NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/54

3:00 p.m., March 25, 1986

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

Executive Directors	Alternate Executive Directors
A. Alfidja	J. K. Orleans-Lindsay, Temporary
C. H. Dallara	M. K. Bush
	M. Lundsager, Temporary
J. de Groote	H. G. Schneider
	M. Z. M. Qureshi, Temporary
	M. Sugita
G. Grosche	W.-R. Bengs, Temporary
Huang F.	
J. E. Ismael	
A. Kafka	
	M. Foot
H. Lundstrom	
	L. Leonard
E. I. M. Mtei	
F. L. Nebbia	B. Jensen
	M. A. Weitz, Temporary
	J. E. Suraisry
P. Pérez	G. Ortiz
H. Ploix	
J. J. Polak	A. Steinberg, Temporary
	A. V. Romuâldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. Vasudevan, Temporary
	N. Coumbis

L. Van Houtven, Secretary
K. S. Friedman, Assistant
R. S. Franklin, Assistant

Also Present

IBRD: J. A. Katz, Operations Policy Staff, Country Policy Department; P. M. Landell-Mills, Western Africa - Country Programs Department II. African Department: A. D Ouattara, Director; J. C. Brou, E. A. Calamitsis, T. P. McLoughlin, T. Muzondo, S. M. Nsouli, P. C. Ugolini. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; S. J. Anjaria, C. Atkinson, J. T. Boorman, C. Brachet, E. H. Brau, K. B. Dillon, J. Hicklin, S. Kanesa-Thasan, M. R. Kelly, G. R. Kincaid, C. M. Watson, M. Xafa, E. J. Zervoudakis. External Relations Department: I. S. McDonald. Fiscal Affairs Department: M. I. Blejer, F. L. Corfmat. IMF Institute: O. B. Makalou; M. Diakhate, C. Diouf, Participants. Legal Department: J. G. Evans, Jr., Deputy General Counsel; H. Elizalde, W. E. Holder, L. Maktouf. Middle Eastern Department: S. von Post, M. Zavadjil. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; M. C. Deppler, M. P. Dooley, D. Folkerts-Landau, P. Isard, G. G. Johnson, A. Lanyi, D. J. Mathieson. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; P. B. Clark, S. I. Fawzi, T. M. Tran. Western Hemisphere Department: S. T. Beza, Associate Director; E. Decarli. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, L. P. Ebrill, J. Hospedales, G. Nguyen, J.-C. Obame, A. Ouanes, P. Péterfalvy, G. W. K. Pickering, I. Puro, Song G., K. Yao. Assistants to Executive Directors: J. R. N. Almeida, M. Arif, A. Bertuch-Samuels, B. Bogdanovic, J. de la Herrán, F. Di Mauro, G. Ercel, R. Fox, G. D. Hodgson, O. Isleifsson, S. King, H. Kobayashi, J. A. K. Munthali, K. Murakami, A. Mustafa, J. Reddy, J. E. Rodríguez, V. Rousset, S. Simonsen, B. Tamami, L. Tornetta, A. J. Tregilgas, H. van der Burg, E. L. Walker, Wang X., B. D. White.

1. DEBT SITUATION AND STRATEGY

The Executive Directors continued from the previous meeting (EBM/86/53, 3/25/86) their consideration of staff papers on prospects and policy issues with respect to the debt situation (EBS/86/43, 2/28/86; and Cor. 1, 3/19/86) and financing issues with respect to the implementation of the debt strategy (EBS/86/41, 2/24/86; and Sup. 1, 3/21/86). They also had before them background papers on developments in and prospects for export credits (SM/86/10, 1/14/86; and Sup. 1, 3/20/86) and on developments in 1985 concerning Fund-Bank collaboration (SM/86/40, 2/25/86).

