04

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/17

10:00 a.m., January 31, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

| Executive Directors | Alternate Executive Directors |
|---|---|
| A. Alfidja | Mawakani Samba |
| C. H. Dallara | M. K. Bush |
| J. de Groote | H. G. Schneider |
| M. Finaish | T. Alhaimus |
| | M. Sugita |
| G. Grosche | |
| Huang F. | |
| J. E. Ismael | Jaafar A. |
| A. Kafka | |
| T. P. Lankester | M. Foot |
| H. Lundstrom | |
| M. Massé | L. Leonard |
| E. I. M. Mtei | A. Abdallah |
| F. L. Nebbia | |
| Y. A. Nimatallah | J. E. Suraisry |
| | G. Ortiz |
| | S. de Forges |
| J. J. Polak | J. de Beaufort Wijnholds |
| | A. V. Romuáldez |
| G. Salehkhou | O. Kabbaj |
| A. K. Sengupta | A. S. Jayawardena |
| S. Zecchini | N. Coumbis |

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

Also Present

Asian Department: Tun Thin, Director; C. M. Browne. European Department: A. Fidjestol. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; J. T. Boorman. External Relations Department: P. J. Bradley, M. Goldstein. Legal Department: F. P. Gianviti, Director; J. G. Evans, Jr., Deputy General Counsel; P. L. Francotte, W. E. Holder, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; S. H. Hitti. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; D. Folkerts-Landau, P. Isard, P. J. Mathieson. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. B. C. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; W. L. Coats, Jr., E. Decarli, M. A. Lumsden, O. Roncesvalles. Western Hemisphere Department: S. T. Beza, Associate Director. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, W.-R. Bengs, L. K. Doe, L. P. Ebrill, S. M. Hassan, J. Hospedales, G. Nguyen, A. Ouanes, P. Péterfalvy, G. W. K. Pickering, Song G., N. Toé, A. Vasudevan, K. Yao. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, M. Arif, B. Bogdanovic, F. Di Mauro, J. J. Dreizzen, G. Ercel, R. Fox, V. Govindarajan, N. Haque, G. D. Hodgson, O. Isleifsson, Z. b. Ismail, S. King, H. Kobayashi, S. Kolb, M. Lundsager, A. H. Mustafa, J. Reddy, J. E. Rodríguez, M. Sarenac, B. Tamami, L. Tornetta, H. van der Burg, B. D. White.

1. UNITED STATES - PAYMENTS RESTRICTIONS FOR SECURITY REASONS - COMPLAINT UNDER RULE H-2 BY SOCIALIST PEOPLE'S LIBYAN ARAB JAMAHIRIYA

The Executive Directors considered a staff paper relating to the notification by the United States of restrictions imposed for security reasons under Executive Board Decision No. 144-(52/51), adopted August 14, 1952 and the complaint by the Socialist People's Libyan Arab Jamahiriya under Rule H-2 (EBS/86/21, 1/29/86, and Cor. 1, 1/30/86; EBS/86/8, 1/15/86, and Sup. 1, 1/22/86). They also had before them a communication from the United States on the notification of restrictions (EBS/86/9, 1/16/86), and a communication from the Arab Monetary Fund (EBS/86/17, 1/23/86).

The Chairman recalled that at EBM/86/12 (1/24/86) the Executive Board had decided that he should conduct consultations pursuant to Rule H-3 with the Executive Directors for the United States and the Socialist People's Libyan Arab Jamahiriya concerning the complaint by Libya in respect of certain exchange restrictions imposed by the United States. Those restrictions had been notified to the Fund by the United States, which had availed itself of Decision No. 144-(52/51). The consultations had been completed, and he would report by summarizing briefly the position of each party.

During the consultations, the Executive Director for the United States had stated that the restrictions had been taken to preserve national security and that they were in accordance with Decision No. 144-(52/51), the Chairman said. The Executive Director had also indicated that when the national security concerns that had given rise to the need for those measures had been removed, the U.S. authorities would be prepared to work toward an orderly restoration of normal commercial relations between the United States and Libya. The Executive Director for Libya had stated that in the opinion of his Libyan autorities, the U.S. exchange restrictions had not been taken solely to preserve national or international security, and that they were outside the scope of Executive Board Decision No. 144-(52/51) and inconsistent with the Articles of Agreement; in the circumstances, his Libyan authorities did not intend to withdraw their complaint under Rule H-2.

Mr. Finaish expressed appreciation for the opportunity to present before the Executive Board Libya's position on the matter of the restrictions on payments and transfers that had been imposed by the United States under Executive Orders 12543 and 12544, issued by the President of the United States on January 7 and 8, 1986, respectively. His authorities considered those restrictions to be inconsistent with U.S. obligations under the Fund's Articles of Agreement. Libya strongly protested those actions, which were not only in violation of specific U.S. obligations under Article VIII, Section 2(a) and Section 3, and Article VI, Section 3, but were also contrary to the general spirit of members' commitment to the purposes of the Fund as enunciated in Article I. Moreover, those actions violated the accepted principles of international financial relations and entailed grave implications for the international economic and financial cooperation on whose foundation the institution stood.

The case before the Board was of considerable importance to the Fund, Mr. Finaish stated. Directors had before them not only a complaint by a member against another member--on a question of great significance to the member making the complaint--but also a matter that extended well beyond the bilateral dimension and that should be of concern to the membership at large. The matter entailed broad implications for the prestige and credibility of the institution; its integrity in the discharge of its responsibilities; and the sanctity of its Articles of Agreement, particularly the protection of the interests of its members, both large and small, under those Articles. The U.S. actions, given the large weight of the United States in international trade and banking and its position as the key reserve currency country, also carried serious and wide-ranging implications for international financial relations. Those actions put at risk national reserves and other assets held in other member countries, belittled respect for the obligations of reserve currency countries, shook confidence in the international banking system and the security of international investments, and disrupted trade and international financial transactions in general. Those implications should clearly be of serious concern to an institution such as the Fund.

The United States had invoked Executive Board Decision No. 144-(52/51), which applied to payments restrictions imposed solely for the preservation of national or international security, for the imposition of the payments restrictions contained in its two Executive Orders, Mr. Finaish continued. He considered that the said payments restrictions were inconsistent with Decision No. 144-(52/51) and that they were therefore not permissible under that decision. Those restrictions had been imposed for political reasons that lay outside the scope of the security reasons to which Decision No. 144-(52/51) applied. The circumstances of the case did not establish the existence of a threat to U.S. security by Libya.

Without going into details, Mr. Finaish said that he wished to state broadly the reasons why the U.S. claim that the restrictions in question had been imposed in order to preserve its national security from a threat by Libya could not be accepted. The incidents said to have triggered the U.S. measures had taken place in the territories of third countries and had not been directed at the United States. Moreover, no evidence had been established linking Libya with those incidents nor had any convincing evidence been presented previously that implicated Libya in incidents or actions threatening U.S. security. For its part, Libya had not acted injuriously with respect to the property rights or other legitimate interests of U.S. citizens or companies in Libya. Full legal protection had always been and continued to be accorded to U.S. citizens in Libya. The lack of evidence in support of the U.S. claim that its security was being endangered by Libya pointed to the U.S. measures as having been motivated not by any pressing concern for the preservation of its security but rather by a policy of exerting pressure on Libya for other political purposes.

It also deserved to be noted, Mr. Finaish added, that the party claiming that its security was being threatened happened to be the most powerful country in the world while the country that was alleged to be threatening U.S. security was by comparison a very small one. The presence of the U.S. fleet off the shores of Libya and the military maneuvers taking place there led one to wonder which country's security was being threatened by the other and which country was being provoked by the other.

It was important to note that the U.S. claims against Libya and the measures it had taken against Libya subsequently had found hardly any support from the international community whose voice the Fund, given its international character, should be attentive to, Mr. Finaish observed. Members of the European Communities had taken a clearly different view on the matter from that taken by the United States, both individually as well as collectively at their ministerial meeting earlier in the week. There had also been no international pronouncements either at the United Nations or in other forums that suggested any threat by Libya to U.S. security or to international security; nor had the United States cared to bring its case against Libya before any such international forum or an international legal body. It should be noted in that connection that in some previous cases of the imposition of restrictions by the United States for which Decision No. 144-(52/51) had been invoked, the U.S. authorities had placed great weight on pronouncements from such international forums to support its case that the actions of the other country had posed a threat to its national security or to international security. In the present case, no mention had been made of any UN or other international resolutions against Libya, for none existed. As a matter of fact, even the countries where the airport incidents had taken place were clearly not convinced of the U.S. claim that Libya was responsible.

On the other hand, a large number of countries had expressed strong disapproval of the U.S. actions against Libya, Mr. Finaish noted. Resolutions to that effect had been passed, for example, by the nearly 50 members of the Fund who were members of the Islamic Conference at their meeting in Fez, Morocco, January 6-10, 1986, and by the Commission of Afro-Arab Cooperation in its meeting in Damascus, Syria, January 15-17, 1986. In a resolution passed on the previous day, the Arab League had condemned U.S. economic and military pressures against Libya, stating that the U.S. actions contravened the international legality embodied in the UN organization and represented an artificial and contrived crisis that sought to divert world public opinion from the real problems of the Middle East. Moreover, in a telex to the Managing Director, the Arab Monetary Fund--a specialized institution like the Fund--had called the U.S. measures unwarranted and expressed grave concern at their implications.

