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EBS/86/271

CONFIDENTIAL

December 2, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Sale and Use of Currencies of Members in Arrears to the Fund

The attached paper on the sale and use of currencies of members in arrears to the Fund is proposed to be brought to the agenda for discussion on Wednesday, January 7, 1987.

Mr. Blalock (ext. 8341) or Mr. Corr (ext. 7621) is available to answer technical or factual questions relating to this paper prior to the Board discussion; Mr. Munzberg (ext. 6675) is available to answer legal questions.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

# Sale and Use of Currencies of Members in Arrears to the Fund

Prepared by the Treasurer's and Legal Departments

(In consultation with the Exchange and Trade Relations Department)

Approved by W.O. Habermeier and F.P. Gianviti

December 1, 1986

## I. Introduction

In the course of the Executive Board's discussion in June of the six-monthly report on overdue financial obligations to the Fund and a paper on the legal aspects of ineligibility and subsequent actions by the Fund (EBM/86/92 and 86/93, 6/6/86), the question was raised whether it would be possible and desirable for the Fund to sell or use some of its holdings of the currencies of members in arrears to the Fund as a means of reducing the amount of those arrears. Among the possibilities mentioned by Executive Directors were sales to other members to cover some of their expenditures in the countries in question and use of these currencies in financing the Fund's administrative expenditures. It was agreed that the staff would prepare a paper on the matter. 1/

Accordingly, this paper examines the legal and practical scope for use by the Fund of its holdings of the currencies of members in arrears and discusses certain issues that arise in considering such use. 2/ Section II of the paper sets out the legal framework for sale or use by the Fund of its holdings of members' currencies. Section III discusses the possible techniques, purposes and effects of the use of the currencies of members in arrears, from the points of view of the Fund and of members. Section IV sets out some specific questions that would need to be considered if the Fund were to pursue use of the currencies in question. Section V provides a summary and some concluding remarks and questions for discussion.

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1/ See the Chairman's summing up at the conclusion of the Board discussion in Buff Statement 86/102, (6/16/86).

2/ Although the discussion in June was in the context of possible steps by the Fund in the case of members that had been declared ineligible to use the Fund's general resources, sale or use of currencies need not be confined to those members.

## II. Legal Framework under the Articles

The following paragraphs discuss the legal provisions relating to the sale or use by the Fund of currency holdings that should have been repurchased. Two types of transactions are examined involving either the sale of currencies against other currencies (paragraph 1) or the sale of currencies against SDRs (paragraph 2). The legal basis for the use of currencies by the Fund, particularly in administrative expenditures, is discussed in paragraph 3.

### 1. Transactions in currencies

#### a. General limitations on transactions by the Fund

(i) Article V, Section 2(a) 1/ limits the powers of the Fund with respect to the sale of its holdings of a member's currency. 2/ While the Second Amendment has provided the Fund with the authority to sell gold to members or others, 3/ no such general authority exists with respect to the sale of currencies. 4/ The authority to sell gold under the broad terms of Article V, Section 12(c) must be contrasted with the limited power of the Fund to sell currency under Article V, Section 2(a). The latter provision limits the sale of currencies to purchasers that are members, whereas there is no such limitation in the provision relating to the sale of gold. Article V, Section 2(a) states that "except as otherwise provided in this Agreement, transactions on the account of the Fund shall be limited to transactions for the purpose of supplying a member, on the initiative of such member, with special drawing rights or the currencies of other members...in exchange for the currency of the member desiring to make the purchase."

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1/ Article V, Section 2(a) provides that: "Except as otherwise provided in this Agreement, transactions on the account of the Fund shall be limited to transactions for supplying a member, on the initiative of such member, with special drawing rights or the currencies of other members from the general resources of the Fund, which shall be held in the General Resources Account, in exchange for the currency of the member desiring to make the purchase."

2/ The limits on an exchange of currency holdings for SDRs are established by Article V, Section 6. (See paragraph 2 below.)

3/ Article V, Section 12(c) provides in part: "The Fund may sell gold for the currency of any member...." The commentary on the Second Amendment (II.I.8.b, page 47) states that "the Fund will be able to sell any part of the balance of the gold held on the date of the amendment to members or to others at a price based on prices in the market."

4/ The question whether the authority to sell currency was similar to the Fund's power to sell gold was raised at the Board discussion in June.

(ii) The limitation on the Fund's transactions 1/ under Article V, Section 2(a) is subject to the proviso "except as otherwise provided in this Agreement". The sale of a member's currency in the General Resources Account by the Fund otherwise than to a member is provided for in the Articles only in Schedule J. Schedule J prescribes that, upon withdrawal of a member and after certain conditions are fulfilled, "the Fund may in an orderly manner liquidate in any market the amount of currency which should have been redeemed" (paragraph 4; see also paragraph 8).

(iii) A sale of currency by the Fund to a member that is not the issuer of the currency can only take place "on the initiative of such member" (Article V, Section 2(a)). Consequently, the Fund cannot require members to enter into transactions to purchase another member's currency.

(iv) The member desiring to make a purchase has to meet the conditions of Article V, Section 3(b). In particular, the purchasing member has to represent that "it has a need to make the purchase because of its balance of payments or its reserve position or developments in its reserves" (Article V, Section 3(b) (ii)). 2/ The fact that the currency provided could be used by the member in its transactions would not be sufficient.

b. Rules on selection of currencies by the Fund

The Fund has the power to select the currencies available for purchases in accordance with the general provision of Article V, Section 3(d) and the special provision of Article V, Section 7(h).

(i) Rules

(a) Under Article V, Section 3(d), in order to place a currency in the operational budget, the Fund has to take into account, inter alia, the balance of payments and reserve position of the member 1/

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1/ Under certain conditions, the Fund has the power to invest the holdings of a member's currency in marketable obligations (see Article V, Section 12(h) and (g), and Article XII, Section 6(f)).

2/ Prior to the Second Amendment the purchasing member had to represent that it presently needed the currency "for making in that currency payments which are consistent with the provisions of this Agreement" (Article V, Section 3(a)(i)).