The Director of the Exchange and Trade Relations Department recalled that a question had been raised about the difference between the Fund and the World Bank's projections of the financing requirement of the 15 countries mentioned in the Baker initiative in coming years. The staffs of the two institutions had maintained a continuing dialogue on a number of debt-related issues. The World Bank had generally used formal development models in estimating members' capital requirements, and the Fund had emphasized that efforts to meet those requirements would depend importantly on the policies that were maintained by the countries concerned as well as on the availability of capital. The World Bank's estimate of a financing need of $75 billion had been derived in a mechanical way in the Fund staff's view. It was based on a straight line calculation of past capital/output ratios and assumed future economic growth of 4 percent per year in the countries concerned. The staff considered that some of the World Bank's assumptions should be re-examined, and the staff was in touch with the World Bank staff on the matter.

The Deputy Managing Director remarked that in recent months the Fund staff had been working intensively with the World Bank staff on a number of medium-term scenarios for individual countries as well as on the general medium-term scenario for the group consisting of the major borrowers. In addition, the Fund staff had discussed how its approach to the medium-term scenarios fit into the medium-term scenarios that were developed by the World Bank. The discussions would continue in coming months. Possible differences of views might surface during Executive Board discussions on individual countries.

Mr. Dallara said that his authorities had made a number of different calculations of the likely financing need of the debtor countries that were mentioned in the Baker initiative, and none of the calculations was nearly as large as the $75 billion estimate of the World Bank. Such a figure seemed possible only if it were assumed that the countries concerned would make no improvements in their policies. In any event, there was no possibility of attracting such a large amount of financing. He wondered what assumptions the World Bank staff had made concerning likely policy changes in the countries concerned.

The Director of the Exchange and Trade Relations Department remarked that the World Bank staff had assumed no changes in the relevant ratios. The staff would prepare a brief paper on the subject.

The Chairman made the following summing up:

Our discussion on the debt situation and the implementation of the debt strategy has covered a broad range of topics. I will organize this summing up around three general areas of your discussion: the recent evolution of the debt situation; the assessment of medium-term prospects; and policy issues. Under the latter heading, I will discuss the contribution to the debt strategy that needs to be made by the debtor countries themselves, by the industrial countries, by the private creditors, and by the Fund and other multilateral institutions.

1. Evolution of the debt situation

There was broad agreement with the staff's characterization of the origins of debt problems, namely, that they had arisen from a combination of adverse external circumstances, inadequate domestic policies, overborrowing, and overlending. Developing countries had confronted in the 1980s weak export markets, deteriorating terms of trade, and a sharp escalation of interest rates. However, most of those countries that eventually experienced debt-servicing difficulties had increased their vulnerability to external shocks through unduly expansionary fiscal and monetary policies, distorted price incentives, and inappropriate exchange and interest rates. Together, such policies had combined to hamper export growth, discourage savings, misallocate investment, and induce capital flight. All of these developments resulted in a rapid buildup of external debt.

Directors generally recognized the efforts made by debtor countries and by private and official creditors to deal with the problems that had arisen since 1982. They also recognized the leading role played by the Fund in organizing coordinated responses to those problems, thus avoiding a collapse of the financial system. They nevertheless expressed disappointment that greater progress had not been made in lowering debt ratios and in reviving growth. The weakness of world trade and primary commodity prices in 1985 was cited; in this connection, many Directors noted that the recent fall in oil prices would have a serious further impact on indebted fuel exporters. Several Directors expressed the view that the efforts to rectify the debt situation since 1982 had placed too large a burden--indeed, some said, all the burden--on the indebted countries, entailing substantial falls in consumption, living standards, and an increase in political strains.