As he had noted, Decision No. 144-(52/51) applied to payments restrictions imposed solely for the preservation of national or international security, Mr. Finaish went on. Admittedly, it was difficult to establish a precise definition of the phrase "preservation of national or international security." However, for a proper application of the decision, and to avoid its abuse, it should be evident that reasonable clarity was needed on the kind of situations covered by that phrase. The text of Decision No. 144-(52/51) itself did not provide an explanation of how the concept of national or international security as used in the decision was to be interpreted. The only Fund document that provided guidance on the point was the staff memorandum (No. 620) that had been prepared by the Legal Department in 1951 to explain the reasoning behind what had later become Decision No. 144-(52/51). That memorandum had defined "actions for the preservation of national or international security" as "measures intended to meet war or a threat of war." The expression "emergency in international relations" had also been used in that staff memorandum but it had also been defined similarly as "an emergency of a general character containing a threat of war." Mention had also been made in the staff memorandum of the concept of "collective security," particularly as it was embodied in the UN Charter, and it had been noted that members might at times have to take actions to meet international obligations arising from that concept; restrictions that had been imposed in the past by many Fund members against Rhodesia and South Africa might be cited as a case in point.

Under the definitions given in the staff memorandum to which he had referred, situations to be covered by Decision No. 144-(52/51) could be either situations of war or situations where a threat of war existed, or situations where the concept of collective security was involved, Mr. Finaish observed. Clearly, the circumstances in which the said U.S. actions against Libya had been taken did not fit into any of those situations. He did not consider those actions as falling within the purview of the decision; they represented a hostile political and economic action by the United States against a Fund member that had not posed any verifiable threat to U.S. security. To deem the said U.S. actions as belonging within the scope of Decision No. 144-(52/51) would amount to stretching the concept of security well beyond its intended scope, and would be tantamount to allowing any consideration of a political nature to be treated as a security consideration for the purpose of that decision. That would be a dangerously broad interpretation of the concept of security and would open the way for an even greater misuse of Decision No. 144-(52/51) in the future. The possibilities for abuse of that decision, through misrepresentation of political considerations as security considerations, had not been lost on the drafters of the 1951 staff memorandum. With such possibilities in mind, the staff memorandum had stated that, outside the context of situations where security reasons were present, "restrictions for internal or international political purposes...would be in conflict with the spirit of the Fund agreement."

It should also be understood clearly that the mention of the expression "political" considerations in the brief preamble to Decision No. 144-(52/51) could not be construed as meaning that the intention was to extend the applicability of that decision to all payments restrictions for which the reason for imposition was said to be of a political nature, Mr. Finaish commented. The statement in question in the preamble, read in context, was meant only to point to the difficulty for an institution such as the

Fund to discuss political and military considerations that might be involved in a situation that was claimed by a member to represent a threat to national or international security justifying the imposition of payments restrictions. Obviously, that did not mean that all politically motivated restrictions would fall within the purview of Decision No. 144-(52/51). Political reasons had a much broader connotation than security reasons; reasons for political action might exist in the context of a security situation or outside of one. Decision No. 144-(52/51) applied to security reasons; if the intention had been otherwise, the drafters of the decision would have mentioned political reasons in the body of the decision in place of or in addition to security reasons.

To consider further the implications of the aforesaid reasoning, Mr. Finaish observed that Decision No. 144-(52/51) required the Fund, upon the invocation of that decision by a member, to determine to its satisfaction whether the payments restrictions in question had been imposed solely for security reasons. Evidently, if a certain economic motive could be established as having been part of the reason for the imposition of the restrictions in question, the restrictions would not be consistent with the decision. However, even if no economic motive could be established, it should not be concluded that the restrictions in question were necessarily consistent with Decision No. 144-(52/51). The absence of an economic motive was not a sufficient condition to permit the decision to be invoked. The 1951 staff memorandum stated that "the absence of economic or financial reasons would 'normally' lead the Fund to refuse its approval." The word "normally" in that statement denoted conditions in the absence of security reasons. The statement clearly implied that there could well be situations where the Fund would not approve payments restrictions even if no economic or financial considerations were involved in their imposition, namely, even if the reasons for imposition were solely noneconomic or political. Only if those noneconomic or political reasons had the nature of security reasons should Decision No. 144-(52/51) become applicable. On the other hand, it should be clearly understood that if all noneconomic or political motives were treated as security motives for the purpose of that decision, such an interpretation would effectively reduce to a mere formality the Fund's jurisdiction over payments restrictions that were not imposed for economic reasons. Decision No. 144-(52/51) was not intended to be interpreted in that way.

Thus, in applying Decision No. 144-(52/51), the Fund needed to determine first whether any economic motives for the restrictions in question could be identified, Mr. Finaish stated. In making that determination, it should be remembered that, as recognized in the preamble to Decision No. 144-(52/51), it was not easy to distinguish clearly between economic and other types of motivation. Consequently, the Fund should examine each case, including the present one, closely. If no economic motives could be identified, a determination would then need to be made whether or not the noneconomic motives were security motives. Admittedly, the specialized character of the Fund limited the extent to which it could attempt to make judgments on political and security matters. Yet in the exercise of its jurisdiction, the Fund had to determine pursuant to the said decision whether or not the payments restrictions for which that decision was invoked were related solely to security reasons. The 1951 staff memorandum that he had cited argued that the making of such a determination by the Fund did not mean that "the duty of the Fund would call for judgment on the specific defense, security or diplomatic policies adopted individually or collectively by members to meet these emergencies, or on the political wisdom of adopting restrictions on payments and transfers as economic sanctions. On the other hand, it is proper for the Fund--as necessarily incident to the discharge of its functions--to determine to its satisfaction whether the existing circumstances can be reasonably considered as requiring the imposition of exchange restrictions." The staff memorandum had stressed that a "fundamental determination" to be made by the Fund with respect to payments restrictions claimed to be security related was to "establish to its reasonable satisfaction that the member country proposing them is facing a situation which endangers its security."

The argument that the Fund, in applying Decision No. 144-(52/51) should give the benefit of the doubt to the claim of the member imposing restrictions that its security was endangered was seriously flawed, Mr. Finaish stated. In the event of a challenge to that claim by the member affected by those restrictions, the question was what basis there would be for giving the benefit of the doubt to the claim of the one and not to that of the other. Surely, the matter would have to be resolved by looking into the merit of the respective claims.

Normally, it would be expected that payments restrictions for security reasons would be linked to specific circumstances, a change in which would then lead to the lifting of those restrictions, Mr. Finaish commented. Since there was no clear basis for the restrictions imposed in the present case, it was also unclear what would bring about a reversal of those restrictions. In a way, Fund approval of, or acquiescence in, the U.S. restrictions would be tantamount to giving the United States open-ended permission to maintain those restrictions without any understanding of the circumstances that should lead to their elimination.

As for the possibilities of misuse of Decision No. 144-(52/51), it might be noted that the United States had been by far the most frequent user of that decision, Mr. Finaish observed. The decision had been invoked 42 times to date; on 26 of those occasions, the decision had been invoked by members imposing restrictions involving Rhodesia or South Africa, out of what could be broadly termed reasons of "international or collective" security. Of the remaining 16 cases, the decision had been used as many as 9 times by the United States, a country that most vocally proclaimed the cause of freer international trade and financial flows. It was noteworthy that it had been the United States--the largest member of the Fund and the most powerful country--that had felt the need to use the decision dealing with payments restrictions in conditions of a threat to security the greatest number of times, and against countries that in comparison were very small. Could it not be said that a mechanism that was supposed to allow members to resort to temporary payments restrictions in self-defense in situations of legitimate security risks had a serious flaw, allowing it to be misused for other purposes by the more powerful among the membership? A question that had to be asked was whether the possibilities of abuse of Decision No. 144-(52/51) did not represent a serious chink in the ability of the Fund to enforce its jurisdiction, and one that particularly compromised the protection of the interests of its smaller members.

Misgivings about the possible misuse of Decision No. 144-(52/51) had been expressed at the Executive Board meeting in 1952 when the decision had been taken (EBM/52/51, 8/14/52), Mr. Finaish remarked. Several Directors had objected to the decision at that meeting. Apprehensions had been expressed that restrictions imposed ostensibly for security reasons could in fact be used as "a weapon of aggression" or as "aggressive devices of economic warfare." Doubts had been expressed whether the decision "would give adequate safeguards against such cases." Even some of the Directors who had supported the decision had done so with qualifications and reservations. The decision had been approved with only a small majority, the United States having been its principal supporter. It was significant to note in that connection that the Executive Board had been considering at that meeting not only the adoption of the general decision but also its first invocation by the United States. For that reason, some Executive Directors had felt that Decision No. 144-(52/51) had been taken in haste.

A review clause had been explicitly incorporated in Decision No. 144-(52/51), Mr. Finaish noted. Paragraph 2 of the decision stated that "the Fund will review the operation of this decision periodically." It was surprising that, despite the serious doubts and misgivings expressed at the time of its adoption, and despite the clear injunction in the decision to undertake periodic reviews, not a single review of the decision had yet taken place. However the term "periodically" might be defined, a period of three and a half decades was long enough for at least one review to have taken place in pursuance of the decision. On the occasion of the U.S. invocation of Decision No. 144-(52/51) against Iran in 1979, questions had again been raised about the decision and the possibilities of its misuse. In his statement at a Board meeting held in that connection (EBM/79/191, 12/27/79), he had asked specifically for a staff paper to review certain aspects of the decision, particularly important issues such as the circumstances in which a member was justified in acting under that decision. Some explanation of why no review of that decision had been undertaken to date was in order. He wished to stress again the need for a review, both to re-examine the substance of the decision as well as to clarify concepts to limit the possibilities of its misuse.

