have the benefit of increasing the incentive to pursue adjustment, but also at the cost of reducing the effectiveness of the facility in stabilizing foreign exchange earnings."

The Chairman then made the following summing up:

In this most useful discussion of the compensatory financing facility, Executive Directors considered two sets of issues. The first set dealt with possible operational modifications of the facility so as to better adapt the facility to today's environment. The second set addressed two important recent proposals--one concerning concessional assistance under the compensatory financing facility to low-income countries, and the other exploring the possibility of introducing a broader treatment of external contingencies, either by extending the compensatory financing facility or perhaps even by replacing that facility with a new external contingency facility. I should note at the outset that many Directors stressed that their interventions at this stage should be considered tentative in nature. There was a wide divergence of views on the issues before the Board, and in this summing up I will attempt to reflect the range of views that were expressed on these subjects.

It would be fair to say that, while all Directors were willing to consider the issues involved in establishing an external contingency facility, the large majority of Directors also felt that any broader treatment of contingencies should not be at the expense of diminishing the vital role played by the compensatory financing facility in Fund operations. They emphasized that the compensatory financing facility's traditional role of compensating for past deviations of export receipts was a valuable one that ought to be retained. At the same time, many Directors felt that various aspects of the compensatory financing facility could be improved by modifying some of its features. Therefore, let me first turn to the issues surrounding such modifications. Following that, I will attempt to summarize the views of Directors on the two previously mentioned proposals regarding concessional assistance and a broader contingency mechanism.

In reviewing compensatory financing conditionality, Directors noted that the interpretation of the current guidelines had been such as to greatly reduce use of the lower tranche of the facility and to make access to the upper tranche virtually dependent upon having a contemporaneous stand-by or extended arrangement with the Fund.

One group of Directors took issue with the inference that strict conditionality was needed because the compensatory financing facility had been a major factor in the growth of overdue obligations. They argued that the emergence and growth of overdue obligations could be found in the difficult state of the world economy. These Directors were not persuaded that the proposals in the staff paper to divide compensatory financing purchases into three tranches, instead of the present two, would promote operational flexibility of the compensatory financing facility. While they understood that the intention was to ensure greater use of the proposed new lower tranche, they thought that in practice this tranche would again become the subject of negotiations and there would be no effective easing of conditionality governing purchases from this tranche. In general, they felt that an increased number of tranches would reduce the effectiveness of the facility in providing timely compensation for export shortfalls and that phasing would undermine the stabilizing role of the facility. At the same time, they did not feel that directly associating the two proposed upper tranches with performance under stand-by or extended arrangements would assist greatly in reducing the incidence of overdue obligations. It is probably fair to conclude that these Directors were of the view that the current conditionality is already too tight, with some strongly urging an interpretation of the guidelines that would allow more timely compensation for export shortfalls and reduced association between stand-by arrangements and the use of the compensatory facility that has characterized the recent past. A few Directors could go along with the phasing arrangement proposed by the staff provided total access was raised.

Another group of Directors reaffirmed their position that safeguarding the revolving nature of the Fund's resources was--and should continue to be--an important concern in governing access to the compensatory financing facility. They believed that the 1983 guidelines had been overtaken by changes in the global economic environment. They were concerned that potentially large compensatory financing purchases at the outset of adjustment programs could leave the Fund in a seriously exposed position and put additional strain on a member's debt servicing capacity. It was these concerns that led this group of Directors to express a preference for moving toward some form of phased access for compensatory financing purchases. They considered that, overall, the tranching proposal in the staff paper represented a reasonable solution to their concerns, but some proposed that the lower tranche should be reduced to 25 percent of quota and the second tranche raised to 58 percent of quota. In general, these Directors remained concerned, however, that the proposal for a more liberal access to the reduced lower tranche, by providing it at the stage of discussion of an arrangement, would involve no effective conditionality and would provide little in the way of genuine safeguards for Fund resources. Some Directors were not in favor of allowing a compensatory financing purchase up to 50 percent of quota for a member with a program in the first credit tranche, but would in exceptional cases allow a purchase accompanied by an arrangement approved in principle. For the third tranche, purchases by members with a structural adjustment arrangement would be allowed on a case-by-case basis.

In concluding this part of our discussion, I think it would be helpful to recall the rationale underpinning the proposal contained in the staff paper. It should be stressed that, as with current practice, access up to the maximum quota limit would continue to be made available for members for which the only source of balance of payments difficulty is the effect of the temporary export shortfall. For countries with shortfalls superimposed on longer-term balance of payments difficulties, use of the reduced lower tranche would be applied more flexibly than at present, with the effect that the lower tranche would become more accessible, thereby ensuring that the facility would continue to fulfill its intended role of providing timely compensation for export shortfalls. Release of the upper tranches, however, would be more closely linked with the adoption and the implementation of needed adjustment. I would conclude from the discussion that Directors wish the staff to continue to explore ways of incorporating various ideas that have been put forward, as well as the views reflected in my summing up of the March 1987 discussion--both with regard to compensatory financing and contingency arrangements--into proposals that could lead to a consensus by the Board.

On the more technical issue concerning the calculation of shortfalls, some Directors agreed that the setting of a ceiling on export projections would provide a suitable solution to the problem of compensation in the case of rapid export growth either in the shortfall year or in the postshortfall period. They also agreed that a lower projection limit was not warranted, since the present formula has a built-in safeguard against compensation in case of an accelerating decline in exports. Some Directors did not consider that the staff suggestions go far enough, while others did not see a need to change the present calculation method.