3/ Article V, Section 3(d) provides that "the Fund shall adopt policies and procedures on the selection of currencies to be sold that take into account, in consultation with members, the balance of payments and reserve position of members, as well as the desirability of promoting over time balanced positions in the Fund." Article V, Section 3(d) also contains the proviso that "if a member represents that it is proposing to purchase the currency of another member because the purchasing member wishes to obtain an equivalent amount of its own currency offered by the other member, it shall be entitled to purchase the currency of the other member unless the Fund has given notice under Article VII, Section 3 that its holdings of the currency have become scarce."

The Fund has adopted policies and procedures for the selection of currencies to be sold. 1/

These policies and procedures include provisions on the sale by the Fund of the currency of a member with outstanding purchases. Decision No. 6274-(79/158), adopted September 14, 1979, 2/ states in its paragraph 2 that "under procedures to be adopted, the currency of a member with outstanding purchases subject to repurchase, whose balance of payments and gross reserve position is judged sufficiently strong for the purposes of operational budgets and designation plans, normally will be sold by the Fund under Article V, Section 3(d) only if the member and the Fund agree." 3/

However, Decision No. 6774-(81/35), adopted March 5, 1981, 4/ makes a distinction between (i) members with outstanding purchases subject to the guidelines on early repurchase (paragraph 2(a), and (ii) members with outstanding purchases not subject to the guidelines on early repurchase (paragraph 2(b)). 5/ In both cases, the Fund has to find that the balance of payments and gross reserve position of the member is sufficiently strong. Decision No. 6273-(79/158) G/S, adopted September 14, 1979, in its paragraph 4, provides criteria for this assessment. They include, inter alia, judgments on the improvement of the member's position in comparison with the position at the time of the last purchase from the Fund, and the extent and the sustainability for the foreseeable future of the improvement. The wording indicates the need for an assessment by the Fund that takes account of those additional factors, if the currencies under consideration were to be considered for inclusion in the operational budget.

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1/ Decision No. 6273-(79/158) G/S, adopted September 14, 1979 (Selected Decisions, Twelfth Issue, page 104); Decision No. 6274-(79/158), adopted September 14, 1979 (Selected Decisions, Twelfth Issue, page 105); Decision No. 6772-(81/35) G/S, adopted March 5, 1981 (Selected Decisions, Twelfth Issue, page 110); Decision No. 8265-(86/70) S adopted April 25, 1986 (Selected Decisions, Twelfth Issue, page 112); and Decision No. 6774-(81/35), adopted March 5, 1981 (Selected Decisions, Twelfth Issue, page 112).

2/ Selected Decisions, Twelfth Issue, page 105.

3/ Emphasis Added.

4/ Selected Decisions, Twelfth Issue, page 112.

5/ The difference is relevant with respect to the procedures adopted by the Fund by Decision No. 6352-(79/183), adopted December 12, 1979 (Selected Decisions, Twelfth Issue, page 108), and modified with respect to the second alternative by the Annex to Decision No. 6774-(81/35), adopted March 5, 1981 (Selected Decisions, Twelfth Issue, page 112).

The difference between the two cases is that, with respect to members with outstanding purchases not subject to the guidelines on early repurchase, a sale of currency would take place only after an agreement between the member and the Fund, whereas in the case of members with outstanding purchases subject to the guidelines on early repurchase, the sale would normally be subject to an agreement between the Fund and the member. "Normally" implies that exceptions can be made. In this case the Fund could disregard a member's objection and proceed with the inclusion in the operational budget. Once the currency of a member has been included in the operational budget the member cannot object to its use in transactions by the Fund.

(b) With respect to holdings of a member's currency that the member has failed to repurchase, Article V, Section 7(h), which was introduced by the Second Amendment, authorizes the Fund to adopt policies supplementing the policies under Article V, Section 3(d). 1/ These policies have not been established. Their adoption would require a majority of the votes cast.

Under Article V, Section 7(h), the Fund can select, for inclusion in the currency budget, holdings of a member's currency that the member has failed to repurchase in accordance with Article V, Section 7 "even though, in the absence of that failure, the currency would not have been selected for a sale at that time." 2/ This provision, therefore, obviates the need for the Fund to find that the balance of payments and reserve position of a member is sufficiently strong.

The sale by the Fund does not require the member's agreement. It is only subject to a consultation with the member. An additional opportunity is thereby given to the member to fulfill its obligation to repurchase the Fund's holdings of its currency that should have been repurchased, but the member cannot prevent the Fund from selling its currency. The intention was expressed during the discussions of the Second Amendment that priority should be given to the sale of such currency holdings that should have been repurchased, and the similarity

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1/ Article V, Section 7(h) provides that: "the Fund's policies under Section 3(d) of this Article may be supplemented by policies under which the Fund may decide after consultation with a member to sell under Section 3(b) of this Article its holdings of the member's currency that have not been repurchased in accordance with this Section 7, without prejudice to any action that the Fund may be authorized to take under any other provision of this Agreement."

2/ DAA 75-3 Sup. 1 (Documents Relating to the Second Amendment, Volume I, Part 1, page 873b).

of the designation of participants for corrective purposes under Article XIX, Section 5(a)(iii) was pointed out. 1/

(ii) Problems of implementation

(a) The necessary corollary of the Fund's power to select the currencies to be sold are the obligations imposed on the issuers of these currencies by the provision of Article V, Section 3(e). 2/ During the deliberations on the Second Amendment it was explained that Article V, Section 3(e) applies to a sale under Article V, Section 7(h), since it covers every sale of currency by the Fund. 3/ Article V, Section 3(e) 4/ imposes on the member whose currency is

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1/ See remarks by the General Counsel at EBM/75/36 of March 24, 1975, Documents Relating to the Second Amendment, Volume II, Part 1, page 790-791: "The General Counsel said that Section 7(h) went beyond the general policy on the selection of currencies to be sold. The provision stated that notwithstanding that general policy, the currency in question would be given priority in sales. There was a parallel provision in the Special Drawing Account for the priority designation of a participant that had not observed the expectation of need. The participant, therefore, had to receive SDRs ahead of the participants that would be designated according to the economic criteria for designation."