In conclusion, Mr. Finaish stated, his authorities considered the restrictions on payments and transfers involving Libya that had been imposed by the U.S. Administration pursuant to Executive Orders 12543 and 12544 issued by the U.S. President on January 7 and 8, 1986, respectively, to be inconsistent with Executive Board Decision No. 144-(52/51) because a situation containing a threat to national or international security to which the decision applied did not exist. The action had been motivated by political purposes that lay outside the purview of the decision and the said restrictions were in violation of U.S. obligations under the Fund's Articles of Agreement. The Fund should disapprove those restrictions and direct the U.S. Administration to withdraw them with immediate effect. As he had said at the outset, the case before the Executive Board should not be looked at merely as a dispute involving two members nor should its outcome be perceived in terms of victory for one or the other party. The case should be looked at primarily as a question of principle: for the Fund, that principle was the upholding and fair application of the laws of the institution. The objective should be to ensure that the outcome was a victory for that principle. Libya was a member with a good record of cooperation with the Fund. Like many other members of the Fund, it was relatively small, and did not possess the voting power or other advantages to influence decisions in its favor. The protection of its interests in the Fund lay entirely in objectivity and fairness in the application of the laws of the institution and the conformity of those laws with the institution's purposes.

Mr. Dallara noted that the two Executive Orders signed by President Reagan on January 7 and January 8, which were attached to EBS/86/9, prohibited inter alia the extension of credits or loans by U.S. persons or the U.S. Government and blocked all property and interests in property of the Government of Libya or its entities in the United States or held by U.S. persons. The blocking order did not apply to the property of Libyan citizens or entities not controlled by the Government of Libya. The President had ordered those prohibitions by the authority vested in him under certain U.S. legislation--most importantly, the International Emergency Economic Powers Act. That law provided that the President might exercise his authority to issue such Executive Orders "to deal with any unusual or extraordinary threat, having its sources in whole or substantial part outside the United States, to the national security, foreign policy, or economy of the United States if the President declared a national emergency with respect to such a threat." The President had based his Executive Order on a finding that "the policies and actions of the Government of Libya constitute an unusual and extraordinary threat to the national security and foreign policy of the United States." Therefore, the President had declared a national emergency to deal with that threat.

The Executive Orders of the President had not been based on the existence of a threat to the U.S. economy, Mr. Dallara added. Nor had they been taken for broad political reasons. The policies and actions which had led to the need for the Executive Orders included the support by the Government of Libya of the terrorist attacks of December 27, 1985 in the Rome and Vienna international airports in which 19 people had died, including 5 U.S. citizens. The attacks demonstrated Libya's role in international terrorism, which constituted a threat to the national security of the United States and which had led to the need for the actions taken by his authorities.

The U.S. authorities were fully aware that Article VIII, Section 2(a) of the Articles of Agreement provided that "subject to the provisions of Article VII, Section 3(b), and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions," Mr. Dallara went on. However, as noted in EBS/86/21, Executive Board Decision No. 144-(52/51) stated that situations did arise in which members imposed restrictions for the preservation of national or international security--based solely on the judgment of the member--and the decision required that the Fund be notified in advance of, or within, 30 days of the imposition of such restrictions. In accordance with that Executive Board Decision, his authorities had notified the Fund of their actions on January 16, within the 30-day limit. In that notification, it had been made clear that the President's measures were imposed for the purposes set forth in Executive Board Decision No. 144-(52/51)--namely, for the preservation of national security. Thus, the U.S. actions were in full accord with the Articles of Agreement and with Executive Board Decision No. 144-(52/51). He would not elaborate further on the basis for the U.S. actions since, as Decision No. 144-(52/51) recognized, the Fund did not "provide a suitable forum for discussion of the political and military considerations leading to actions of this kind."

He saw nothing to be gained from a review of Executive Board Decision No. 144-(52/51), Mr. Dallara remarked. It was true that the decision provided for such reviews periodically, yet there must be a good reason why a review had not been conducted in the more than three decades that it had been in effect. His authorities believed that the decision had served the Fund well by protecting it from inappropriate involvement in political or military matters in the world. Therefore, he would not support the conduct of such a review.

The U.S. action in blocking the property of the Libyan Government did not in any way represent a seizure of the assets or the property of the Libyan Government, which would continue to earn income on those assets as appropriate, Mr. Dallara explained.

The U.S. authorities did not consider reliance on Executive Board Decision No. 144-(52/51) as an inconsequential event, Mr. Dallara remarked. The decision was designed to be used in limited circumstances--namely, when the national or international security of a nation was threatened. It was the hope of his authorities that the decision would be used as infrequently as possible by all members of the Fund. More generally, his authorities recognized their responsibility as a reserve center to help maintain an open international monetary system that provided for the free flow of capital. The actions taken in no way represented a departure from the U.S. commitment to fulfill that responsibility.

In closing, Mr. Dallara said that the United States deeply regretted the circumstances that had led to the need for the measures. When the national security concerns that had given rise to the need for them were removed, the U.S. authorities would be prepared to work toward an orderly restoration of normal commercial relations between the United States and Libya.

Mr. Lankester said that his authorities were satisfied that the restrictions on payments and transfers which had been imposed recently by the United States against Libya were not motivated by economic or political considerations but were related solely to the national security of the United States. Accordingly, they were satisfied that the Executive Orders implementing those restrictions met the requirements of Decision No. 144-(52/51); they were thereby consistent with the Articles of Agreement, and there were thus no grounds for the Fund to object to them. As the preamble to Decision No. 144-(52/51) suggested, the Fund did not provide a suitable forum for discussion of the national security considerations that had led to the actions taken by the U.S. authorities. It followed that the Fund was also not a suitable forum for discussion of the actions themselves.

Finally, Mr. Lankester stated that he did not believe anything would be served by a review of Decision No. 144-(52/51) at the present time.

Mr. Massé said that in the view of his authorities, the question was one of principle: the role of the Fund and the types of issues that should be discussed in the Board. They would prefer to confirm the judgment that the issues for discussion should not be of a political nature. Thus, in cases such as the one under consideration at the present meeting, the Executive Board should not take up the substance of the action by the U.S. authorities or its justification. The discussion should be restricted simply to determine whether the United States, in taking its actions, had done so for national security reasons. He had no reason to doubt that intent. Therefore, within the purview of Decision No. 144-(52/51), the action of the United States could not be discussed in substance, and he supported the U.S. position.

As for the review, his authorities believed that Decision No. 144-(52/51) had served the Fund well, Mr. Massé concluded. It had prevented the Fund from being implicated in difficult decisions of a more political nature. Therefore, a review of the decision was not necessary.

Mr. Nimatallah said that he had been very disappointed to learn of the imposition by the United States, which was the biggest member of the organization, of economic sanctions on Libya and the freezing of its assets. That action was unnecessary and unwarranted. In principle, he was opposed to the freezing of assets of members by other members. Such action constituted a threat to the smooth functioning of, and confidence in, the international monetary system. Furthermore, the freezing of assets of other members could also have a detrimental impact in the long run on the freedom of trade and capital movements. That kind of potential harm was even greater when a country as large and important as the United States was imposing such a freeze. He had always thought that the United States should be the first among the Fund's members to protect the integrity and freedom of the system and generate confidence in it, instead of resorting to actions that could shake an already fragile system.

It had been stated by Mr. Finaish on one hand that there was no evidence that the action taken by the United States was for national or international security reasons, Mr. Nimatallah noted. Mr. Dallara, on the other hand, had said otherwise. In his own judgment, no reason whatsoever was strong enough to warrant freezing the financial assets of one country by another. Such a sanction was too dangerous for such casual use by members, especially large members. The potential damage to the system and the principles of the Fund was far greater than any benefit to the member imposing the sanctions. Therefore, he believed that the Executive Board should stand firm against the particular action under discussion and any similar action in the future.

A review of Executive Board Decision No. 144-(52/51) should be undertaken as soon as possible because the decision seemed to raise many questions, Mr. Nimatallah considered. In the meantime, he wondered whether there was anything that the Chairman personally could do to help end the crisis.

Mr. Grosche considered that as Decision No. 144-(52/51) applied to the case under discussion, the question that arose was whether economic considerations, in whole or in part, had been involved in the measures taken by the United States. He had no doubt on that score. In fact, for the United States, the economic effects might be negative; under no circumstances could they be positive. Therefore, he saw no reason why the United States would have taken the measures if not solely for other than economic considerations. Consequently, the Fund was not in a position to state that it was not satisfied that such restrictions were proposed solely to preserve national or international security.

To conclude, Mr. Grosche observed that Decision No. 144-(52/51) had served the Fund well over the years, isolating it from tensions that had arisen again and again between member countries. He saw no necessity to review the decision at the present stage.

Mr. Polak noted that the United States had stated in its communication to the Managing Director (EBS/86/9, 1/16/86) and in the statement by Mr. Dallara that its restrictions had been imposed pursuant to Decision No. 144-(52/51)--namely, solely for security reasons. As noted in the preamble to that decision, "the Fund does not...provide a suitable forum for discussion of the political and military considerations leading to actions of this kind." Accordingly, he would refrain from addressing the merit of the restrictions imposed by the United States. The only question before the Executive Board was whether the U.S. restrictions properly fell under Decision No. 144-(52/51)--in particular, by not being in whole or in part inspired by economic motivations. He was satisfied that the U.S. restrictions met that test.

Finally, Mr. Polak remarked, the discussion at the present meeting had led him to believe that no useful purpose would be served by a review of Decision No. 144-(52/51) at the present time.