On the issue of overcompensation in successive purchases, most Directors agreed with the inherent logic of reducing the size of a second purchase which fell within the projection period (i.e., roughly two years) of an early purchase where those projections had proved to be optimistic. Failure to make such a deduction was indeed contrary to the spirit of the compensatory financing facility. Reasons of symmetry would suggest, however, that any undercompensation of the first purchase should also be corrected if found to be the case when calculating eligibility for the second purchase. Some Directors also thought it entirely appropriate to make an adjustment for overcompensation even after a longer period, when a member requests a purchase while an earlier purchase is still outstanding.

While not all Directors addressed themselves to the proposals concerning the cereal decision, a number of them were in favor of either the relaxation of the three-year rule under the cereal decision or the establishment of a separate facility. Other Directors did not support any change in the current arrangement, with some reiterating their general opposition to a facility oriented toward a specific component of the balance of payments. Thus, it is too early to draw the sense of the Board on this matter.

Directors commented favorably on the motivation behind recent proposals to provide compensatory financing on concessional terms, encompassing both the rate of charge and the repayment period, for low-income members. A number of Directors thought that it would be appropriate for members embarking on the long process of structural adjustment supported by Fund lending under the structural adjustment facility to receive compensatory financing assistance on similar terms. I think that it is fair to say, however, that in our discussion, the majority of Directors thought that there would be considerable merit in channeling concessional assistance through augmentation of the resources under the structural adjustment facility. Nevertheless, some Directors felt that the concessional use of the compensatory financing facility should remain under consideration, with one Director suggesting examination of the possible use of structural adjustment facility resources to provide concessional compensatory financing assistance.

Our preliminary discussion on a possible contingency facility has been very broad ranging and stimulating. I will be guided by your views in suggesting the direction of our further work on this topic. There was a broad consensus that contingent access to the Fund's resources based on developments in external factors over which members exercise little or no control could contribute to the success of adjustment programs in the present difficult and unpredictable external environment.

The majority of Directors were not in favor of replacing the compensatory financing facility by a contingency facility, but a few Directors supported consideration of this idea and a few others were willing to consider integrating an external contingency facility with the compensatory financing facility. Those Directors in favor of retaining the compensatory financing facility supported further consideration of a contingency mechanism so long as it worked alongside the compensatory financing facility.

Some Directors were opposed to contingency mechanisms that would be triggered by specific balance of payments components, as this would run counter to the purpose of the Fund to provide overall balance of payments support. Some Directors were also of the view that the inclusion of interest rates in a contingency mechanism would not be appropriate, or that such inclusion would pose a number of operational problems and could have a damaging effect on the Fund's liquidity position; on the other hand, some other Directors not only favored the inclusion of interest rates but a broadening of the contingency concept to include a growth contingency.

My sense of the meeting is that Executive Directors wish the staff to examine in detail the technical aspects of approaches to contingent use of Fund resources and the modalities of their possible operation, taking into account the views expressed at this meeting.

I would propose that a further round of discussion of the issues considered at this meeting be conducted in February or early March 1988. It remains my view that we should complete the review of the compensatory financing facility before the April 1988 meeting of the Interim Committee, in keeping with our mandate from the Committee as expressed in its most recent communiqué.

Mr. Dallara said that he agreed that only a few Executive Directors were open to, or supportive of, the proposal to replace the compensatory financing facility with an external contingency facility, and most Executive Directors obviously did not feel that such a replacement should occur. However, a group of Executive Directors, possibly including Mr. Massé, Mr. Enoch, Mr. de Groote, and others seemed to be open to the idea of integrating a contingency mechanism into the compensatory financing facility, and he wondered whether that group was clearly captured in the summing up.

Mr. Sengupta remarked that most Executive Directors seemed to favor having a contingency mechanism supplement the existing compensatory financing facility. For example, Mrs. Ploix had used the term "supplement" and that term was consistent with the spirit of the statements by most Executive Directors.

Mr. Dallara remarked that he wondered whether the several Executive Directors who favored substituting an external contingency facility for the compensatory financing facility together with Executive Directors who could accept some integration of the two did not constitute a majority of Executive Directors who had taken a position on that matter. He doubted whether it was correct to conclude that a majority of Executive Directors felt that contingency mechanisms should be a supplement to the compensatory financing facility.

Mr. Nimatallah commented that the Executive Directors appeared to be willing to consider a contingency mechanism--rather than an external contingency facility--only if it would not be at the expense of eliminating the compensatory financing facility. Accordingly, the contingency mechanism would have to be in combination with the compensatory financing facility in order to supplement the facility.

Mr. Lankester said that in the future he hoped that there would be an in-depth discussion of the external contingency facility. His preference was for such a facility to replace the compensatory financing facility. He was prepared to regard melding a contingent facility into a compensantory financing facility as a fallback.

Mr. Kafka considered that it was important to state clearly that there was no majority in favor of eliminating the compensatory financing facility and replacing it with a contingency facility or mechanism.