2. Medium-term prospects

Many Directors noted that the baseline scenario presented by the staff underlined the fragility of the debt situation for the countries with heavy debt service burdens. While several

Directors thought that the baseline scenario might in some respects be too pessimistic--for example, with regard to the interest rate assumptions or to the scope for export expansion by indebted countries--a number of other Directors felt that its assumptions, especially that of sustained growth in the industrial countries, were rather optimistic, as a cyclical downturn in economic activity before 1991 ought to be allowed for. In any event, the medium-term scenarios developed by the staff suggested that the debt ratios would remain high, and would indeed be higher than had been thought previously. Directors noted that the projected growth rates for capital-importing countries, and especially for the 15 countries covered by the Baker initiative and for highly indebted and sub-Saharan African countries, were low, despite the assumption that imports would grow no faster than output. This "import intensity of growth" was considerably lower in the latest staff projections than during earlier periods, and the feasibility of this lower import intensity of growth was questioned by several Directors. Directors cited the sensitivity analysis showing lower growth in industrial countries as perhaps the most striking evidence of the vulnerability of the capital-importing countries to developments in the industrial countries.

3. Policy issues

Directors reiterated their support for the U.S. initiative presented by U.S. Treasury Secretary Baker in Seoul. They stressed that co-responsibility of all the participants in the debt strategy is an essential aspect of the U.S. approach. They urged members to make concrete progress toward reaching the goal of growth-oriented adjustment.

a. Directors agreed that sound policies in indebted countries remained essential for the success of the debt strategy. In this connection, emphasis needed to be placed on macroeconomic and structural policies that would achieve adjustment in a growth-oriented framework. Specific policies mentioned by Directors included interest rate and exchange rate policies designed to discourage capital flight and to mobilize domestic savings, realistic pricing policies, tax reforms, and the improved management of public sector enterprises. A number of Directors remarked that the outward orientation of economic policies, underlying the Fund's policy advice and Fund-supported programs, could be successful only if accompanied by an opening of export markets in industrial countries.

b. Directors emphasized that appropriate policies of creditor governments were also essential for a successful debt strategy. Achievement of satisfactory and sustained rates of growth of output, reductions in interest rates, a stable pattern of exchange rates, and a rollback of protectionism were considered crucial elements in creating a global economic environment conducive to permitting a growth-oriented debt strategy to succeed. Policies to achieve these objectives have been reviewed in connection with the recently concluded discussion of the world economic outlook. The importance of Fund surveillance in this regard was particularly stressed. Some Directors called for further coordinated action by creditor countries to lower interest rates and urged the Fund to encourage such action.

Directors commented on the direct financing role to be played by creditor governments. With regard to export credits, a large number of Directors agreed that export credit cover policy should be aligned more closely with progress in debtor country adjustment, with greater transparency of cover policy, and with improved statistics. A number of Directors voiced support for the suggestion that, on a case-by-case basis for countries taking measures sufficient to restore commercial creditworthiness, staff papers concerning the use of Fund resources should attempt to assess the impact on export credit flows of the cover policy stances of export credit authorities, and that papers on reviews under arrangements with the Fund should indicate the actual level of export credits, aggregated across creditor countries. However, several Directors stressed that there should be no attempt to pledge export credit commitment levels.

Directors noted that creditor governments' policies on banking supervision are also relevant to the mustering of financing in support of sound policies. A number of Directors stressed the importance of consistency between governments' attitudes toward new money packages from commercial banks and the actions of supervisors. In general, Executive Directors agreed that the task of securing a strengthening of banks' balance sheets could be facilitated, rather than retarded, by reasonable additional financing in support of economic policies that will help to restore countries' creditworthiness. In the period ahead, flexible and forward-looking supervisory practices should facilitate the mobilization of essential new financing where appropriate policies are in place, while also helping to improve the quality of banks' existing assets. In particular, they felt that it was important that provisioning practices should not inhibit appropriate new financing.