Mr. de Forges noted that in the view of his authorities, the Fund did not provide a suitable forum for the discussion of measures that had no economic motivation or effect. It seemed incontestable to the French authorities that the measures taken by the U.S. authorities, which were the grounds of the complaint, had not been taken for any economic or financial reasons. The Executive Board was thus not the appropriate place to discuss them, and the Fund was not in a position to withhold its agreement. Normally, the Fund would grant its approval of measures that were necessary for the preservation of national security, as in the case under discussion, on a lapse of time basis.

His authorities did not consider that a review of Decision No. 144-(52/51) would be useful at the present time, Mr. de Forges concluded, for the reasons mentioned by Mr. Grosche.

Mr. Salehkhou stated at the outset that he fully associated himself with Mr. Finaish's most thoughtful and comprehensive presentation. To avoid repetition, he would try to highlight only some of the issues that needed to be seriously addressed at the present meeting. By so doing, and to do justice to Mr. Finaish's convincing arguments, he would leave time for those who had expressed support for the U.S. position to elaborate further on their arguments.

The blocking of the Libyan Government's property in the United States and the imposition of restrictions on current and other transactions of the Libyan Jamahiriya were matters of serious concern and should be considered as such by both the Fund and the membership at large, Mr. Salehkhou said. The measures involved constituted a clear breach of obligations under the Fund's Articles of Agreement by a major member whose role as a reserve currency center was crucial to the orderly functioning of the international monetary system. Indeed, the U.S. measures had significant negative implications not only for Libya but also for the stability of the system as a whole, which was to a large extent dependent on the confidence of all participants and on the implied sovereign immunity enjoyed by foreign governments and central banks. The U.S. action had also greatly constrained Libya's ability to face its international obligations. It was fitting to note in that context that similar concerns had been expressed by a number of international organizations, including the Arab Monetary Fund, which shared most of the Fund's principles and objectives.

The Fund's responsibilities in promoting a stable international monetary system, orderly trade and financial transactions, and secure international investments required that the Executive Board take an unequivocal stand on the imposed restrictions by expressing its serious concern and disagreement, Mr. Salehkhou observed--the more so since there seemed to be no indications that those sanctions had been provoked or that the involved assets constituted any threat to U.S. national or international security. Failure to act on the Fund's part would be tantamount to condoning unjustifiable sanctions against Libya. In that respect, he wished to stress his doubts about the application of Decision No. 144-(52/51) to the present case. Apart from the fact that there was no clear evidence linking the sanctions to any action by Libya, and that no attempt had been made by the United States to present its case before suitable international forums, the security argument appeared to lack credibility. As Mr. Finaish had convincingly argued, the reasons for the U.S. action clearly went beyond security and were of a purely political nature. At best, it was the security of Libya that was being threatened.

Beyond the specific issue before the Executive Board, and sharing as he did Mr. Finaish's analysis of the flaws and inherent biases of Decision No. 144-(52/51), Mr. Salehkhou said that he wished to refer to some of the provisions of that decision. There seemed to be some contradiction between the provision of a 30-day period to assess whether the restrictions involved were taken solely for national or international security reasons, and the provision that "the Fund does not, however, provide a suitable forum for discussion of the poltical and military considerations leading to actions of this kind." The decision also provided that when no action was taken by the Fund "the member may assume that the Fund has no objection to the imposition of the restrictions." The latter provision resulted, for all practical purposes, in the Fund's endorsing the "political and military considerations" of one party to the conflict at the same time that it recognized its unsuitability as a forum for discussing such considerations.

For those reasons, and for those expressed by Mr. Finaish, he believed that it was urgent that the Executive Board review Decision No. 144-(52/51) so as to define more precisely what was meant by national and international security reasons and whether an individual country could judge what might constitute international security, Mr. Salehkhou stated. Such a review would remove the existing biases of the present decision and ensure that confidence in the international monetary system was not adversely affected by unilateral decisions by some major participants. As the decision provided for periodic reviews, he asked the staff why, after so many controversial cases, no such review had taken place since its adoption in 1952. Paragraph 2 of that decision appeared in fact to call for automatic periodic reviews.

Finally, Mr. Salehkhou remarked that even under the existing provisions, he had been surprised to find no analysis or appraisal in the staff paper, despite the requirement of the decision that the Fund express its satisfaction or objection to the restrictions.

Mr. Fujino said that his authorities understood that the circumstances that had led the United States to take the measures that were under discussion were not of an economic or financial nature but fell under Decision No. 144-(52/51). Moreover, because one of the institution's purposes was to promote better international economic relations between member countries, it would be better for it not to be involved in substantive judgment of a political nature. As he understood it, Decision No. 144-(52/51) was an expression of that wisdom.

Mr. de Groote requested that his abstention on the vote on the matter under discussion be recorded.

Mr. Pérez said that there was a general consensus among the members of his constituency that such measures as trade embargoes and the freezing of financial assets of any country were not an appropriate way to deal with political problems, a concept that included security reasons. Previous experience with that type of action--the list in Attachment II to EBS/86/21 was quite long--showed that it did not contribute to solving political disputes; on the contrary, it only created uncertainties about the stability and good functioning of the international monetary system. In that respect, he shared most of the concerns expressed by Mr. Nimatallah.

Referring to the specific legal aspects for consideration in assessing the matter under discussion, Mr. Pérez continued, it was quite clear that if Decision No. 144-(52/51) was the relevant rule, the Board should center its discussion on whether or not it believed that the action had been taken for economic reasons or for the preservation of national or international security. As far as he had been able to analyze the matter, he had found no clear economic reasons compelling the United States to adopt the measures. Accordingly, it had to be concluded that national security considerations, as stated by the U.S. authorities in their communication to the Fund, could have prompted the action.

Nevertheless, the question remained as to whether or not Decision No. 144-(52/51) remained valid in assessing the issue, Mr. Pérez noted. While he was not convinced of the appropriateness of giving a free hand to any member country to impose economic sanctions for security reasons, evaluated only by the member itself, he believed that the Fund was not the appropriate forum for judging when a security problem reached the point of justifying the adoption of strong economic actions. In other words, if Decision No. 144-(52/51) had not been adopted, one more or less along the same lines would have to be approved, given the character of the institution; that was perhaps why the decision had remained in force without modifications during the past 34 years.

To conclude, Mr. Pérez said that it was regrettable that such action had been taken. Political problems should be solved by political means. Even though it had to be recognized that economic matters were not completely without political aspects, the economic character of the Fund should be preserved.

Mr. Nebbia stated that, as a matter of principle, his chair did not accept the validity of coercive measures--whether of an economic, political, or any other character--that were incompatible with the Charter of the United Nations and that might impair multilateral agreements. Dialogue constituted the only mechanism for resolving conflicts; furthermore, the dialogue should not be imposed by violating the principle of nonintervention.

His authorities had instructed him to record their abstention on the specific case under discussion under Decision No. 144-(52/51), Mr. Nebbia said.

It was also the view of his authorities that that decision had been and remained useful to avoid the discussion of purely political problems within the institution, Mr. Nebbia concluded. Therefore, there was no need for a review at the present time.

Mr. Zecchini observed that Executive Board Decision No. 144-(52/51), adopted August 14, 1952, stated quite plainly that the Fund did not provide "a suitable forum for discussion of the political and military considerations leading to actions of this kind"--namely, restrictions on current payments and transfers. Moreover, the same decision ruled that the Fund might object to those restrictions only if it was not satisfied that they had been taken solely for the preservation of national or international security.

He had listened carefully to the arguments put forward by the Executive Directors for both the United States and Libya, Mr. Zecchini added. Mr. Dallara had not presented any economic motivation for the action of his Government; similarly, the official text of the measures taken by the U.S. authorities did not refer to any motivation other than reasons of national security and foreign policy. By the same token, Mr. Finaish had presented no economic motivation that could be attributed to the U.S. authorities' action, or motivation of any other nature that could not be linked to national or international security. Therefore, it was apparent that the motivations were outside the realm of the economic and were specifically related to national or international security matters, so that the Executive Board was not the appropriate forum for discussing the restrictions.

He had not consulted his authorities on the question of the review of the operation of Decision No. 144-(52/51) because it had not been included on the agenda, Mr. Zecchini observed. Therefore, he was not in a position to express a view on that point. In any event, the case for revising Decision No. 144-(52/51) would have to be properly argued and a paper would have to be prepared by the staff before it was placed on the Board's agenda for discussion.

Mr. Huang noted that the Fund was an international financial institution. It had a clear interest in protecting at all costs the functions, operations, and stability of the international monetary system. Article VIII, Section 1, of the Articles of Agreement clearly stated that "no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions."

The U.S. authorities had availed themselves of the provision of Executive Board Decision No. 144-(52/51) concerning the preservation of national and international security, on account of events whose gravity he recognized, Mr. Huang commented. However, he was unaware of any irrefutable facts providing justification for the U.S. authorities to take, in line with that decision, economic sanctions against a sovereign country. In his judgment, the Fund did not provide a forum to discuss political issues. He hoped that the Managing Director would continue his valuable efforts to bring the two parties together so that an appropriate solution could be found.

Mr. Alfidja remarked that he had been unable to obtain instructions from all of the countries in his constituency because of the short time that had elapsed between the notification of the complaint by the Socialist People's Libyan Arab Jamahiriya under Rule H-2 and the Executive Board's consideration of that complaint. As a result, he could not express an overall position on behalf of his constituency.

He was in favor of a review of Decision No. 144-(52/51), Mr. Alfidja stated. In the absence of such a review, he would welcome a staff paper explaining why no such review had been undertaken to date.