The Chairman remarked that the current discussion had, of course, been preliminary in nature. The fact that there had not been broad support for a particular proposal did not mean that the proposal should be put aside. For example, there had not been broad support for Mrs. Ploix's proposal to introduce concessional compensatory financing, but the discussion of the idea had been continued in order to give the French authorities an additional opportunity to elaborate on their proposal. The same conclusion was applicable to Mr. Dallara's proposal. It was important to give a chair a full opportunity to present constructive proposals.

There appeared to be a broad consensus in favor of more in-depth discussion of the proposal to establish contingent access to the Fund's resources, based on developments in external factors over which members exercised no control, as a means of contributing to the success of adjustment programs in the present difficult and unpredictable external environment, the Chairman continued. While the proposal at hand was a contingency facility, Executive Directors seemed to be more inclined to discuss contingent mechanisms. The present starting point of the discussion would of course not prejudge the final outcome. However, it might be useful to state in his summing up that the majority of the Executive Directors were more inclined to consider contingency mechanisms than a contingency facility. His summing up had meant to show clearly that there was more interest in the Executive Board in contingency mechanisms than in introducing a contingency facility as a replacement for the compensatory financing facility. All the operational issues that had been raised would be carefully assessed by the staff in coming weeks.

Mr. Sengupta remarked that he had noted that the Chairman had stated that most Executive Directors did not favor giving up the compensatory financing facility in favor of an external contingency facility. At the same time, the possibility of introducing a contingency mechanism was still under consideration. That point could be usefully underscored in the summing up.

Mr. Dallara commented that it was difficult to make a sharp distinction between a contingency mechanism and a contingency facility. If contingency mechanisms were built into the existing compensatory financing facility, would that facility continue to be just the compensatory financing facility, or a compensantory and contingency facility? It would perhaps be accurate to state that the majority of Executive Directors had expressed a preference to explore contingency mechanisms, perhaps incorporated in the existing facilities, in lieu of the creation of a separate facility.

Mrs. Ploix said that she agreed with Mr. Kafka that it should be clearly stated that the majority of Executive Directors did not favor eliminating the compensatory financing facility in favor of establishing an external contingency facility.

Mr. Kafka remarked that, as the Chairman had noted, the Interim Committee had expressed the hope that the Executive Board would complete its review of the compensatory financing facility by the time of the Committee's spring 1988 meeting. However, the Executive Board had sometimes found it necessary to go beyond deadlines set by the Interim Committee, and, given the importance of the review of the compensatory financing facility, it might be necessary to seek the Interim Committee's views before completing the review if the Executive Board did not have sufficient time to complete its discussions before the April 1988 meeting. The Executive Board should not feel pressured to reach a conclusion on the review of the facility. If a contingency facility were further discussed, the issue of voting majorities should be examined.

The Chairman commented that every effort should be made to meet the Interim Committee's request to complete the review of the compensatory financing facility before the April 1988 meeting. It was conceivable that the Executive Board might decide, say, in March 1988, that further guidance from the Interim Committee was necessary before the review of the compensatory financing facility could be completed. However, he hoped that all involved would make every effort to conclude the review in time.

The Executive Directors agreed to resume their discussion on the review of the compensatory financing facility in the afternoon, after taking up the other items on the agenda.

2. JAMAICA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff paper for the second review under the 15-month stand-by arrangement for Jamaica approved on March 2, 1987 (EBS/87/217, 10/15/87; and Cor. 1, 11/17/87).

Mr. Massé made the following statement:

> The Jamaican economy continues to perform well under the adjustment program supported by Fund resources. All performance criteria have so far been met, and external payments arrears were eliminated at the end of June 1987. Economic performance has been sufficiently robust to warrant an upward revision in projected real GDP growth in 1987/88 to 4 percent. Although this faster growth poses some added complications to economic management in terms of balance of payments and inflationary pressures, my authorities are pleased by the strong signs of recovery.
>
> It appears likely that the balance of payments current account deficit will be larger than initially projectd, about 5 percent of GDP. To a great extent, the larger current account deficit stems from a recovery in investment. Imports of capital goods and raw materials have grown rapidly. Private capital flows have increased sharply to finance the import expansion, ensuring that the balance of payments test within the program is being met. Nevertheless, my authorities understand and share the concerns of the staff about the risks of overheating. Some questions also exist as to the nature and sustainability of private capital inflows.

My authorities do not wish to see any reversal of the hard-won gains so far achieved and therefore have adopted a more active stance with respect to monetary policy while maintaining fiscal restraint. The Bank of Jamaica is now making more active use of its open-market operations to ensure that the growth of liquidity within the financial system is held in check. A careful balance with respect to interest rates and credit policy has been struck, since slower growth of credit to the private sector is desirable at this time; my authorities also wish to avoid any sudden or sharp increase in interest rates which might disrupt the nascent recovery in economic output.

Fiscal policy during the remainder of the adjustment program will need to complement this monetary stance. It should be emphasized that fiscal performance so far in 1987/88 has been very strong, with expenditures in line with program projections, and revenues significantly higher than originally projected. To ensure that fiscal performance continues to be cautious, the Government will maintain a safety margin below the fiscal deficit ceilings, rather than devote the entire increment in available fiscal resources toward higher government investment outlays.

With respect to incomes policy, the broad range of recent wage increases has been more or less consistent with the 10 percent wage guideline. My authorities recognize the staff's concern with respect to incomes policy, and will continue to apply the incomes policy standard in an even-handed fashion to build public support for the adjustment process.