A number of Directors felt that the direct financial responsibility for and contribution of industrial countries to the solution of the debt problem was not spelled out clearly enough in the papers. They stressed the importance of increasing official development assistance--all the more so, some said, given the weakened position of oil exporting countries--and of enhancing the financial capability of international financial and development institutions. One speaker recalled that in its paper on policy interactions in industrial countries prepared for the latest world economic outlook discussions (SM/86/46, 2/28/86), the staff had mentioned that, on the assumption that the level of lending to developing countries were to increase by $20 billion above the baseline level in 1987 and to remain at the new level thereafter, staff estimates suggested that the level of both imports and real GDP in those countries could be expected to be higher by some 3 percent after a two- to three-year period. Those Directors mentioned in this respect the crucial questions of a General Capital Increase for the World Bank, the Eighth Replenishment of IDA, and the attitude of the Fund toward its access policy and the Ninth General Review of Quotas. Several Directors asked the staff to lay out more clearly how additional public capital flows, given the assumptions underlying the staff projections, could improve the growth prospects and the debt situation of developing countries and asked management to raise those issues with the industrial countries.

c. Commenting on the role of multilateral institutions, Directors drew attention to the need for increased concessional aid for poorer countries--particularly those whose prospects do not justify additional borrowing on commercial terms--and said that development finance will be especially important for those countries. More broadly, many Directors emphasized the enhanced role to be played by the World Bank in providing desired financing and promoting structural policies to improve efficiency in the period ahead; other multilateral development agencies should also play a greater role. They welcomed the support expressed by the United States and other members for expanded World Bank lending and noted that the capital backing for such increased lending should be available when needed.

d. In connection with the role of private creditors, Directors agreed that additional borrowing by debtor countries on commercial terms would be justified only when economic policies and prospects indicate that such borrowing would be accompanied by an increase in debt-servicing capacity. In many cases, however, debtor countries implementing appropriate policies to promote sustained growth and adjustment will need further commercial bank lending to support such policy reforms. It was noted that sound policies will enhance confidence and thus encourage a reversal of capital flight, as well as support additional inflows of foreign capital, including foreign direct investment.

Directors expressed concern about the unsatisfactory levels of recent bank lending. They felt that, for heavily indebted countries that have experienced payments difficulties, a lag might well remain in the transition period ahead between the implementation of appropriate policies and the readiness of creditors to undertake spontaneous financing in support of these policies. Directors noted that there will therefore remain a need for coordination of financing and concerted lending, on a case-by-case basis, in support of sound policies aimed at growth and adjustment. Some Directors warned, however, against the institutionalization of concerted lending, as the return to spontaneous debtor-creditor relationships was an ultimate objective. Directors noted their opposition to widespread guarantees of commercial bank lending, which would run counter to the cooperative thrust of the debt strategy.

Many Directors said that the type and terms of new bank lending should be graduated realistically, in accordance with the circumstances of debtor countries, and should in general avoid sharp departures from market terms to avoid jeopardizing a return to normal market relations. They felt that banks should accept their share of the burden of dealing with the debt problems, but should do so voluntarily and at their own risk. In some cases, multiyear rescheduling agreements could assist the return to normal market access of countries that have advanced beyond the early stages of the adjustment process. Financing packages should facilitate cohesion among different banking groups while preserving the principle of agreed burden sharing among the banks. Mention was made of the development of "innovative" mechanisms and instruments, such as secondary markets, trust funds, and exit bonds. It was generally noted that these mechanisms and instruments would have to be developed, if necessary, by the banking community itself. In the case of some low-income countries with little prospect of returning to spontaneous flows, some Directors expressed the view that the possibility of more far-reaching debt relief by banks and official creditors should be examined. Several Directors noted that, in some cases, a reduction of spreads might well be called for. Directors expressed support for attempts to expand financing from sources other than commercial banks. Equity financing--for instance, in the form of foreign direct investment--was seen as a promising alternative for expanding financing in the long run.