2/ See Proposed Second Amendment, 1976, Commentary, II.D.11, page 23: "These provisions of Article V, Section 3(e) supplement Article V, Section 3(d) which empowers the Fund to select the currencies to be sold to members making purchases from the Fund."

3/ See the remarks by the General Counsel at EBM/75/36 of March 24, 1975 in Documents Relating to the Second Amendment, Volume II, Part 1, page 790: "...the member would have an obligation to convert if the Fund did use the procedure under Section 7(h). The effect of the sale would be to discharge the repurchase obligation."

4/ Article V, Section 3(e) reads:

"(i) Each member shall ensure that balances of its currency purchased from the Fund are balances of a freely usable currency or can be exchanged at the time of purchase for a freely usable currency of its choice at an exchange rate between the two currencies equivalent to the exchange rate between them on the basis of Article XIX, Section 7(a).

(ii) Each member whose currency is purchased from the Fund or is obtained in exchange for currency purchased from the Fund shall collaborate with the Fund and other members to enable such balances of its currency to be exchanged, at the time of purchase, for the freely usable currencies of other members.

(iii) An exchange under (i) above of a currency that is not freely usable shall be made by the member whose currency is purchased unless that member and the purchasing member agree on another procedure.

(iv) A member purchasing from the Fund the freely usable currency of another member and wishing to exchange it at the time of purchase for another freely usable currency shall make the exchange with the other member if requested by that member. The exchange shall be made for a freely usable currency selected by the other member at the rate of exchange referred to in (i) above."

purchased from the Fund the obligations to "ensure that balances of its currency purchased from the Fund are balances of a freely usable currency" or, (and this is most likely the relevant provision with respect to sales of currency under Article V, Section 7(h)), that such balances of its currency "can be exchanged at the time of purchase for a freely usable currency...." (Article V, Section 3(e)(i)). This exchange "shall be made by the member whose currency is purchased unless that member and the purchasing member agree on another procedure" (Article V, Section 3(e)(iii)).

(b) Once a currency is included in the operational budget, the purchasing member cannot object against receiving the currency sold. The criteria for selection of currencies are intended to provide a guarantee to the purchasing member that any currency will be either freely usable or be exchanged against a freely usable currency by the member whose currency is sold (the "issuing member"). Legally the member whose currency is included in the operational budget and sold under Article V, Section 7(h) has an obligation to exchange the currency if it is not freely usable and the purchasing member has a right to obtain such a freely usable currency (Article V, Section 3(e)). A member that does not comply with its obligation to provide a freely usable currency is in breach of an obligation under the Articles. 1/ The Fund must avoid imposing the negative consequences of a breach of an obligation by a member on another member. This principle is relevant for two possible cases with respect to a sale under Article V, Section 7(h):

(i) The Fund, after selling the currency to the purchasing member, finds that the issuing member does not fulfill its obligation to exchange the currency against a freely usable currency. If the purchasing member, at the time of the purchase, requested the exchange prescribed under Article V, Section 3(e)(i) and the exchange was not made, the purpose of the purchase would be frustrated as the purchasing member would not obtain a freely usable currency. The Fund would have the obligation to substitute another currency for the currency that is not exchanged by the issuing member. This situation has to be distinguished from a purchase where the purchasing member did accept the purchased currency and did not request the exchange at the time of the purchase. While in this case the purchasing member may subsequently

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1/ The member failing to comply with its obligation to exchange its currency against a freely usable currency would violate an obligation under the Articles that may justify a declaration of ineligibility.

If the Fund finds that no exchange is made by the issuing member, it becomes apparent that the member's currency is not usable. Since it is one of the purposes of a quota increase to provide the Fund with additional usable resources, such a finding may have an effect on the participation in a quota increase of members whose currencies the Fund has found to be not usable.

attempt to sell the currency in the market and may find that such a sale is impossible or does not provide the member with a value equal to the value of its purchase from the Fund as recorded in the Fund's books, the Fund would have no obligation to substitute since no exchange was requested at the time of the purchase as required by Article V, Section 3(e)(i).

(ii) The Fund, before proceeding to the sale, finds that the issuing member will most likely not comply with its obligation of exchange. If, in this case, the Fund sold that currency, it would impose a currency on the purchasing member, while presuming that it will not be exchanged for a freely usable currency. The Fund would transfer its own risk to the purchasing member. A sale of currency under circumstances in which it is not reasonably certain that exchange will be made, if requested, should not be made or would therefore need to be accompanied by arrangements for substitution of another currency by the Fund in the event a requested exchange were not made.

The question of exchange would not arise where the purchase is made in order to make use of the currency provided by the Fund without need for an exchange. The Fund could consider adopting policies under Article V, Section 7(h) limited to circumstances in which the purchasing member could either use the currency or obtain an exchange.

(c) In the particular case of a member which is unable or unwilling to comply with its obligations under Article V, Section 3(e) the mechanism introduced by the Second Amendment through Article V, Section 7(h) and Article V, Section 3(e) will not operate. Under the present Articles the Fund has no power to dispose of these currency holdings on its own initiative in any other way and in particular not through a sale in the market. The Fund cannot use these currency holdings contrary to the purposes of Article V, Section 7(h) in circumstances where members do not observe their obligation to exchange. The member's compliance with its obligations under Article V, Section 3(e) is a necessary part of the mechanism.

It would be possible to examine in the context of an amendment of the Articles changes that would give effect to the purposes of Article V, Section 7(h), e.g., a sale by the Fund in the market in these specific circumstances. Such a modification of the Articles would require careful study.

(d) When an exchange of the purchased currency under Article V, Section 3(e)(i) for a freely usable currency takes place, the exchange rate between the two currencies must be equivalent to the exchange rate between them on the basis of Article XIX, Section 7(a) (Article V, Section 3(e)(i). According to Rule O-6(a)(i) the exchange of currency shall be made at an exchange rate between the two currencies corresponding to their exchange rates in terms of the SDR as determined under

Rule O-2, if the exchange is requested under Article V, Section 3(e)(i). Under Rule O-2 the value of a currency other than the United States dollar in terms of the SDR is to be determined on the basis of a representative rate; in the absence of such a representative rate, a rate has to be determined by the Fund.