Mr. Mtei said that he had noted, both in Mr. Dallara's statement and in the communication submitted by the U.S. authorities, that the U.S. Government had acted out of national and international security considerations. It was not for him or even for his authorities to challenge the U.S. statement that their national security was being threatened by Libya; even if the United States could supply the evidence, it would surely be a matter for individual judgment to weigh the various ingredients of the evidence. Decision No. 144-(52/51) itself implied that the question of national security was a matter of judgment for the state imposing the restrictions; therefore, the production of any evidence proving that U.S. national security was being threatened was a moot point.

He accepted the implication in the preamble to Executive Board Decision No. 144-(52/51) that the Fund was not the proper forum to discuss the political and military considerations of such matters, Mr. Mtei added. However, he wished to record the concern and great regret of some of his authorities that it had become necessary for the United States to act in the manner it had to block the assets of the Libyan Government held in the United States and in U.S. institutions abroad. In the judgment of those of his authorities who had reacted, the United States had a great responsibility as a reserve currency center. Any action tending to exploit the privilege of a reserve currency center to attain specific national interests at the expense of any reserve holder must be viewed with considerable caution and circumspection. They believed that other options had been available to the United States to fulfill its national objectives. If the international monetary system as it was known at present was to function with the confidence of its members and in an equitable manner, those members serving as reserve currency centers had to approach their special role with the knowledge that they bore serious responsibilities and obligations. The Fund, as the institution responsible for overseeing the international monetary system, should therefore regret the action, and, while noting that the United States had asserted that the measures were purely for national security, should urge the adoption of alternative measures if necessary instead of those that had been taken.

Mr. Ismael said that his chair wished to record its abstention on the matter under discussion.

Mr. Sengupta said that he had not received any instructions from the authorities of Bhutan and Sri Lanka. On the basis of his consultations with his other authorities, he wished to note that as the Fund was not a political organization, it should try to avoid deliberating on political considerations motivating the actions of a member country. However, the implications of such action could sometimes be quite serious for the orderly functioning of the international monetary and financial system. To cite the communication from the President of the Arab Monetary Fund, with which the Fund shared "a clear interest in the preservation of the viability and stability of the system," he too was worried that the U.S. action could "harm confidence in international financial markets with detrimental implications for international flows of resources and investments at the very time when the need for such flows was at its highest." That was true even if the U.S. action was in accord with a strict interpretation of Decision No. 144-(52/51), not having been motivated, as Mr. Dallara claimed, by any consideration other than the U.S. authorities' perception of national and international security. While that claim might prevent the Fund from discussing the substance of the measures, as suggested in the staff paper, he requested the Managing Director to continue his consultations with the authorities concerned in order to redress the situation as soon as possible.

The Director of the Legal Department noted that paragraph 2 of Executive Board Decision No. 144-(52/51) said that "the Fund will review the operation of this decision...," which was not the same as a review of the decision itself. Reviewing the operation meant informing the Executive Board of the measures introduced under the decision with an indication of which measures were still in effect and which had been revoked. A list of precedents had been attached to EBS/86/21; a list of measures currently in effect under Decision No. 144-(52/51) could be circulated. The Board could decide on the basis of that list whether it wished to modify the decision itself. It should be noted, however, that providing information on measures imposed under the decision was not the same as proposing to amend the decision itself.

Mr. Salehkhou recalled that he had referred to the unusual absence of any staff analysis of the problem in order to prepare the ground for the Executive Board's deliberations. In addition, no decision had been proposed, suggesting that the Fund would keep silent and that the restrictions would be automatically approved.

The Director of the Legal Department said that the only information available to the staff had been the communications received from the U.S. authorities and the Libyan authorities, which had been circulated to the Executive Board.

Mr. Finaish inquired what procedure would be followed in responding to the request of a number of members of the Executive Board for a review of a given decision, especially when that decision itself incorporated a clause calling for periodic review. Mr. Dallara had said that there must be good reasons for the decision's not having been reviewed so far; but there must also be good reasons for those who had drafted the decision having wanted it to be reviewed, particularly in light of the record of the meeting at which it had been discussed. The abstentions and hesitations expressed at that meeting, and the fact that the decision had been approved with a very narrow majority, suggested that the Board had been unsure of its ground and, because it had taken a decision in some haste, had wanted the opportunity to review it. The Executive Board should take the opportunity to reconsider the substance of the decision as well as clarify the concept of national security. The frequency with which the decision had been invoked was evidence of its significance. Failure to follow up the discussion at the present meeting of the general issues that had been raised would give the wrong signal. The implication would be that any country could claim security reasons as justification for proposing sanctions and that the Fund would have to approve the restrictions involved because it was unable either to define national security or pass judgment upon political issues. Consequently, the judgment of the country itself would prevail.

The dilemma faced by the Executive Board in 1952 had been that although it recognized that it was not the appropriate forum for a discussion of political and military matters, it had not wanted to give up its jurisdiction under the Articles of Agreement that allow it to approve restrictions without regard to motivation, whether political, military, or economic. Under Decision No. 144-(52/51), the Executive Board could not completely avoid having to consider such matters; on the present occasion, it had to be reasonably convinced that there were genuine security reasons for the actions taken by the U.S. authorities and that the said actions had been taken solely for those reasons. At the time when the issue of payments restrictions for security reasons had first been discussed, the staff had at least issued a paper in which it had been noted that the condition for invoking the decision must be the existence of genuine security reasons. Some consideration would have to be given to the question of how far to go in permitting members to judge that issue for themselves, together with a consideration of the implications for other countries. The latter point had been made in 1952. In the present instance, there were several implications of a systemic nature. In addition, there was the issue of extraterritoriality; for instance, what position would be taken regarding the enforceability of U.S. restrictions with respect to the foreign branches of U.S. commercial banks? The matter was not clear but had to be considered seriously because it involved members' rights and obligations under the Articles of Agreement.

On the more strictly procedural question, Mr. Finaish asked whether an individual Executive Director or a group of Executive Directors had the right to ask the Fund to review a particular decision. He believed that it was important to have an opportunity to analyze the concepts underlying Decision No. 144-(52/51) so that members would be more careful about invoking it in future. Those Directors who did not wish to modify the decision could participate in such a review, based on an analysis by the staff, even if they came to the conclusion that modification was unnecessary. Otherwise, members would be able to freeze the assets of other countries in a rather casual manner; when they so informed the Fund, the general reaction would be that it was inappropriate for the institution to consider politically motivated issues. The advantage of a review and dicussion, based on a staff paper, would be that at least certain issues would be clarified.

Mr. Salehkhou said that he could not accept the explanation by the staff for the lack of substance and analysis in its paper. The Chairman had consulted with both parties and he felt sure that more information than that contained in the communications from the Executive Directors concerned was available. Furthermore, he had raised the issue of the lack of a proposed decision because it had been clearly indicated in paragraph 4 of EBS/86/21 that the U.S. measures requiring Fund approval under the Articles of Agreement would be considered consistent with the Articles unless the Fund took a decision that it was not satisfied that the restrictions had been imposed solely to preserve national or international security, such decision to be taken by a majority of the votes cast. The usual practice was for the staff to propose a draft decision, whether or not the Executive Board wanted to approve it.

Nor could he accept the staff interpretation of paragraph 2 of Decision No. 144-(52/51)--namely, that it was the operation of the decision and not the decision itself that was to be reviewed periodically, Mr. Salehkhou added. In his view, the decision clearly "reserves the right of the Fund to modify or revoke, at any time, the decision or the effect of the decision." After all, the Board was constantly reviewing operational matters, such as charges, as well as decisions of substance. He saw no reason why the decision on payments restrictions for security reasons should not be reviewed after 35 years.

Mr. Nimatallah considered that Mr. Finaish had rightly pointed out that the Executive Board would have to respond to the request of those Executive Directors who had asked for a review of Decision No. 144-(52/51), even if they were not in the majority. Other Executive Directors who would prefer to retain the decision without change would have the opportunity to express their opinions during that review.

The Chairman responded that any Executive Director could ask for an item to be placed on the agenda of the Executive Board. It was then up to the Board to decide, by a majority of the votes cast, whether it wanted to take up that item. From the discussion so far, he had not ascertained that a majority was in favor of placing the matter of reviewing Decision No. 144-(52/51) on the agenda.

Mr. Salehkhou asked whether it would be possible for the staff to prepare a paper on why a review was not in order, since he had not heard a single substantive argument for not holding such a review. Presumably, majority support was not needed for the preparation of such a paper. His request was based on concern over the failure to review either the decision or its operation for 3 1/2 decades, even though a number of members of the Executive Board--admittedly not the majority--had questioned the logic and rationale for the decision and its frequent invocation by certain members. If a review required a majority of the votes cast, which were not forthcoming, surely it would be possible to have some idea of the reasons for not reviewing the decision. Those Executive Directors who were in favor of a review had presented various arguments and expressed various concerns, but other Directors had not agreed. His question was whether the staff could not explain the lack of agreement.

The Chairman replied that he would be most reluctant to put the staff in the position of having to substitute its judgment for that of a large group of member countries who had explained, through their Executive Directors, why they did not want a review. It would be practically impossible to evaluate the nuances of the different individual perceptions and judgments underlying national views.

Mr. Finaish commented that if a review of Decision No. 144-(52/51) could not be undertaken for lack of majority support in the Board, he wished to ask whether one or more Executive Directors had the right at least to ask the staff to prepare a paper clarifying certain concepts in the decision. In connection with the present case, for example, he had been trying for three weeks to obtain from the staff a satisfactory explanation of the meaning and scope of the concept of national and international security, as used in the decision.