e. With regard to the role of the Fund, many Directors stressed the importance of its continued role as a financial catalyst for countries carrying out sound policies, pointing out that the Fund's responsibility for overall balance of payments and financing issues and its unique expertise in the design and monitoring of adjustment programs make its role in the debt strategy a central one. In a number of cases, countries' economic programs will be supported by the use of Fund resources, while in other cases its catalytic role may extend, through enhanced surveillance, to countries that have a good record of adjustment but do not need or wish to have a Fund arrangement. Some Directors expressed concern that the Fund's role might be adversely affected by a withdrawal of its own exposure and felt that access policy should be flexible enough to sustain the effectiveness of the crucial function of the Fund in the difficult period ahead. Directors strongly emphasized the importance of collaboration between the Fund and the World Bank, which would be critical both in the effort to help countries design comprehensive growth-oriented adjustment programs and in the coordination of financing in support of these policies. Each institution shall concentrate on areas where it has relative expertise and responsibilities, and on programs that are mutually supportive and complementary, and avoid cross-conditionality.

2. SENEGAL - 1985 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with Senegal and the third review under the stand-by arrangement (EBS/86/44, 2/27/86). They also had before them a report on recent economic developments in Senegal (SM/86/59, 3/13/86).

The staff representative from the African Department observed that according to the latest information received from the Senegalese authorities, all performance criteria for end-December 1985 had been observed.

Mr. Alfidja made the following statement:

The Senegalese economy is continuing to make significant progress toward viability. As the staff report on the third review of the current economic and financial program indicates, the internal and external imbalances have been reduced further and all performance criteria have been satisfied. As I have stated on several occasions, this favorable evolution underscores my Senegalese authorities' commitment to reverse the deterioration of their economy.

As Executive Directors will recall, the main objective of the present program, which spans an 18-month period, is to reduce to a sustainable level the fiscal and external deficits, hence firming up the ground for strong economic growth in the medium term. In this context, emphasis is to be placed on reinforcing the role of the private sector in the production and distribution of agricultural goods and sevices through price incentives and reform of the public enterprise sector.

In the real sector, contrary to expectations, real GDP is estimated to have fallen in 1984/85, compared with the 4 percent increase projected. This evolution resulted principally from the lingering drought, which continues to affect adversely agricultural production, notably groundnuts. The unfavorable climatic conditions virtually annihilated the stimulative effects that were expected from the substantial increase in the producer price of several crops. Major institutional reforms were undertaken in the groundnut sector with a view to enhancing the efficiency of the various operators in this sector and reducing the need for government subsidies. Particularly noteworthy, as I stated during the September 1985 Board meeting on Senegal, is the authority granted to oil millers to make, on their own, a variety of decisions aimed at improving the profitability of the sector.

In the area of government finance, reflecting the adjustment measures introduced earlier by the authorities, the overall fiscal deficit--on a commitment basis--declined by 15 percent to CFAF 38.1 billion in 1984/85. Contributing to this favorable outcome was the impact of additional measures taken by the Senegalese authorities partially to offset a shortfall in revenue. In that regard, the service tax was extended to telecommunication services and the tax rate applicable to motor vehicles was increased. Efforts were also made to control the growth of expenditure. In particular, the number of civil servants was reduced, leading to a lower than programmed wage bill. Outlays on materials and supplies were also revised downward.

In the external sector, the sharp drop in marketed output of groundnuts led to a shortfall in export earnings. Nevertheless, the effects of the tight aggregate demand policies followed by the authorities, together with a decline in imports, contributed to an improvement in the external payments position. In particular, the current account deficit as a percentage of GDP fell to 9.9 percent in 1984/85 from 11.7 percent in 1983/84.

As noted in the staff report, economic activity is now expected to evolve less satisfactorily than envisaged earlier. Indeed, real GDP growth is now estimated at 3.6 percent in 1985/86, by comparison with the 5 percent programmed initially. The inflation rate, as measured by the rise in the GDP deflator, is forecast to increase--although moderately--when compared with earlier projections. The downward revision of economic expansion is due to the lower level of groundnut output expected to be harvested in the 1985/86 season.

In the state enterprise sector, the reform program is being implemented. In this context, the number of public enterprises operating under the "contract plan" obligations is being increased. With regard specifically to the stabilization fund, the trading of rice earlier undertaken by this agency is being turned over to the private sector and its management is being improved.