Even if no exchange between members were necessary, the Fund would have to determine a rate at which it would account for the member's currency. This rate would be used to calculate the value of the purchase, to calculate the extent of the discharge of the obligations to the Fund of the member whose currency is sold, and to revalue the remaining Fund holdings of the member's currency. If the new rate were lower than the previously used rate, the member would have to make additional payments in its currency to the Fund under the maintenance of value provisions.

If an exchange is necessary and the exchange is not made by the issuing member, the Fund would have to revalue the holdings of the issuing member's currency on the basis of a rate determined by the Fund.

(e) The Fund has decided that a member is free to attribute the reduction in the Fund's holdings of its currency to any of its repurchase obligations and (subject to limitations) to enlarge its reserve tranche. 1/ An elimination (or reduction) of overdue obligations would only be ensured if the decision were amended by mandating the attribution of a reduction to overdue obligations. The Fund would be free to limit the scope of the amendment to a sale of currency under Article V, Section 7(h).

2. Transactions in currencies for SDRs

a. Transactions with participants

Under Article V, Section 6(a) "the Fund may accept special drawing rights offered by a participant in exchange for an equivalent amount of currencies of other members."

(i) The exchange of SDRs against currencies has to take place on the initiative of the participant wishing to sell SDRs. The Fund cannot initiate the transaction.

(ii) Contrary to the requirements with respect to a purchase by a member, the participant requesting an exchange under Article V, Section 6(a) does not have to represent a balance of payments need.

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1/ Decision No. 6831-(81/65) as amended (Selected Decisions, Twelfth Issue, page 124). The decision contains limitations of the principle with respect to an attribution to an obligation to repurchase financed from borrowed resources and to an attribution to create a reserve tranche (paragraph 1(b) and (c) of the decision).

The transaction under Article V, Section 6(a) is not " a 'credit' transaction comparable to the transactions, other than reserve tranche purchases, in which a member makes purchases under Article V, Section 3 in return for its own currency." 1/

(iii) The major difference between transactions in SDRs and transactions in currencies is that the member whose currency is being sold by the Fund has to agree to the sale (Article V, Section 6(c)). 2/

(iv) Article V, Section 6(c) prescribes 3/ that the currencies provided by the Fund shall be selected in accordance with policies that take into account the principles of Article V, Section 3(d). While there is no specific reference to the policies adopted under Article V, Section 7(h), a sale of currency holdings that the member has failed to repurchase is not precluded. Article V, Section 6(c) does not refer to the policies to be adopted under Article V, Section 3(d), but to the principles guiding the adoption of these policies. These principles do not only comprehend the balance of payments and reserve position of members, but the desirability as well of promoting over time balanced positions in the Fund. The latter criterion is a relevant element with respect to currencies that should have been repurchased. It should also be noted that Article V, Section 6(c) only requires that these principles be taken into account in the selection of currencies to be sold. These considerations are, however, less important in the context of Article V, Section 6 than with respect to a purchase under Article V, Section 3. When a currency is included in the operational budget the issuing member cannot object to its use for a purchase. Under Article V, Section 6 the consent of the member whose currency is used is required. Accordingly, with the consent of the member whose currency is sold, it is possible for the Fund to exchange the currencies of members in arrears for SDRs.

b. Transactions with prescribed holders

Under Article XVII, Section 2 "the Fund may hold special drawing rights in the General Resources Account and may accept and use them in operations and transactions conducted through the General Resources Account with participants in accordance with the provisions of this Agreement or with prescribed holders in accordance with the terms and

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1/ Proposed Second Amendment, 1976, Commentary, II.D.17, page 26.

2/ Article V, Section 6(c) (second sentence) reads: "The Fund may enter into transactions under the Section only if a member whose currency is provided or accepted by the Fund concurs in that use of its currency."

3/ Article V, Section 6(c) (first sentence) reads: "The currencies provided or accepted by the Fund under this Section shall be selected in accordance with policies that take into account the principles of Section 3(d) or 7(i) of this Article."

conditions prescribed under Section 3 of this Article." While the sale of currencies to a participant is provided for in Article V, Section 6, the Fund also has the power to enter into operations and transactions with prescribed holders. In order to give effect to this power, the Fund would have to prescribe, by a majority of votes cast, under Article XVII, Section 3(iii) "the terms and conditions on which...the Fund through the General Resources Account may enter into operations and transactions in special drawing rights with prescribed holders."

A sale of currencies by the Fund is a transaction in the sense of Article XVII, Section 2 (Article XXX(h)). Any prescription of terms and conditions of a transaction has to respect Article XVII, Section 3 (last sentence) which states that "terms and conditions prescribed by the Fund shall be consistent with the provisions of this Agreement and the effective functioning of the Special Drawing Rights Department". While the Articles do not establish specific criteria for the sale of currencies by the Fund to prescribed holders, the provisions of the Articles provide the general legal framework for such transactions, and conclusions can be drawn from provisions regulating similar cases.

Article V, Section 6 addresses the similar situation of a sale by the Fund to a participant. Insofar as the rationale expressed in the conditions of Article V, Section 6 applies to a sale to a prescribed holder, the conditions of Article V, Section 6 should, by analogy, be considered relevant for the similar case. The requirement of the consent of the issuing member is intended to give the member the right to protect its interest when the Fund sells its currency in a voluntary transaction. The rationale of this provision is relevant with respect to a transaction by an agreement between the Fund and a prescribed holder.

Article XIX, Section 7(a) states "that the exchange rates for transactions between participants...shall be such that participants using special drawing rights shall receive the same value whatever currencies might be provided and whichever participants provide these currencies...." Article XIX, Section 7(a) is referred to in Article V, Sections 10 and 11 on computations and maintenance of value with respect to currencies of members held in the General Resources Account. The principle expressed in these provisions is of a general nature and has to be applied to a transaction between the Fund and a prescribed holder.