This arrangement is a valuable example of reasoned flexibility on the part of the Fund staff in the design and monitoring of a stand-by arrangement. As economic circumstances in Jamaica have evolved, the staff has proposed various modifications and adjustments to the arrangement itself, consistent with the changing circumstances. This sort of practical judgment is essential if we are to continue to make progress in designing programs which incorporate adjustment with growth.

Mr. Hospedales made the following statement:

The second review of the stand-by arrangement with Jamaica highlights a number of remarkable achievements: after a long period of economic stagnation, recovery in economic activity is becoming sustainable; at the same time, the rate of inflation has been reduced considerably and all of the performance criteria have been met--some with significant margins. Economic growth and financial adjustment is now proceeding satisfactorily as a result of the determined implementation of a comprehensive adjustment program, flexibly designed and appropriately financed.

Although Jamaica is clearly achieving a viable external payments position consistent with sustainable economic growth, the economy remains fragile and extremely vulnerable to external shocks, with a number of major imbalances lingering: the upturn in growth has led to increased employment, but the level of unemployment is still alarming; despite the initial improvement stemming from lower oil prices and international interest rates, the external position is now weakening, owing to the higher imports which have resulted from the increase in investment and the continued buoyancy in consumer expenditure; the reduction in the overall public sector balance and the central government borrowing requirement should not mask the fact that external public debt is still inordinately high; and debt servicing is equivalent to approximately 46 percent of exports of goods and services.

To their credit, the authorities fully recognize their responsibility to ensure that the growth-oriented adjustment under way is not undermined. Their prompt reaction to contain credit expansion and tighten fiscal policy when the effects of strong domestic demand growth, particularly on private consumption, became visible, was commendable. In addition, the policy mix ensures that the interest rate structure will remain appropriate. In light of the revised monetary outlook, which envisages a higher than expected growth in currency issue and private financial savings, the waiver of the ceilings on net domestic assets of the Bank of Jamaica is clearly necessary and appropriate. The complementary strong fiscal action which is creating a margin of overperformance with respect to the fiscal deficit would provide some assurance of additional financing during the course of the program, if the factors that are having a favorable impact were to suddenly turn against Jamaica.

The completion of the rescheduling agreements with commercial banks and official creditors and the debt conversion scheme have made a solid contribution to reducing the rate of growth of the external debt and to improving its maturity structure. For this reason, the proposed modifications to the stand-by arrangement to neutralize the impact of the debt-equity conversion scheme on changes in the ceiling on net external debt and the public sector borrowing requirement are broadly acceptable to my authorities, and the proposed waiver of the performance criterion on exchange restrictions associated with the limitations on profit remittances under the debt-equity scheme--a standard practice under such arrangements--are justifiable.

Competitiveness is one element that will stand in the way of fully exploiting the potential for economic expansion. Therefore, a stable exchange rate policy is a key element in the new policy approach, because it will help to achieve benefits such as: moderation of the inflation rate, restoration of business confidence, and increased private commercial inflows. I will caution, however, that the implication of this approach implies that medium-term competitiveness must be achieved in other ways; and for this reason, rising wage costs are a matter for concern. Continuing efforts to strengthen wage restraint must be accorded a high priority if the external deficit and economic growth are to be made sustainable.

Mr. Fernández made the following statement:

The significant improvement in Jamaica's economic performance and prospects since the approval of the stand-by arrangement in 1986 is encouraging. Considerable progress has been made toward the reduction of domestic and external imbalances, and after years of stagnation, the economy has begun to grow at a very satisfactory rate.

This economic recovery has been accomplished in the framework of a Fund-supported adjustment program which has been successfully adapted to the varying circumstances facing the country. Performance under this stand-by arrangement has been highly satisfactory; not only has Jamaica complied with all the performance criteria for end-June 1987, but it has also successfully maintained a very low rate of inflation in an atmosphere of strong economic reactivation.

The welcome strengthening in the net international reserve position of the Bank of Jamaica was sustained not only by the very rapid growth of tourism and nontraditional exports, but also by the public sector's financial outcome. In fact, the better than programmed financial outturn in this sector allowed for a reduction in net external financing. However, I am concerned about a possible short-term overheating of the economy. Although the strong recovery in different areas and the concomitant growth in aggregate demand will be adequately absorbed in the medium term and will have a positive economic impact, the possible short-term pressures on domestic prices and the balance of payments is worrisome.

If Jamaica is to consolidate recent gains, extreme caution should be exercised in monetary and fiscal management. In this respect, I welcome the authorities' intention--as stated both in the letter of intent and in Mr. Massé's opening statement--to implement monetary and fiscal policies that will moderate the growth in overall demand. The measures already implemented, such as the increase in open market sales by the Bank of Jamaica and further restraint in new public investment, are steps in the right direction, especially because they are being accompanied by flexible exchange and interest rate policies. However, although a general improvement in business confidence is evident, the authorities should be prepared to take any additional fiscal measures that may become necessary to further stimulate private sector activity.

I support the authorities' request for modification to the performance criteria as indicated in the proposed decision. I share the staff view that there is a methodological reason for the first two modifications listed on page 1 of EBS/87/217, which relate to the recently initiated debt-equity conversion scheme. Those modifications will only neutralize the effects of this scheme on the program supported under the stand-by arrangement. Furthermore, the stronger than expected growth performance and the concomitant higher than expected growth of currency issue and private financial savings amply justify the modification of the ceiling on net domestic assets of the Bank of Jamaica.