The Chairman said that the staff would provide whatever factual background information it could in order to further the understanding of the way in which any decision was operated. The staff had in fact provided such information on the decision under discussion. What the staff could not be expected to do was to devise criteria for evaluating the national or international security problems motivating the restrictions imposed. That would contradict the approach that the Executive Board had assumed over the years. The Executive Board had not asked for such criteria to be developed, nor would it be possible to develop a Fund theory of national and international security that would be more precise and binding than the one in Decision No. 144-(52/51). Mr. Finaish had made an eloquent case for more precision in the setting of the criteria for fear that the decision as it stood could be used too casually. But the sense of the meeting had not been in favor of such an exercise.

Mr. Finaish remarked that his point was that the staff had in fact prepared a paper on the issues, but 35 years previously. Since that time, much further experience had been gained with respect to those issues. Decision No. 144-(52/51) had been invoked a number of times, most frequently by the United States. On several occasions, including the present one, important questions of interpretation had arisen. The concern was not only that the decision as it stood could be used too casually but also that it had already been. It seemed to him to be legitimate to request the staff to write another general legal paper, as it had done preceding the 1952 discussion in the Executive Board, on such issues as the need for prior approval of restrictions, the meaning of national and international security, and the need to determine that the restrictions were not excessive in extent and did not cause unnecessary damage to other members. The outcome might not necessarily be a formal review but those who might wish either to invoke the decision or to defend themselves against its invocation would have a better understanding of the general legal concepts underlying it. With respect to the periodic review of the operation of the decision, which was required under the decision, he could not accept the interpretation by the Director of the Legal Department that that requirement simply meant providing the Board with a list of measures taken and rescinded under the decision. A review, even if it were a review of the operation of the decision and not of the decision itself, would be expected to consist of more than just such a list without any accompanying analysis or assessment. Furthermore, even a simple list of precedents, such as that attached to EBS/86/21, had not been prepared "periodically"; as far as he could recall, such a list had not previously been circulated to the Board.

If the view were taken that the Fund did not provide a suitable forum for any discussion at all to establish the validity of a member's claim of a threat to national or international security, or that it could not take any position at all on what constituted a threat to national or international security sufficient to justify the imposition of payments restrictions, then some might say that a better alternative could be for the Fund to give up its jurisdiction over the matter, which might perhaps be passed on to the UN Security Council or to some other more qualified institution, Mr. Finaish stated. It could be said that simply to retain the jurisdiction without possessing the necessary competence to execute it satisfactorily seemed inappropriate.

Mr. Salehkhou explained that he had not requested a staff paper on issues of a political or security nature but for one on why a review under paragraph 2 was or was not in order.

The Director of the Legal Department said that paragraph 2 had two parts. The first part contained a decision to the effect that the Fund, meaning the Executive Board, would review the operation of Decision No. 144-(52/51). The Executive Board had agreed in 1952 that the operations of the decision would be reviewed from time to time; the duty of the staff was to provide information on the cases in which the decision had been applied. Under the second part of the decision, the Fund reserved the right to modify or revoke its decision; the Fund did not state that it would modify the decision but only that it might possibly decide in the future to modify the decision, in which case a majority of the votes cast would be required.

Mr. Finaish said that another country in his constituency had asked for a staff paper on the implications of such restrictions for international financial transactions. Executive Order No. 12544 froze official Libyan assets in the United States as well as those controlled by overseas branches of U.S. entities. An important legal question was whether Article VIII, Section 2(b) applied to such restrictions on current payments. One legal view was that such restrictions on current payments did not fall under the extraterritorial provision of Article VIII, Section 2(b). Moreover, there was nothing in Decision No. 144-(52/51) to suggest that restrictions imposed for security reasons were covered by that extraterritorial provision. Under international law, sovereign governments could not be obliged to carry out the political acts of other governments, and the Fund's Articles of Agreement likewise could not be interpreted as allowing one member to impose political obligations on other members. He recalled that in other cases--for instance, that of the restrictions imposed by the United Kingdom in respect of Argentinian assets--the freeze had not been extended to the foreign branches of U.K. banks. Yet the restrictions imposed by the U.S. authorities had been extended to foreign branches of U.S. banks. The Fund needed to address that technical, legal issue.

Mr. Dallara stated that he considered such a paper to be entirely inappropriate and inconsistent with what appeared to be the majority view of the Executive Board that the U.S. actions were consistent with the Articles of Agreement and with the relevant decision of the Executive Board. Extant legal views on the issue were no doubt accessible to Mr. Finaish; continued work on the matter would cast doubt on the Executive Board's conclusion relating to the complaint on the agenda by the Libyan authorities.

Mr. Zecchini asked whether paragraph 2 of Decision No. 144-(52/51) should not be interpreted as consisting of two separate and different parts. The first part seemed to state that "the Fund will review the operation of this decision periodically," and the second, that the Fund "reserves the right to modify or revoke, at any time, the decision or the effect of the decision on any restrictions that may have been imposed pursuant to it." It was also not clear to him whether the reference made in the Board to reviewing the decision was correctly addressed to the operation of the decision and not to the substance of the decision which was covered by the second part of the paragraph.

The Director of the Legal Department explained that the two parts of paragraph 2 dealt first with the Fund's review of the decision itself and its right to modify or revoke it; and second, with the effect of the decision on any restrictions imposed thereunder. According to the second part, the Board could decide to review at any time the consistency of certain measures with Decision No. 144-(52/51) and decide, for instance, that the security reasons that had been invoked for its application no longer existed.

Mr. Salehkhou considered that the first part of the decision was of a mandatory nature, stating as it did that the Fund "will review the operation of this decision periodically." A period of 35 years was certainly long enough to require a review. In addition, he saw no ambiguity in the second part of the decision, which referred clearly both to the decision itself and to its effect as being subject to modification and revocation.

The Chairman remarked that the legal reading of the decision--that the periodicity applied to the review of the operation of the decision and not to the right to modify it--did not weaken Mr. Salehkhou's point. However, the Fund was the Executive Board and the majority of the Board did not wish to engage in the review; it did not even wish to review the operation of the decision, let alone the decision itself.

In response to a further remark by Mr. Salehkhou, the Chairman reiterated that the staff and management were not in a position to explain why that majority of Executive Directors preferred not to undertake such reviews. Of course, Executive Directors were free to do so themselves, if they wished.

Mr. Salehkhou remarked that he still failed to understand why it was not possible for Executive Directors to be told what technical, legal, or procedural reasons there were for not holding a review.

The Chairman, referring to Mr. Finaish's question about the implications of the restrictions on international financial transactions, remarked that different national laws and different interpretations by courts on the application of a measure taken by a sovereign country in another territory gave rise to jurisdictional conflicts between states into which the Fund would not wish to inject its opinion, especially if an issue was before the courts.

The Director of the Legal Department noted that because the U.S. regulations covered the branches of U.S. banks abroad, the question that arose was whether those regulations would be enforced in the courts of a foreign state. As the Chairman had observed, the Fund so far had refrained from interfering in judicial procedures, for various reasons, including respect for the courts and the difficulty of obtaining the facts. According to one legal view, the courts of another country had a duty under Article VIII, Section 2(b), to enforce such regulations; the contrary view also was taken. When the problem had arisen in connection with the orders freezing official Iranian assets, legal action had been brought before the courts of different countries. To his knowledge, no decision on the substance had been taken that could be regarded as authoritative for the future. Therefore, the relevant provision of

Article VIII, Section 2(b) might be interpreted differently in different countries. There was also no uniform solution to the problem of whether such regulations should be enforced under domestic laws. Courts in some countries might take the view that the U.S. measures should apply because the payments in U.S. dollars would be channeled through clearing systems within the United States. Courts in other countries might hold a different view. Additional information on the subject could be provided but it would not be possible to cite decisive cases in which the same type of regulation had been recognized.

Mr. Lankester noted, in answer to Mr. Salehkhou, that it was not incumbent upon Executive Directors to state in detail the reasons for positions that they or their authorities had taken. He respected the arguments put forward by Mr. Finaish and Mr. Salehkhou, but the fact was that a clear majority of Executive Directors, both in terms of numbers and in terms of the majority of votes cast, had stated the view--however briefly--that they wanted neither a review of the operation of the decision nor of the decision itself.

Mr. Dallara remarked that the right of Executive Directors to ask questions was universally respected in the Board, which also had to respect the right to focus on the issue at hand. The issue under discussion was not one of the relevant international law relating to the application of executive orders issued by the U.S. authorities, or of any other such orders. As he had already mentioned, the preparation of any paper on that issue--even though it was not the issue under discussion--would cast doubt on the clear decision of a majority of Executive Directors. However, he had no doubt that the Legal Department could provide an extensive bibliography on that issue.

Mr. Finaish observed that he had been raising relevant legal and technical questions to which his authorities were seeking an answer from the Fund because of their implications. The relevant provision of Article VIII, Section 2(b) had been subject to different interpretations. Under those circumstances, could the Fund refrain from taking a position on the matter? As for the definition of the review for which provision was made in Decision No. 144-(52/51), he reiterated his disagreement with the interpretation by the Director of the Legal Department of the periodic review of the operation of the decision as merely the provision of factual information to the Board on the measures taken under the decision. The Executive Board should consider the broader issues of principle, which were of concern to and had implications for all members. Indeed, his Libyan authorities had brought the matter under discussion before the Executive Board in that spirit and not as a narrow political issue. As matters stood, the country injured by the restrictions suffered the burden; the country imposing the restrictions was given the benefit of the doubt.