Fiscal policy continues to aim at containing overall aggregate demand. Toward this end, the authorities are taking the measures to enhance revenue and rein in expenditure growth. On the revenue side, the projected surpluses of the stabilization fund and the oil refinery are expected to be used to alleviate the financial constraints of the Treasury, while restraint on the wage bill and outlays on materials and supplies will be maintained. As a result, the fiscal deficit is projected to decline from 3.5 percent of GDP in 1984/85 to less than 1 percent of GDP in 1985/86. Over the medium term, steps have been taken with a view to enhancing revenue flows. Noteworthy in this respect are the enactment of a selective reduction of import duties in order to increase the flow of imported commodities passing through official channels and measures taken to strengthen tax administration with a view to increasing the collection of tax arrears. Concurrently, the existing exemption scheme is being re-examined.

The ongoing restrictive demand management policies combined with the debt rescheduling obtained from both private and official creditors are expected to have a favorable impact on the external payments position. With export earnings projected to grow faster than imports, and net inflows of unrequited transfers forecast to increase, the current account deficit might amount to SDR 200 million, down from SDR 235 million in 1984/85. In relation to GDP, this deficit would be reduced by 3 percentage points to 6.8 percent.

In conclusion, progress is undoubtedly being made toward restoring viability in the Senegalese economy. My authorities remain committed to pursuing their adjustment efforts. It is to be hoped that the international financial community will continue to provide the financial assistance vital to the success of these efforts.

Mr. Mtei stated that he had been encouraged by the Senegalese authorities' commitment toward adjustment, which had been demonstrated by their prompt action to ensure that the program supported by the stand-by arrangement remained on track; as a consequence, all performance criteria had been met, despite adverse developments. The return of favorable weather conditions had led to some rebound of agricultural production, particularly of groundnuts, which were the mainstay of the agricultural sector. The strengthening of agricultural production had also resulted in a resumption of overall growth in the economy in 1985, almost reversing the decline that had taken place in 1984. Meanwhile, however, inflationary pressures had persisted, mainly because of price adjustments in the context of the stand-by arrangement. It was to be hoped that the improvement in the supply situation would contribute toward gradually reducing the rate of inflation over time.

The manner in which the Senegalese authorities had responded to adverse developments in implementing the current program gave him confidence that the program would be completed successfully, Mr. Mtei continued. Thus far, however, serious problems had been encountered on the revenue side of the program. In both 1984/85 and 1985/86 shortfalls in tax revenue had occurred, and import duties had fallen short of projections, although in the latter year, the shortfall could be attributed to lag effects of the decline in real income and imports that had taken place in the previous two years. The shortfall might also have been due to optimistic assumptions on which the original program estimates had been based and, if so, the authorities should take a more cautious and realistic approach to estimating government revenue so as to avoid difficult decisions in the course of the financial year.

Notwithstanding the revenue shortfall sustained by the economy, the authorities should be commended for having taken prompt action that could lead to the attainment of the program objectives, Mr. Mtei commented. In 1984/85, they had reduced the wage bill, as well as expenditures on materials, supplies, and transfers. Supported by the introduction of new revenue measures, the budget deficit had been reduced from 4.6 percent of GDP in 1983/84 to 3.5 percent of GDP in 1984/85, and significant progress had been made toward clearing domestic arrears. However, the Government had encountered a setback when arrears on external debt had been incurred. He welcomed the authorities' commitment to clear those arrears and noted that they had accepted additional performance criteria to ensure that their commitment was eventually fulfilled.