I congratulate the authorities for the substantial progress made thus far. However, the difficulties ahead should not be underestimated, particularly in view of the still fragile external situation. Therefore, the authorities should persevere in their efforts and continue to pursue prudent domestic policies. I endorse the proposed decision and strongly support the authorities' request--stated in their letter of intent--for technical assistance from the Fund in the areas of public finance statistics and monetary accounts.

Mr. Lankester made the following statement:

I commend the authorities for their continued compliance with the performance criteria, and particularly the overperformance so far achieved on the fiscal side. However, I am concerned about the substantial increase in public sector wages. There is a risk of overheating in the economy, and the authorities should adopt a cautious approach to the continued expansion of demand. The overperformance by the Government and by the Bank of Jamaica, during the first quarter of 1987, is expected to be reversed during the remainder of the year, and the fiscal position for the year as a whole is expected to deteriorate with the overall deficit slipping back to the originally targeted level--thus, implying a higher than expected deficit for the remainder of 1987.

Domestic financing in the second to fourth quarters is now estimated to reach nearly double the level originally planned--J$413 million compared with J$236 million. In view of the need to restrain demand through monetary and fiscal action, it would seem desirable for the progress made in the first quarter to be maintained rather than being used to allow some relaxation in the remainder of the year.

The expected achievement of the deficit target for 1987 is based on an increase in proceeds from divestment, amounting to J$34 million, which accounts for almost all of the improvement in the Government's position. I hope the authorities agree that additional revenue obtained through sales of assets is more akin to financing than to increased revenues in terms of its impact on effective demand, and that fact needs to be considered in policy formulation.

It was reported in the London Financial Times on October 13, 1987 that ALCOA intended not to sell the Clarendon Aluminum Refinery to the Government, and the staff should comment on the present status of that refinery. If the purchase by the Government does not proceed, the change in the performance criteria agreed to in August to allow for that purchase should be reversed. In addition, Air Jamaica has netted some $14.5 million from terminating a leaseback agreement, and I would welcome the staff's comments on how that transaction will be treated in the fiscal accounts.

The acceleration of bank credit to the private sector is potentially worrying. However, this is mitigated somewhat by the concentration of additional credit in investment projects, which in turn accounts for much of the higher than expected imports. In this context, the adjustments made to monetary policy are welcome.

While the better than expected performance of the overall balance of payments is welcome, the weaker performance of the current account is a little worrying. The latter trend is expected to continue, albeit to a reduced extent through the remainder of the financial year, while private capital inflows are projected at a lower level than previously anticipated.

As Mr. Massé noted in his opening statement, there are some doubts about the nature and sustainability of the private capital inflows that enabled Jamaica to finance the larger than expected current account deficit; therefore, it would be prudent to avoid undue dependence on the continuation of those inflows and to bring the current account deficit back into line with the original projections.

The introduction of the debt-equity scheme is welcome, and I support the modifications to the performance criteria contained in the proposed decision. The Board has approved Jamaica's exchange restrictions evidenced by external arrears until March 1988. In view of the current legal action described on page 10 of EBS/87/217 and the legal implications of Article VIII of the Fund's Articles of Agreement, I wonder whether it would be better to limit this approval so as to exclude those loans subject to litigation. I believe that was done in a previous case, that of Costa Rica.

Mr. Grosche made the following statement:

The authorities have been making substantial progress under the stand-by arrangement in a number of areas that are of critical importance to the restoration of overall stability. Increased nontraditional exports, the performance of the tourism sector and the inflow of private capital have contributed to an expansion in real output. All quantitative performance criteria for end-June 1987 were met, and the end-September performance criteria are likely to be met. I commend the authorities for these achievements.

However, the difficult medium-term outlook has not changed materially, and the external position remains fragile. Projections contained in the staff report for the first review of the current stand-by arrangement indicated that Jamaica's balance of payments position will remain under pressure for several years. Furthermore, the financing will continue to be difficult, as was demonstrated by a legal dispute with one creditor bank regarding the multiyear rescheduling agreement.

The economic expansion is welcome, but clearly is not without risks for the external position. If too much emphasis is placed on growth, an overheating of the economy cannot be ruled out. Under the present circumstances, timely measures to reduce domestic liquidity through monetary and fiscal action are warranted and appropriate, and Mr. Massé's assurance that the authorities are aware of potential problems and are willing to continue fiscal restraint and contain monetary expansion is welcome. However, there are other areas that require continuous or even increased attention including, in particular, incomes policy and external competitiveness.

The authorities have proposed that the external debt ceiling should not be affected by any debt-equity transaction, and that the related increase in domestic debt should be excluded from the calculation of the public sector borrowing requirement. In other words, the Government would not have to lower its expenditure and borrowing ceilings to accommodate possible larger private investments. As expenditure cuts might be required under present economic conditions, I wonder whether it would be more appropriate to finance the debt-equity conversion scheme out of savings rather than through monetary expansion. I endorse the staff appraisal and the proposed decision.