Several provisions of the Articles establish the principle that the Fund cannot impose a transaction on a member or participant. Article V Section 2(a) states that transactions with a member shall take place on the initiative of such member. Article V, Section 6(a) and (b) provides that the Fund may accept SDRs, offered by a participant (a) and may provide a participant, at its request, with SDRs (b). Under Article XVII, Section 3(ii) prescribed holders "may accept" SDRs. It can be concluded that the general principle whereby the Fund may not require a member or participant to enter into a particular transaction with the Fund, except as otherwise provided in the Agreement, would be relevant with respect to a transaction with a prescribed holder.

The Fund has not yet prescribed any terms and conditions for the sale by the Fund of currencies to other holders. The Board paper on "Other Holders of SDRs" (EBS/80/74, 4/1/80) discussed legal and policy considerations with respect to transactions between the Fund and other holders:

> Other holders could be authorized to buy or sell SDRs in transactions with the Fund's General Resources Account but, as a matter of policy, it is not proposed that they be permitted to do so. While a broad authority is contained in the Articles of Agreement for transactions between the General Resources Account and participants, it has so far not been used except for limited and clearly defined purposes, such as the sale of SDRs to participants needing to acquire SDRs to pay charges or to reconstitute their SDR holdings under Article XIX, Section 6. These particular purposes would not be applicable to other holders. In the staff's view, if the Fund were generally to authorize transactions in SDRs between other holders and the General Resources Account the impression might be created that the Fund stood ready to act as a "buyer of last resort" supporting the market in SDRs. This would be a most undesirable situation since the market should be given the opportunity to develop and function on its own. This kind of support could also lead to the Fund receiving possibly very large amounts of SDRs, which could materially affect the management of the Fund's holdings of SDRs and currencies, as well as the volume and distribution of members' reserve positions in the Fund....
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> It cannot be wholly ruled out, however, that circumstances might arise in which a particular other holder would have a temporary need to buy or sell SDRs in a transaction with the General Resources Account.....there is nothing in the proposed decision that would preclude the Fund from deciding at any time to provide for dealings in SDRs between other holders and the General Resources Account.

It may be concluded, therefore, that is is legally possible for the Fund to prescribe sales, to a prescribed holder, in exchange for SDRs, of the currency of a member in arrears to the Fund. Such sales would require, in addition to the participation of the Fund, the concurrence of both the purchaser and the issuing member.

3. <u>Use in the Fund's administrative expenditures and other uses</u>

a. The Fund has the power to use its holdings of currencies for its administrative expenditures. Under Rule E-1, the Fund may maintain "administrative accounts", also called No. 2 Accounts, which can be debited or credited with respect to the Fund's administrative expenditures and receipts payable in a member's currency. These expenses may be incurred by the member on behalf of the Fund or represent payments which the Fund may make or authorize for its own purposes.

The currency holdings in the Fund's accounts are in the sole ownership of the Fund. The Fund is, therefore, free to spend its holdings of a member's currency in the administrative account, provided, of course, that the expenditure is bona fide. Article IX, Section 6 prescribes that "to the extent necessary to carry out the activities provided for in this Agreement, all property and assets of the Fund shall be free from restrictions, regulations, controls, and moratoria of any nature." It is, therefore, the member's obligation to provide to the Fund unrestricted access to its assets.

If the Fund were to use the currencies of a member in arrears for administrative expenditures, the Fund would have to decide on the attribution of the reduction of its holdings of the member's currency to its obligations to the Fund.

b. The Fund may also use its holdings of a member's currency in several other circumstances. For example, currency holdings can be reduced as a result of a setoff, and under certain of the Fund's borrowing agreements the use of currencies for payments of interest or principal can be agreed between the Fund and the lender. In addition, under Article V, Section 9(d) "remuneration shall be paid in special drawing rights, provided that either the Fund or the member may decide that the payment to the member shall be made in its own currency."

## III. Purposes and Effects of Use of the Currencies of Members in Arrears

Under the conditions outlined above, the Fund has the authority (i) to sell its holdings of a member's currency to other members in exchange for their currencies, (ii) to sell its currency holdings to other members or prescribed holders in exchange for SDRs, and (iii) to use its currency holdings, inter alia, for payments of administrative expenditures.

To facilitate consideration of the desirability and potential scope for the sale or use by the Fund of currencies of members in arrears, this section discusses possible purposes the use of these currencies might serve and describes the effects of any of these sales or uses on the financial position of the Fund, the members whose currencies would be sold or used, and other members.

1. Purposes and techniques of sales 1/

a. In financing purchases

As noted, any sale of currency by the Fund, whether in financing a purchase or in exchange for SDRs, must be made at the initiative of the member (or prescribed holder) acquiring the currency. In financing a purchase under Article V, Section 3, the Fund has the ability to select the currency to be sold; but if the currency is not a freely usable currency, the issuing member has an obligation to exchange the currency purchased for a freely usable currency at equal value exchange rates, if so requested by the purchaser at the time of the purchase.

The question arises whether, in the context of sale of the currency of a member in arrears, it could be expected with confidence that the member would meet its exchange obligation or whether the purchasing member might have a desire to hold the purchased currency or use it directly in transactions. The member making the purchase must have a balance of payments need, and it would be expected in most cases that it would seek exchange of the currency purchased. 2/ If the issuing member failed to meet its exchange obligation, it would be in breach of a further obligation under the Articles, and the needs of the purchasing member--and the objective of the purchase--would be frustrated. Moreover, it may be considered that, if the issuing member were prepared to meet its exchange obligation, the more straightforward and preferable course would be for it to use the foreign exchange directly to settle its obligations to the Fund.

In the cases of most countries in arrears to the Fund, the members face serious balance of payments difficulties and are accumulating arrears not only to the Fund but also to other creditors. It would not appear prudent for the Fund to assume that these members would in fact meet their exchange obligations if their currencies were used to finance purchases in the circumstances discussed, and it would be contrary to the purposes of the Fund for the Fund to place the purchasing member at risk that an exchange would not be made. It might, therefore, be considered that, in the absence of a clear assurance that exchange would be made if requested by the purchaser, the Fund should not provide the currencies of members in arrears in financing purchases except at the specific request of the purchaser, and on the understanding that no exchange would be requested.