The Chairman said that he had noted with great care the arguments and concerns that Executive Directors had expressed, in a thoughtful and guarded way, on both sides of the issue. In taking the sense of the

Executive Board's consideration of the complaint of the Socialist People's Libyan Arab Jamahiriya under Rule H-2, he had concluded that the Executive Board had not upheld the complaint; that the Board had not challenged the U.S. notification of restrictions imposed for security reasons under Executive Board Decision No. 144-(52/51); and that the Board did not favor a review of that decision. The Legal Department would provide any background information that Mr. Finaish might need on the matter.

Mr. Finaish asked whether the finding that the Executive Board had not objected to the restrictions imposed by the United States was the end of the matter, or whether it would be kept under review and consultations held with the U.S. authorities by the staff or the Managing Director. He recalled that several Directors, including Mr. Huang, Mr. Nimatallah, and Mr. Sengupta, had requested the management to continue its efforts with a view to helping in the resolution of the matter.

The Chairman said that his understanding was that since the Executive Board had not challenged the security motivation advanced by the United States for imposing the restrictions under Decision No. 144-(52/51), the U.S. measures would run their course and were not objected to by the Board.

The Executive Board took note of the Chairman's understanding of the sense of the meeting and concluded its consideration of the complaint by the Socialist People's Libyan Arab Jamahiriya under Rule H-2 with respect to the imposition of restrictions by the United States under Executive Board Decision No. 144-(52/51).

## 2. KIRIBATI - MEMBERSHIP - REPORT OF COMMITTEE

The Executive Directors considered a report by the Chairman of the Committee on Membership for Kiribati and Tonga and a proposed decision recommending the submission of a draft Resolution to the Board of Governors for a vote by mail on the admission of the Republic of Kiribati as a member (EBD/86/5, 1/10/86).

The Executive Board then took the following decision:

1. The Board of Governors is requested to vote without meeting pursuant to Section 13 of the By-Laws of the Fund upon the attached draft Resolution.

2. The Secretary is directed to send the attached report and draft Resolution on Membership for Kiribati to each member of the Fund by rapid means of communication on or before Tuesday, February 4, 1986.

3. To be valid, votes must be cast by Governors or Alternate Governors and must be received at the seat of the Fund before 6:00 p.m. on Wednesday, March 5, 1986. Votes received after that time will not be counted.

4. The effective date of the Resolution of the Board of Governors shall be the last day allowed for voting.

5. All votes cast pursuant to this decision shall be held in the custody of the Secretary until counted, and all proceedings with respect thereto shall be confidential until the Executive Board determines the result of the vote.

6. The Secretary is authorized to take such further action as he shall deem appropriate in order to carry out the purposes of this decision.

Decision No. 8195-(86/17), adopted January 31, 1986

## REPORT BY THE EXECUTIVE BOARD

### MEMBERSHIP FOR KIRIBATI

The Government of Kiribati applied on July 18, 1984 for admission to membership in the International Monetary Fund in accordance with Article II, Section 2 of the Articles of Agreement of the Fund; and, pursuant to Section 21 of the By-Laws, the Executive Board has consulted with the representative of that Government and has agreed upon the terms and conditions which, in the opinion of the Executive Board, the Board of Governors may wish to prescribe for admitting Kiribati to membership in the Fund.

The Executive Board has therefore approved the attached Resolution for submission to the Board of Governors for a vote without meeting pursuant to Section 13 of the By-Laws.

## DRAFT RESOLUTION

### MEMBERSHIP FOR KIRIBATI

WHEREAS, Kiribati on July 18, 1984 requested admission to membership in the International Monetary Fund in accordance with Article II, Section 2, of the Articles of Agreement of the Fund;

WHEREAS, pursuant to Section 21 of the By-Laws of the Fund, the Executive Board has consulted with the representative of Kiribati and has agreed upon the terms and conditions which, in the opinion of the Executive Board, the Board of Governors may wish to prescribe for admitting Kiribati to membership in the Fund;

NOW, THEREFORE, the Board of Governors, having considered the recommendations of the Executive Board, hereby resolves that the terms and conditions upon which Kiribati shall be admitted to membership in the Fund shall be as follows:

1. Definitions: As used in this Resolution:
   (a) The term "Fund" means the International Monetary Fund;
   (b) The term "Articles" means the Articles of Agreement of the International Monetary Fund, as amended;

2. Quota: The quota of Kiribati shall be SDR 2.5 million.

3. Payment of Subscription: The subscription of Kiribati shall be equal to its quota. Kiribati shall pay 22.7 percent of its subscription in SDRs or in the currencies of other members selected by the Managing Director from those currencies that the Fund would receive in accordance with the operational budget in effect at the time of payment. The balance of the subscription shall be paid in the currency of Kiribati.

4. Timing of Payment of Subscription: Kiribati shall pay its subscription within six months after accepting membership in the Fund.

5. Exchange Transactions with the Fund and Remuneration: Kiribati may not engage in transactions under Article V, Section 3, or receive remuneration under Article V, Section 9, until its subscription has been paid in full.

6. Exchange Arrangements: Within 30 days after accepting membership in the Fund, Kiribati shall notify the Fund of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1 of the Articles.

7. Representation and Information: Before accepting membership in the Fund, Kiribati shall represent to the Fund that it has taken all action necessary to sign and deposit the Instrument of Acceptance and sign the Articles as contemplated by paragraph 8(a) and 8(b) of this Resolution, and Kiribati shall furnish to the Fund such information in respect of such action as the Fund may request.

8. Effective Date of Membership: After the Fund shall have informed the Government of the United States of America that Kiribati has complied with the conditions set forth in

paragraph 7 of this Resolution, Kiribati shall become a member of the Fund on the date when Kiribati shall have complied with the following requirements:

(a) Kiribati shall deposit with the Government of the United States of America an instrument stating that it accepts in accordance with its law the Articles and all the terms and conditions prescribed in this Resolution, and that it has taken all steps necessary to enable it to carry out all its obligations under the Articles and this Resolution; and

(b) Kiribati shall sign the original copy of the Articles held in the Archives of the Government of the United States of America.

9. Period for Acceptance of Membership: Kiribati may accept membership in the Fund pursuant to this Resolution not later than six months after the effective date of this Resolution, which date shall be the date of its adoption by the Board of Governors; provided, however, that, if the circumstances of Kiribati are deemed by the Executive Board to warrant an extension of the period during which Kiribati may accept membership pursuant to this Resolution, the Executive Board may extend such period until such later date as it may determine.

## 3. ROLE OF SDR - IMPLICATIONS OF CHANGES IN INTERNATIONAL MONETARY SYSTEM

The Executive Directors considered a staff paper on the implications of changes in the international monetary system for the role of the SDR (SM/85/340, 12/27/85).

Mr. Polak made the following statement:

The paper before us is predominantly historical in nature, but that is not the purpose of our discussion today; on the contrary, our interest is clearly policy oriented, in order to seek agreement on the appropriate role for the SDR in present circumstances. It is necessary to clarify this question before we attempt to answer it, because the SDR has more than one role. I would list at least four such actual or potential roles, which are essentially independent from each other.

(1) The SDR mechanism provides a means of enlarging members' reserves by allocation--namely, without recourse to balance of payments surpluses on current or capital account.

(2) Since SDRs have, since 1974, been defined as a package of currencies, they constitute a distinct component of international reserves that can perform a separate role in members' portfolio policy.

(3) The SDR constitutes a unit of account for the operations of the Fund.

(4) Suggestions have also been made for use of the SDR mechanism to finance the financial activities of the Fund itself.

The first mentioned role was the original one, designed to meet the concern at the time about the potential inadequacy and asymmetry of the supply of reserves. The second role is primarily related to the composition of reserves; it received particular attention some years ago, when consideration was given to substitution rather than allocation to raise the stock of SDRs in the system. The role of unit of account for the Fund, while not of major importance to the functioning of the system, is nevertheless indispensable since gold can no longer perform that function. The possibility of a fourth role, to finance the Fund itself by the issuance of SDRs for this purpose, has drawn attention in recent years to such ideas--which might or might not involve amendment--as an "SDR-based Fund," "conditional SDRs," and a "safety net."

I am afraid that for our policy purposes, the decision taken to split the discussion on the appropriate role for the SDR in present conditions into two parts has not worked out well. The present paper concentrates on the changes in the system over the last 20 years that may have caused changes in the role of the SDR; but that role--or, these roles, as they might apply in present-day conditions--is sketched out only lightly and incompletely in the last few pages of the paper and essentially left for a later paper and a second round of discussion.

However, we have to proceed on the basis of what we have and attempt to arrive at least at provisional conclusions, which may need expansion or amendment as we go over some of the same ground again in a few weeks' time. Here I want to limit myself to the first and original role of the SDR--reserve creation. There have been no SDR allocations since 1981. Is there, or is there not, a solid basis in the system as it now functions to resume such allocations?

Section I of the paper provides an excellent historical presentation of the arguments for the allocation of SDRs in the original SDR scheme. Foremost among these was the fear that the gold exchange standard based on a fixed dollar price of gold would either lead to a reserve shortage or to a breakdown of the system. These fears proved not unjustified. Symptoms of reserve shortage were evident in the latter part of the 1960s, as indicated in the 1969 proposal by the Managing Director to proceed to SDR allocation; and in spite of the decision to allocate a first round of SDRs, the system did break down in 1971--after the United States had abandoned the policies that would have been required to maintain the $35 per ounce gold price in the face of a declining U.S. gold stock and rising dollar liabilities.