Mr. Sliper made the following statement:

The staff's description of recent trends in Jamaica as being satisfactory is appropriate and accurate. In this case, satisfactory depicts a situation in which there are both good and not so good things happening, which is a fair representation of economic trends and economic policymaking in Jamaica.

The encouraging developments are the steady growth in 1987 and the growth prospects for 1988. Similarly, the rise in exports, especially in tourism and nontraditional exports, is encouraging. In addition, the Government's resolve to use open market operations to control the credit expansion and the self-imposed restrictions on public investment are welcome initiatives with respect to economic management.

However, there are some worrying features about the recent trends. The strong expansionary phase is starting to impose significant strains on the domestic economy, especially on the conduct of monetary policy. There are doubts about whether the credit expansion phase is totally under control and whether the policy initiatives were "too little, too late." As the staff pointed out, the recent wage increases in the public sector could set off a significant wage spiral.

On the fiscal front, the authorities have been blessed with larger than expected revenue from income tax receipts. It appears that nearly all of the fiscal deficit--currently about 6 percent of GDP--can be attributed to the losses recorded by the Central Bank. These losses are a reflection of the Government's efforts over recent years to mask the real cost of credit policy. Through a variety of mechanisms, the Government has tried to absorb the costs of borrowing, both domestically and internationally, rather than passing them through to the rest of the economy. These losses are likely to grow as the Central Bank engages more in open market operations and has to pay higher interest rates. There would seem to be significant advantages to transferring these losses to the fiscal account where they rightly belong, and I hope that the Fund will continue to encourage such a transfer in its continuing discussions with the authorities.

When the present stand-by arrangement was originally approved in March 1987, this chair expressed reservations about approving or accepting any waiver of the performance criteria, because Jamaica's performance under previous arrangements had been below average, and my authorities had doubts about the adequacy of the adjustment effort in relation to the problems being encountered by Jamaica. However, my authorities are satisfied that the currently requested changes do not fundamentally modify the adjustment effort, but instead--as Mr. Massé noted--are necessary modifications that reflect changing circumstances. Therefore, I support the proposed decision.

Mr. Ouanes made the following statement:

There is no question that the economy is responding to the adjustment policies put in place under the program supported by the stand-by arrangement. After several years of stagnation, growth has resumed and is accelerating; inflation has been brought under control; relations with creditors have improved; and significant progress has been achieved in reducing internal and external imbalances.

However, as a number of Directors indicated during the first review of this program in August 1987, the progress made thus far remains fragile. While the present program remains broadly on track, recent developments raise a number of questions about the appropriateness of the envisaged policy mix and its effectiveness in sustaining present growth performance. There are also questions about the desirability of the present incomes policy.

With respect to the appropriateness of the policy mix, the recent growth rates of domestic credit and imports clearly suggest that aggregate demand is expanding well above output growth; this calls for prompt policy adjustment if the program objectives are to be achieved. The program's reliance on monetary policy is excessive and could fail to restrain aggregate demand, and I agree with Mr. Sliper's comments on this issue.

Under the circumstances, the only way to bring about the required slowdown in credit to the private sector is to syphon the excess liquidity out of the system. This will inevitably increase the upward pressure on the already high interest rate levels. As of July 1987, domestic interest rates had reached 20 percent, compared with an average annual inflation rate of about 8 percent. I wonder whether pushing this historically high level of real interest rates even further would be consistent with the authorities' objectives, specifically of encouraging real domestic investment and sustaining the current growth performance.

Although private capital inflows have increased, and are expected to increase further in response to the substantial interest rate differential in favor of Jamaica and the improved prospect for a stable Jamaican dollar, it must be emphasized that these capital flows tend to be speculative and could quickly reverse themselves as soon as it became apparent that either the interest rate differential could no longer be mantained or that an adjustment in the exchange rate was inevitable. There are serious questions about the sustainability of such capital inflows and about the wisdom of relying on such inflows to cover the wider current account deficit that is expected.

The Government program to convert foreign debt into domestic equity investment could, in view of the expected tightening of monetary policy, make a difficult situation worse. As Directors have observed, the sale of shares in the Caribbean Cement Company under the government divestment program has added to the pressure on financial resources and led to higher interest rates.

In regard to incomes policy, as I indicated on the occasion of the first review, it is important for both demand restraint and external competitiveness to keep wage increases below 10 percent--the guideline that has been in effect since January 1987. The outcome of recent wage negotiations for a large proportion of government employees--calling for increases in excess of twice the expected rate of domestic inflation in 1988--is a cause for serious concern. These increases are inflationary, they reduce flexibility in fiscal adjustment, and, more important, they set a precedent for wage settlements in the private sector.

The burden of adjustment should be spread more evenly among monetary, fiscal, and incomes policies. Specifically, incomes policy should be more restrained, and greater fiscal retrenchment may be required. In this context, I welcome the decision by the authorities to preserve some margin for maneuver, by not expanding new investment to the full extent achieved from gains in domestic tax collection and foreign proceeds of divestment. However, because it adds pressure on financial resources, the Government's program of divestment should be monitored closely. The pace and extent of the divestiture program should be designed to avoid unnecessary pressure on financial resources and domestic interest rates.