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1/ The purposes discussed in this section could also be met through the use of the currencies of members in arrears for payments of interest and principal under certain of the Fund's borrowing agreements, in agreement with the lenders.

2/ It is the practice in the majority of cases that purchasers request exchange into U.S. dollars.

It is, nonetheless, for consideration whether in specific cases the Fund should not select the currencies of members in arrears in limited amounts to finance purchases as a test of members' resolve to clear the arrears. This step might be taken after other procedures have been exhausted following a declaration of ineligibility and could serve as a test of the willingness of the members concerned to meet their obligations under the Articles by making arrangements for the exchange of limited amounts of their currencies sold by the Fund. In the event that exchange were not arranged, the member in arrears would have failed to meet another obligation. However, as discussed above, the Fund should not place the purchasing member at risk, and it would be necessary to have fallback provisions for the Fund to make available a freely usable currency should the exchange not actually be made.

The possibility would remain open that a purchasing member might desire the currency purchased for its own purposes, for example, for use in payments for trade or to meet other expenses payable in the currency. It would be possible for the Fund to offer purchasing members the option of acquiring the currencies of members in arrears in all or part of any purchase, on the understanding that no official exchange would be needed or sought; and such offers could be made as part of the operational budgets and the Fund's operational communications with members requesting purchases. It is difficult to predict what use might be made of such a facility, but the staff would not expect that such offers would be taken up unless prior agreement had been reached between the issuer and the purchaser of the currency in question.

b. In exchange for SDRs

The Fund's ability to sell the currencies of members in arrears (with their concurrence) to other members or prescribed holders in exchange for SDRs may provide greater scope for use of these currencies. As the range of possible buyers would not be limited to those having a need for, and using, the Fund's general resources, there may be a larger potential demand for use of the currencies in question by other members, for example, in financing payments for trade, expenditures in local currency associated with aid programs, and diplomatic and administrative expenses in the country concerned. It is to be noted, however, that many members impose legal constraints on the media that can be accepted in payments by non-residents, and such constraints are imposed by a number of members that have experienced difficulties in making payments to the Fund.

It is also possible that other institutions, including some that are prescribed holders of SDRs, may have needs for the currencies of members in arrears, in particular associated with the provision of local cost financing as part of assistance programs, and that these needs could to some extent be satisified indirectly through acquisition from the Fund. The Fund can sell a member's currency only to other members that are participants, or prescribed holders. It would also be possible, assuming the agreement of all parties concerned, for a member, in effect, to intermediate between the Fund and another institution that is not a prescribed holder, by purchasing the currency from the Fund with SDRs and selling it immediately to the other institution in exchange for a freely usable currency (or any other agreed medium). Certain of the members presently in arrears to the Fund may receive significant local cost financing from international development institutions (most of which are prescribed holders). 1/ The latter's acquisition of currencies through transactions with the Fund could have a noticeable impact on the Fund's holdings in some cases although, as discussed below, this would effectively reduce the amount of balance of payments financing being provided to the member through this vehicle.

A further possibility is that some members of the Fund might be prepared to acquire and hold the currencies concerned as a means of assisting the members in arrears to become current with the Fund and as a cooperative step in assisting the Fund in dealing with the problem of overdue obligations. Although other techniques for providing financing of course exist and are more normally used for these purposes, it is possible that the technique of acquiring members' currencies from the Fund would provide a vehicle that would be considered useful in some instances.

The staff is not in a position to indicate with any assurance the potential demands for members' currencies for these purposes. To determine the possible amounts that might be involved in sales to finance trade, aid, diplomatic, and other local currency expenses would require detailed examination of the flows of such transactions for each member, for which data are presently unavailable in many cases, and consultation with both the members in arrears and other members having substantial trade and financial relations with these members. While it might be possible in this way to obtain broad indications of potential amounts, the actual sales that might be practical are likely also to be influenced importantly by the particular legal and institutional framework in which foreign exchange transactions are conducted in the individual country. With respect to agencies of member governments and other institutions having a need for the currencies of these members, these organizations may face substantial constraints of a legal or policy nature in acquiring local currencies. It would, therefore, be important to receive positive indications from individual Executive Directors and

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1/ It may be noted, for example, that disbursements for local procurement of goods and services by the IBRD and IDA in FY 1986 in the five ineligible members were: Peru $83.2 million; Liberia, $8.8 million; Sudan, $4.7 million; Guyana, $0.4 million; Viet Nam, none. With the exception of Peru, however, these amounts are small in relation to the members' arrears to the Fund.

creditor members as to whether currency sales by the Fund would be viewed as a useful and practical way in which their authorities could provide financing to members in arrears as a means to assist in resolution of the problem of overdue obligations to the Fund. The staff would also welcome the guidance of Executive Directors as to whether the possibility of sales to other institutions should be actively explored with these institutions.

c. In financing the Fund's administrative expenses

The Fund has certain administrative expenses associated with activities in most of its member countries, such as mission travel, technical assistance, or resident representatives, and maintains administrative accounts in every member's currency. For the most part, these expenses are financed with U.S. dollars, though there are occasional local currency payments funded from the administrative accounts with the members in arrears. 1/ It would be possible to seek to increase the use of these currencies, for example, in payment of local airline, hotel, and subsistence costs and in financing local currency expenses related to technical assistance and the maintenance of resident representatives. In practice, however, there may be substantial obstacles to such use, as airlines normally require payment in dollars for trips originating in Washington and local hotels in many cases require nonresidents to effect payment in foreign exchange.

A very rough calculation suggests that the amount potentially involved for mission-related local currency expenses in the five member countries that are presently ineligible to use the Fund's general resources would be on the order of about SDR 100,000 annually, or about 0.01 percent of these members' arrears outstanding at the end of September 1986. 2/ Technical assistance and the maintenance of resident representatives would in some cases provide further opportunities, but the local currency component of those expenses is also very small compared to the amounts of arrears.

A number of years ago, the Fund standardized the payment of such expenses in U.S. dollars as a means of simplifying administration. A change to require the use of local currencies in financing expenditures in certain member countries would give rise to considerable additional

1/ For example, administrative payments by the Fund in the currencies of the five members that have been declared ineligible to use the Fund's general resources have totaled the equivalent of about SDR 18,000 since the beginning of 1985.