As the staff indicates (p. 10), concern about the asymmetry of the gold exchange standard had also been important in the support for the establishment of a supranational reserve unit, although there was at that time only an imperfect understanding of both the extent of what was called "the unfair advantage" of the reserve center to "produce its own means of payment" to meet balance of payments deficits and of the extent to which the SDR mechanism would generalize the distribution of seigniorage over all participants in the SDR account. Crucial to both propositions is the interest rate that the debtor--a debtor of dollars or a net user of SDRs--has to pay; and this point, obvious as it may seem now, did not get well established until the Conference on "The Need for Reserves" that the Fund held in 1970.

In the last 15 years, important structural changes have taken place in the international monetary system, which, among other things, have gone a considerable distance toward facilitating the supply of reserves and equalizing countries' ability to acquire reserves. Commercial bank credit to sovereign debtors, an exception in the 1960s, has become widespread, although not universal. As a result, the system has developed in quite a different manner from that sketched out as desirable by the Committee of Twenty, which had hoped to bring the main reserve center under the discipline of asset settlement. Instead many countries--and not only the multiple reserve centers--now have the ability, within the limits of their creditworthiness, to meet payments deficits by liability financing. Accordingly, the risk of a global shortage of reserves has been much reduced and the asymmetry in the cost of acquiring reserves has been mitigated considerably. At the same time, the rise in the interest rate on the SDR toward the market level has cut sharply into the seigniorage distribution that could be expected from an SDR allocation in the early days.

On both scores, therefore--the provision of international liquidity and symmetry of cost in balance of payments financing--the present system functions better than that of twenty years ago, but the weaknesses of the 1960s are still to some extent there. On the question of the provision of liquidity, it would be hard to argue that the self-interest of the commercial banks ensures that there can be no problems on this score at the very time when a major governmental initiative--that of Secretary Baker--seems required to induce these banks to resume their credit activities to a broad group of countries, for the benefit not only of these countries but also, as Secretary Baker observed in his message to the U.S. Senate on October 23, to maintain the growth momentum of the world economy. Where countries can borrow reserves, they incur a cost margin that differs among countries. While the countries with the highest credit rating can borrow reserves at close to London interbank offered rates (LIBOR), most developing countries--even those with respectable economic policies--would have to pay considerably more to borrow reserves. SDR allocation saves countries that margin, and the beneficiaries are the poorest countries. Collective action by the Fund membership to allocate SDRs to create these benefits would, of course, reduce somewhat the lending business of international banks; it would also reduce the risk of excessive reliance on borrowed reserves. For the countries that can not borrow reserves, the cost of building up reserves as trade increases is particularly high. The Board is familiar with the question of the competition between higher imports--which usually would mean higher growth--versus the buildup of reserves that arises in every medium-term outlook calculation. To the extent that a country's need for reserves can be met by allocation, this painful conflict between growth and reserve adequacy can be reconciled.

Opinions clearly differ as to the importance that should be attached in present circumstances to having a smoothly functioning system of SDR allocation. For the high-income countries with ready access to capital markets, the direct benefits are likely to be quite small. Even these countries stand to gain indirect benefits, so that the system can be called upon to deal with situations of reserve shortage that may be less than worldwide in origin but that can have spreading effects. This would include situations calling for "safety net" action that the present staff paper does not discuss. The conclusion would, therefore, seem fully justified that in spite of the changes that have taken place in the international monetary system, there continues to be a case for the regular allocation of SDRs, or, as a minimum, there are no systemic reasons against such allocations.

The question then arises why this conclusion has so far not been generally accepted. Why do a few major countries, which admittedly do not need SDR allocations themselves, feel that they need to oppose such allocations? Presumably, such opposition is based on stronger reasons than the conviction that the system can survive without allocations.

If the present exercise is to be brought to a positive conclusion, it will be necessary to get these reasons put on the table, to discuss them in order to establish the extent of their validity, and to explore ways of meeting such reasons as are found to be valid.

From what has been said on earlier occasions and in other contexts, one might expect the following to be included among the reasons against allocation: first, allocation might be seen as a "soft option" for those countries that need adjustment. This is related to the fear that SDRs, which are allocated without policy conditionality, may induce some countries to postpone needed adjustment measures. The effect on world inflation of such a response--which has often been quoted in staff papers--is trivial, however one measures it; but failure of countries to adjust is in itself a weakness in the system which one would not want to encourage.

Second, I wonder whether the continued advocacy of schemes for the use of the SDR for purposes other than the supply of "reserves to hold"--in particular, the concept of the link between allocations and development aid--do not exercise a negative influence on the enthusiasm, or even the willingness, of other countries to consider even allocations in proportion to quotas.

Third, at least in the view of some creditor countries, SDRs are still less than optimal reserve assets, primarily, I believe, because they cannot be used in direct market intervention. This drawback is reinforced to the extent that receiving countries prove unwilling to hold allocated SDRs.

Insofar as these considerations have validity, one should consider appropriate changes in the SDR mechanism, such as measures to enhance the likelihood that SDR allocations do not stand in the way of needed adjustment and measures to enhance the usability of SDRs. Various proposals aimed at these two objectives are on the table--such as reinstatement of reconstitution rules for the first and techniques for the use of SDRs--or perhaps SDR certificates--in intervention activities for the second. These ideas deserve further study to see whether they can lead to an acceptable package of decisions on a policy aiming at regular SDR allocations.

Mr. de Groote noted that although the implications for the role of the SDR of changes in the international monetary system had been presented clearly in SM/85/340, a quick reading of the staff paper prepared for the discussion on February 26, 1986 of the potential contribution of the SDR to economic stability (SM/86/17, 1/29/86) came closer to providing the analytical framework needed for a fundamental assessment of the strength and weaknesses of the present system, permitting a clearer notion of the SDR's prospective role in that system to be formed. Therefore, the discussion at the present meeting should be exploratory, picking up some lessons from the past and indicating desirable directions for the future.

An appropriate place to begin the discussion was indicated on page 14 of SM/85/340, where the rigidities of the Bretton Woods par value system were contrasted with the weaknesses of the hybrid system existing for the past 13 years, Mr. de Groote continued. In fact, the Bretton Woods system had suffered from two closely related constraints: a supply constraint stemming from the balance of payments position of the United States, and a confidence constraint stemming from the convertibility of dollar-denominated foreign exchange reserves into gold at a fixed official price. Those constraints had been closely interrelated because a continuous expansion of the supply of dollar reserves to meet existing reserve needs necessarily undermined confidence in the convertibility and stability of the value of reserve assets. It was precisely to resolve that dilemma--so convincingly presented by Professor Triffin at the time--that the SDR had originally been created "to permit growth in world reserves and buttress confidence in the stability of the entire system of world finance," to quote the U.S. Governor of the Fund at that time.

That original conception of the SDR merited full attention inasmuch as there was still a trade-off between the supply of reserves and the stability of the system, although its precise form and the circumstances in which it existed had changed, Mr. de Groote observed. The present reserve system, in which the creation and distribution of international liquidity was largely accomplished through borrowing from private markets and decentralized decision making, had been saddled with two major imbalances that had undermined its stability and confidence in it to the point where official action might be warranted to support orderly adjustment.

The first of those imbalances was, of course, the international debt problem, which had arisen partly as a result of the lending practices that had developed during the 1970s, Mr. de Groote recalled. Although the recycling process had been welcomed in the beginning, ultimately it proved to have delayed the adjustment process in developing countries, undermining their balance of payments positions to the point that confidence in their debt repayment capacity and in the proper functioning of international capital markets had been lost. Since then, in an effort to restore confidence, the banks had sharply curtailed their lending to developing countries. On several occasions, he had argued in the Executive Board that that situation had put such an intolerable burden of adjustment on many countries that the end result might threaten the stability of the adjustment process itself. Countries were being prevented from increasing their capacity to borrow through higher growth rates and increased exports. The present adjustment process was therefore strongly biased toward the use of deflationary policies, a bias that reconsideration of the role of the SDR might help to correct.

The second major imbalance in the present international liquidity system was the unusually high share of world savings that had been channeled to the United States in recent years, owing to the divergence between the budgetary policies of the United States and those of other industrial nations, Mr. de Groote said. Recent initiatives by the five major industrial countries to correct the large exchange rate misalignments that had emerged from that situation would, he hoped, form a first step in the orderly adjustment of the large trade imbalances that those misalignments had caused. At the same time, the possibility that an erosion of confidence on the part of markets might suddenly affect the exchange rate of the dollar should not be ruled out. Besides a weakening of the U.S. economy, the U.S. authorities would then face the unpleasant consequences of a sharp fall of the dollar and upward pressures on interest rates. Such a disorderly adjustment would again justify the availability of an internationally monitored reserve mechanism to offset excessive exchange rate movements.

In sum, an ideal situation in which sound economic policies and international policy coordination alone would suffice to ensure a satisfactory degree of international monetary stability did not yet exist, Mr. de Groote stated. Countries' economic policies and their ability to create an environment that favored the smooth expansion of international trade would therefore continue to be impaired by the instability of the present system and by uncertainty, the rationale for any reserve need. Under those conditions, international reserves would have to continue to play an important role in enabling countries to counter temporary disturbances. The present reserve system, which was largely based on borrowed reserves, failed to fulfill that role reliably since it was itself largely exposed to the kind of disturbances that it was intended to counteract. The SDR mechanism was therefore still a useful reserve instrument for counteracting possible shortages in the supply of other reserves and for providing the element of confidence essential to back up the system of borrowed reserves.

To conclude, Mr. de Groote said that he was confident that the Board's further development of those issues would lead to a more general acceptance of the SDR's rationale and to mechanisms of SDR creation appropriate to the SDR's prospective role.

The Executive Directors agreed to resume the discussion in the afternoon.

APPROVED: September 25, 1986

LEO VAN HOUTVEN
Secretary