Debt-equity conversions, when they occur during a program period, have significant implications for a number of key macroeconomic variables, including: the fiscal position, the balance of payments, the money supply, the level of reserves, and the stock of external debt. They clearly affect the way performance criteria are designed and adapted, and more generally, the way performance under a program is monitored. The questions raised by Mr. Lankester and Mr. Grosche concerning the treatment of debt-equity swaps underscore the need to establish standards in this area. Perhaps, the staff should develop guidelines to ensure appropriate recording of debt-equity conversion programs, and uniformity of treatment among countries and across programs.

In conclusion, I commend the authorities for their achievements and encourage them to be vigilant and not allow the recent hard-earned gains to erode. I support the proposed decision.

Mr. Othman made the following statement:

The second review of the program supported by the stand-by arrangement indicates that the expected recovery of economic activity has exceeded the original program projections. All of the program's quantitative performance criteria were observed as of end-June 1987, and some with a significant margin. However, this satisfactory performance has been accompanied by an expansion in demand that may increase at a rate significantly faster than that of the rise in output, thereby increasing pressure on both the internal and external fronts. The authorities' main task in the coming months is to tackle the upturn in demand; they are aware of the situation and have already taken certain measures to rectify it.

In the monetary field, the authorities have taken welcome initiatives to increase open market sales of certificates of deposit and treasury bills by the Bank of Jamaica to absorb excess liquidity in the banking system and to pursue a tightened fiscal policy to avoid pressure on interest rates.

The narrowing of the expenditure-revenue gap during 1981/82-1986/87 from 15.8 percent of GDP to 3.5 percent of GDP is impressive. The authorities should maintain this improvement in the fiscal stance to keep expenditure on a path that can be sustained over the medium term from permanent revenue sources. In this respect, the authorities' decision to preserve some of the margin that has been generated under the program's target for the fiscal deficit is welcome.

I agree with other speakers that an increase of more than 10 percent in the wage bill during the second year of the program is a source of concern, and I share the staff's view that such an increase may not be compatible with the maintenance of low inflation and a stable exchange rate beyond the period covered by the stand-by arrangement. However, the authorities are aware of the problem and intend to apply the incomes policy in a manner which will avoid losses of competitiveness or additional burdens on public finances.

As to the fiscal field, while tax revenue has increased from 22.6 percent of GDP in 1985/86 to 26 percent of GDP in 1986/87, the nontax revenue--in spite of its small contribution to the budget--has decreased from 1.2 percent of GDP to 1 percent of GDP during the same period; the staff should elaborate on this point. On the whole, I agree with the staff appraisal and support the proposed decision.

Ms. Bush made the following statement:

We generally welcome developments in Jamaica since the first review of the stand-by arrangement in August, and we commend the authorities for their skill and persistence in keeping a difficult program on track. While we recognize and welcome that persistence, we hope that the authorities will guard against overoptimism, and if steps are needed at any point to strengthen or maintain the strong adjustment effort, that they will not hesitate to take such steps.

In reviewing recent developments, we are encouraged by the growth of tax revenues and the fact that government expenditures remain within the projected path.

Regarding monetary developments, we are pleased that the authorities have responded to the rapid growth in credit by increasing open market operations by the Bank of Jamaica.

As to the external sector, the trends are encouraging, but we remain concerned about the exchange rate, which has not moved against the U.S. dollar for two years, despite a higher rate of inflation in Jamaica than in the United States. We continue to believe that the authorities must be prepared to consider exchange rate action if certain adverse trends, which I will turn to next, are not corrected quickly.

I welcome the introduction of a program for debt-to-equity coversions, and staff comment on the structure of this program would be helpful. Specifically, I would be interested in the staff's view on whether or not the program is structured in such a way as to encourage such conversions. I ask this because there certainly has been a proliferation of debt-equity conversion programs, with some being more successful than others in encouraging the conversion of debt to equity.

Like Mr. Lankester, I am concerned about the court case that has been brought by one creditor and the implications with respect to Article VIII. I would appreciate staff comment on the status of this case.

On the 1987/88 program and the policies for the new fiscal year beginning in April, as we have said in the past, we generally embrace the program, but we do have some concerns in three areas.

First, we share fully the concern expressed by the staff in connection with the wage settlements with the teachers' union and civil servants' union. We have some serious questions about whether wage increases of 15 percent can be reconciled with further progress in reducing inflation and strengthening the balance of payments. We wonder whether it might be feasible to negotiate arrangements that would allow a rollback in those increases if inflation in the next six months were kept below some agreed level.

Second, given the considerable uncertainties about internal and external financing in the months ahead, we are encouraged that the authorities have decided, as a contingency measure, to maintain a margin under the fiscal deficit ceilings. We are attracted to this approach and believe that consideration might be given to such an approach more generally.

Third, we expressed concern last August about the plans for the Government to purchase the Clarendon Aluminum Refinery. I note Mr. Lankester's remark that that purchase might not now go through, and would appreciate hearing more from the staff, because we still have a great deal of concern about the wisdom of that investment for the Government of Jamaica.

In conclusion, we urge the authorities once again to maintain the momentum of ajdustment and to take any steps that might be necessary to assure the continued success of their adjustment effort in order to avoid placing at risk the substantial gains that have been made. And I support the proposed decision.