2/ In connection with a forthcoming mission to one of the members concerned, it has been estimated that, as a practical matter, in light of hotel and airline requirements, local currency funding could be used for only about SDR 5-6,000 of the mission costs, largely for per diem.

administrative effort in accounting for advances in a variety of currencies, making special arrangements for the acquisition of local curency from depositories by mission members, technical advisors, or resident representatives, and tracking the re-deposit of any unused funds. In some countries, staff could be exposed to some additional risks of carrying relatively large amounts of cash.

In the staff's view, therefore, use of local currencies in financing administrative expenditures would not appear to be a particularly effective means of reducing members' arrears to the Fund.

2. Effects on the Fund and members

With respect to the effects on the Fund, it is assumed that the Fund would decide that any reductions in its currency holdings, resulting from a policy on use of the currencies of members in arrears, would be attributed to outstanding overdue repurchases. In that case, the sale or use of the currency of a member in arrears would, pro tanto, reduce that member's repurchase obligations to the Fund and the amount of arrears outstanding. Such use of the currencies of members in arrears would not, in itself, serve to settle overdue charges and thereby improve the Fund's income position. A reduction in arrears to the Fund through such use might lessen the effort required for the member to become fully current with the Fund, including in the payment of charges, and thereby contribute indirectly to the settlement of charges. Any such indirect effects would, however, depend in part on the impact of the use of the currency on the external position of the member whose currency is used.

The sale of a member's currency by the Fund in financing a purchase, with an exchange to a freely convertible currency at the request of the purchasing member, would result in an immediate reduction in the foreign exchange holdings of the member in arrears. If the currency is used (by the purchaser, the Fund, or any other entity) to finance expenditures that would otherwise have been made in foreign exchange or in local currency obtained with foreign exchange, the result would be a reduction (which may, however, be spread out over a somewhat longer period) in receipts of foreign exchange by the member. If the currency is held by the purchaser, there would be no offsetting impact on the member's gross foreign exchange position, although there would be a shift in the member's liabilities from the Fund to the purchaser.

Except in this latter case, therefore, the use of a member's currency by the Fund would result in a corresponding reduction in the availability of foreign exchange to the member in arrears and would not be expected, by itself, to strengthen the member's ability to meet remaining financial obligations to the Fund. In essence, the net foreign asset position of the central bank would be unchanged, and there would be no economic effect unless the purchase of the currency of the member in arrears led to a demand for that country's output that otherwise would not have been made. This is an unlikely event. In contrast, the acquisition and holding of the member's currency by other members would tend to alleviate pressure on the member's external position, though the importance of this effect and the extent to which it was more than temporary would depend importantly on the terms agreed for any liquidation of those holdings.

With respect to the member acquiring the currency of a member in arrears, the effect would depend on the nature and purpose of the acquisition. If the currency were acquired and exchanged or sold at the same (equal value) rate of exchange, the only effect would be on the composition of the member's reserves. If the currency were used in lieu of foreign exchange to finance local payments, and assuming that the exchange rate at which it acquired the currency corresponded to rates otherwise available, 1/ the acquisition would have no net effect on the purchaser's foreign exchange holdings. The purchaser would, however, be exposed to exchange risk on the balance acquired and held for any period prior to the expenditure. If the balances were acquired in order to be held, the purchaser's holdings of usable reserves would be reduced, and the holder would be exposed to exchange risk, unless an exchange guarantee were provided by the issuing member, and perhaps a risk of non-payment.

## IV. Some Operational Considerations

In the event the Fund were to pursue an effort to use the currencies of members in arrears, a number of technical and operational questions would need to be considered. This section briefly sets out some of the main questions.

### 1. Representative rates

All exchanges of currencies between the Fund and members are conducted at an exchange rate between two currencies corresponding to their exchange rates in terms of the SDR. The value of a currency other than the U.S. dollar in terms of the SDR is determined on the basis of the value of the U.S. dollar in terms of the SDR and the representative rate of exchange, the definition of which is discussed with a member upon joining the Fund and is subsequently approved by the Executive Board. The Board's decision in this respect normally incorporates an understanding that the member is to inform the Fund of any change in the representative rate. The rate is adjusted, if indeed there is a change, when the currency is used in a Fund operation or transaction and, in any event, at least once a year at the close of the Fund's financial year for the purpose of valuation adjustments to the Fund's holdings of a member's currency.

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1/ The question of representative rates is discussed further below.

How close the representative rate is to other exchange rates that might apply to foreign exchange transactions is of importance both to the Fund and (unless the currency purchased is to be exchanged immediately at the equal value rate) to a potential purchaser of a currency. The representative rate determines the value of the Fund's holdings and would determine the SDR value of the reduction of holdings associated with a particular use of currency. From the purchasing member's point of view, if use in local currency expenses is anticipated, a purchase from the Fund is not likely to take place unless the Fund's rate is very close to, or more beneficial than, rates that may be obtained otherwise. In the event that a transaction involving the currency of a member in arrears were to be made, it would be necessary to examine closely the representative rate for the member concerned, to determine whether it reflected market conditions and approximated rates that might otherwise be obtained by purchasing members.

## 2. Currencies to be used

During the Board discussion in June 1986, the suggestion for currency use was made primarily with reference to members declared ineligible to use the Fund's general resources. The Fund is not, however, limited legally to the use of the currencies of these members and could, for example, offer to sell the currency of any member that was in arrears on a repurchase obligation, any member that was subject to a complaint with respect to such an obligation, or any member that had been overdue on repurchase obligations for a certain period of time, after consultation with the member and provision of a reasonable opportunity to make the repurchase.

## 3. Amounts to be used or offered

It would also be necessary to develop criteria for determining the amounts of each member's currency that would be used or offered for sale. Such criteria could include, for example, factors related to the size and duration of the member's arrears, its progress in settling the arrears to the Fund, and the prospects for future payment.