The staff representative from the Western Hemisphere Department said that ALCOA, the owner of the Clarendon Aluminum plant, had recently announced that it was interested in resuming operations on a full scale, and the authorities were considering that proposal. The outcome of the authorities' decision would depend on several factors, such as the application of the bauxite levy, certain investments that had to be made, and the level of production. As Mr. Lankester had noted, the program that had been envisaged at the time of the first review of the stand-by arrangement had allowed for an increase in the public sector borrowing requirement to accommodate that transaction. However, the adjustment had been specifically designed to take effect only if and when the transaction was completed. Therefore, if the sale did not take place, there would be no adjustment in the public sector borrowing requirement.

The lease-back arrangements recently made by the national airline, Air Jamaica, had increased the inflow of foreign exchange, the staff representative explained. However, the lease-back arrangement would not affect the public sector borrowing requirement. Although the sale of the airline through the lease-back arrangement would generate cash and reduce domestic liabilities, it would be offset by a new borrowing operation of the same amount. That borrowing operation would certainly be included in the performance criterion on external debt, but there was a sufficient margin in the program to accommodate it.

A question had been raised concerning the status of the court case that had been brought against Jamaica by one of its creditors, the staff representative noted. The staff had recently been informed that that case had been settled out of court, and that the arrangements made by the Government and the foreign claimant had been accepted within the terms of the 1987 bank restructuring agreement. The staff understood that the debt had been purchased by Jamaican entities with foreign assets abroad, and had been incorporated into the new rescheduling agreement. Therefore, there was no apparent threat of a violation of Article VIII.

The general characteristics of the Jamaican debt-equity conversion scheme were roughly similar to others that had recently been introduced by other countries, the staff representative commented. The authorities should take a liberal stance with regard to profit remittances, as this would make the scheme more attractive, and thus would encourage more participation. In principle, the authorities had argued that they would consider requests for profit remittances on a case-by-case basis, but it was not clear how flexible they would be. With respect to the impact of the debt-equity scheme on the domestic economy, the staff's primary concern was to neutralize the effect of such conversions, so that they would not create any artificial modifications to the performance criteria originally intended under the program. The authorities had designed the debt-equity conversion scheme in the hope of finding local financial entities with the available resources to convert foreign debt into domestic equity. The idea behind the scheme was to tap existing savings, rather than to increase the liabilities of the Central Bank.

With respect to the policy mix, the staff shared the Board's view that it would be more appropriate to seek a balanced approach to solving economic problems through monetary and fiscal restraint, rather than emphasizing any sector of the economy in particular, the staff representative remarked. The staff had meant to reflect that view in its report.

The staff representative from the Exchange and Trade Relations Department said that the staff wanted to make sure the debt-equity conversion scheme would not affect the program in any unintended way, owing to its impact on reserves or credit. Debt-equity conversion schemes were becoming increasingly important, because more countries were adopting them, but there was no need for the Fund to develop a general approach to such programs; instead, the Board should examine them on a case-by-case basis, taking the individual circumstances of each country into account.

The staff representative from the Legal Department said that when the court case involving a claim against Jamaica had been filed in a New York court, the Fund had been consulted and had discussed the case with the Jamaican authorities. That particular case concerned only an obligation by the Central Government, and did not involve exchange restrictions; therefore, the Fund had no authority over it, and Article VIII was not involved. If the nonpayment had resulted from exchange restrictions, then the Fund would have had to examine the case under Article VIII, Section 2(a), under which it approved restrictions on payments and transfers for current international transactions.

Mr. Massé said that he had taken note of the comments made by Executive Directors, which he would transmit to his authorities.

The Executive Board then took the following decision:

1. Jamaica has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Jamaica (amended August 3, 1987; EBS/87/27, Sup. 3, 3/4/87; and EBS/87/152, 7/8/87) and paragraph 14 of the letter of December 31, 1986 (amended January 17, 1987; February 26, 1987 and June 19, 1987) from the Prime Minister and the Governor of the Bank of Jamaica, concerning

(a) the second review of the progress made in implementing the policies affecting demand management and the exchange system; ( ) a modification of the performance criteria; and (c) the nonobservance of a performance criterion in paragraph 4(e)(i) of the stand-by arrangement for Jamaica.

2. The letter dated October 2, 1987 with its attachment from the Prime Minister and the Governor of the Bank of Jamaica shall be attached to the stand-by arrangement for Jamaica as amended, and the text of the Technical Memorandum of Understanding in Annex II to EBS/87/217, shall replace the earlier Technical Memorandum of Understanding attached to the letter of December 31, 1986, as amended.

3. Accordingly, the references in paragraphs 4(a) and (b) of the stand-by arrangement as amended to paragraphs 2, 3, 4, and 7 of the Technical Memorandum of Understanding attached to the letter of December 31, 1986, as amended, shall be read as references to paragraphs 2, 3, 4, and 7 as set forth in Annex II to EBS/87/217.

4. The Fund decides that, notwithstanding the imposition of a new restriction on payments and transfers for current international transactions arising from the limitation on remittances of profits abroad under the debt-equity conversion scheme, the second review contemplated in paragraph 4(d) of the stand-by arrangement is completed, and Jamaica may continue to make purchases under the stand-by arrangement.

Decision No. 8731-(87/157), adopted
November 18, 1987

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/156 (11/17/87) and EBM/87/157 (11/18/87).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/245, Supplement 1, (11/16/87) and EBAP/87/248 (11/16/87) is approved.

APPROVED: July 13, 1988

LEO VAN HOUTVEN
Secretary