## 4. Attribution of reduction in the Fund's holdings of currencies

As noted, members are free to attribute a reduction in the Fund's holdings of their currencies to any of their repurchase obligations and (subject to limitations) to enlarge their reserve tranche positions. It would be necessary for the Fund to decide that a reduction resulting from sales or use by the Fund of the currency of a member in arrears would be attributed to that member's overdue repurchase obligations and to determine the order of the obligations to be settled in this way.

## V. Concluding Remarks

1. In response to a request by the Executive Board, this paper has given consideration to certain questions relating to the possible use by the Fund of its holdings of the currencies of members in arrears to the Fund.

2. Legal authority exists for:

(i) sales to other members in exchange for their currencies, subject to the general provision of Article V, Section 3(d), or the special provision of Article V, Section 7(h), on the selection of currencies by the Fund. Article V, Section 7(h), with respect to the sale of holdings of a member's currency that the member has failed to repurchase, obviates the need for the Fund of finding that the balance of payments and reserve position of a member is sufficiently strong. Furthermore, under either provision, the sale by the Fund is not subject to agreement with the issuing member. Difficulties may, however, arise when an exchange requested by the purchasing member under Article V, Section 3(e)(i) at the time of the purchase is not made. The Fund must either refrain from selling the currency or substitute another currency for the currency that the issuing member has failed to exchange. The Fund could consider adopting policies under Article V, Section 7(h) limited to circumstances in which the purchasing member could either use the currency or obtain an exchange;

(ii) sales to other members or prescribed holders in exchange for SDRs. In both cases the Fund may not require the participant or prescribed holder to enter into such transaction. Furthermore, the concurrence of the issuing member would be necessary;

(iii) other uses such as payments of administrative expenditures.

No authority exists for sales of currencies in the market by the Fund except after withdrawal of a member.

3. The possibility exists that sale or use by the Fund of currencies by these methods might create an additional means of channeling payments to the Fund, if the overdue member and other members were prepared to participate. However, for the most part these mechanisms would not in themselves improve the balance of payments position of the member in arrears and would normally involve a transfer of, or failure to receive, foreign exchange resources by the member, with a corresponding transfer of resources to the Fund. If the member were willing to pay, it could be argued that in most cases this transfer might be more straightforwardly effected by other means, such as direct payment by the member with resources acquired through exports or other current receipts or through aid donations or creditor financing.

On the other hand, use of these provisions could provide some additional scope through which the collaborative efforts of the membership to deal with the problem of overdue financial obligations to the Fund could be brought to bear. Insofar as this vehicle could enable resources to be mobilized that might otherwise not be available, it could strengthen members' efforts to service their debt to the Fund. The practicality of these means would need to be explored on a case-by-case basis.

4. In the case of a member which does not appear willing to collaborate with the Fund, even though it is judged to have sufficient resources, it is for consideration whether the Fund should offer the member's currency in financing purchases, with provision of a "fail-safe" mechanism to protect the purchasing member. While the staff would not predict that such a policy would lead to a significant reduction in the Fund's holdings of the currencies of members in arrears, it may nevertheless be valuable as a further formal technique that could be considered after other procedures have been exhausted, and it would be an additional means of judging a member's willingness to cooperate with the Fund following a declaration of ineligibility. The staff would welcome the guidance of Executive Directors in this respect.

5. On the more technical question of how to proceed in making use of the currencies of members in arrears to the Fund, the following considerations are of relevance.

(a) As regards using these currencies to finance purchases by other members, it is for consideration whether the Fund should make such use only in circumstances where there is (i) a firm assurance on the part of the issuing member that the currency would be exchanged promptly, at equal value, if requested; or (ii) an indication by the purchaser that it wishes to obtain the currency from the Fund without seeking exchange.

(b) The possibility of sales to other members or prescribed holders in exchange for SDRs would seem to offer a potentially wider range of demands for the currencies of members in arrears, including:

(i) use by other members in financing transactions (e.g., for trade, aid, and diplomatic purposes) in and with the country in arrears;

(ii) use by other institutions (e.g., to finance local costs of development assistance projects), which could in some cases require the intermediation of Fund members in conducting the sales; and

(iii) acquisition by other members as a technique of assisting the member in arrears to become current and of cooperating with the Fund in dealing with the problem of overdue obligations.

As noted, however, any such sales in exchange for SDRs would require the concurrence of both the member in arrears and the purchaser of the currency, and that of another institution if a "triangular" arrangement were involved.

(c) In considering whether to pursue these possibilities it would be important to have the views of Executive Directors on all these points and, in particular, on whether the countries they represent would be prepared, as may be the case, to permit their currencies to be sold or to purchase the currencies of members in arrears. The Board's guidance is also required on the question whether the staff should pursue discussions with other institutions on their posible needs for currencies concerned and their potential willingness to acquire those currencies in transactions arranged through the Fund.

6. Quantification of the amounts that might be involved in sales of the currencies of members in arrears is difficult, and it may not be possible to be very precise in this respect without extensive further analysis and detailed consultations with the other parties to such transactions (purchasing and selling members, Fund creditors, other institutions). If Executive Directors could identify specific possibilities that they would support and would regard as worth exploring, it would help to focus the required analyses and consultations.

7. With respect to Fund administrative expenses, very minor amounts of the currencies of some countries in arrears have been used in the recent past and there would appear to be some scope for an increase in use. However, the potential amounts are very small in absolute terms and in relation to the obligations outstanding, and use of local currencies would give rise to some administrative inconvenience. If Executive Directors wish greater emphasis to be given to use of these currencies in administrative expenditures, the staff would suggest that for administrative reasons the effort be confined mainly to any large individual outlays that could be made in local currency.

8. In considering whether to pursue further the idea of using the currencies of members in arrears, Executive Directors will wish to bear in mind the effects of such use on the members' external positions, as discussed in Section III above, the needs for consultation and concurrence associated with certain uses, and the views of others as to the preparedness of their authorities to permit, and to participate in, sales by the Fund of the currencies of members in arrears. Specific indications by Executive Directors that their authorities would be willing to support and participate in such sales would be important in determining whether this approach would be potentially effective and meaningful as a technique of reducing arrears.