The problems encountered in implementing the current program served to underscore the serious structural weaknesses in the Senegalese economy, Mr. Mtei observed. He welcomed the policies adopted in the context of the 1985/86 budget aimed at addressing some of the underlying problems facing the economy in the current year and in the medium term. However, he continued to be worried that measures taken to buttress government revenue in the 1985/86 budget included significant transfers from the Price Equalization and Stabilization Fund (CPSP) and the oil refinery (SAR). As he saw it, public sector enterprises were already overextended; in particular, CPSP had been incurring heavy losses and, in 1984/85, it had failed to pay duties on rice imports. One had to wonder whether the budgetary problem would be resolved by the proposed transfer of residual surpluses, which should have strengthened the financial positions of those enterprises in the first place. It was conceivable that the authorities would be forced to take further measures if the transfers did not fully materialize, and he wondered whether any contingency plans for such measures had been drawn up.

The medium-term prospects for Senegal remained worrying, as substantial financing gaps that would require further debt reschedulings were projected into 1988/89, Mr. Mtei noted. It would seem that the authorities had little choice but to press ahead with the adjustment effort and to emphasize, inter alia, cautious demand management policies. It was expected that real GDP would grow by an annual rate of 3-4 percent, but he was concerned that growth prospects had not been appropriately underpinned by certain key parameters. The authorities were only required to create conditions that would promote economic growth and, while that goal was commendable, they needed also to be assured of quick-disbursing financial support in adequate amounts, preferably on concessional terms. Only then could the authorities be expected with confidence to undertake their investment program. In that regard, he encouraged the authorities carefully to select projects that would directly contribute to the expansion of the economy's productive capacity. Finally, he could support the proposed decisions.

Ms. Lundsager observed that the third review of Senegal's program under the stand-by arrangement and the 1985 Article IV consultation provided an opportunity to evaluate the progress made under past programs. In general, the authorities had made great strides in coming to grips with a series of economic difficulties, including a severe drought. They had realized that it was ultimately their own responsibility to deal with such problems, and they had been effective in coordinating their efforts with the Fund, the World Bank, and major donors to mobilize the external support for the adjustment effort. The Board's discussion was a timely one, falling as it did between the discussions on the debt situation and on the use of the resources of the special disbursement account. It should perhaps be added that the Senegalese authorities were anticipating use of the resources of that account on the basis of a policy framework outlined on pages 16-17 of the staff paper. In particular, they were emphasizing private sector activity, mobilizing more resources effectively, giving priority to investment and working toward agricultural policy reform, industrial policy reform, and reform of the parapublic sector.

Major efforts were under way to stimulate domestic production of agricultural products, both for local consumption and export, Ms. Lundsager continued. The emphasis was on producer price increases, as well as on increasing the role of the private sector in marketing. For example, the rice trade reportedly would be privatized, and she hoped to see further speedy action in the public enterprise sector more generally when the program for liquidating or privatizing public sector enterprises was implemented. Furthermore, a rehabilitation program for the public utilities was currently under way with World Bank assistance and, together with the other steps she had mentioned, should lead to a more efficient productive sector that could generate growth rates of 3-4 percent over the medium term, depending on exogenous developments.

The strong effort of the authorities to adhere to their program ceilings, even in the face of revenue shortfalls, was welcome, Ms. Lundsager commented. Unfortunately, revenue shortfalls seemed to occur frequently under Senegal's programs with the Fund, and she hoped that the recent technical assistance provided by the Fund would strengthen the administrative capacity of the authorities in that area. The authorities had been making an effort to hold current expenditures below program levels by putting off salary increases for the time being and stabilizing public sector employment while limiting other current expenditures. In addition, the authorities had made a strong effort to reduce domestic arrears and improve revenue collection. It was disappointing that they had permitted external arrears to emerge in 1985, although their appearance had by no means been expected. Indeed, it had not been felt necessary even to include a performance criterion relating to external arrears in the program, although one had since been added, and it was expected that the arrears would be eliminated by June 1986. In conclusion, Senegal's experience highlighted the fact that adjustment took time. Even with the structural adjustments implemented thus far, the medium-term scenario included financing gaps. Senegal should perhaps be an example to all countries of the importance of moving ahead energetically on a broad set of economic reforms.

Mr. Suraisry remarked that in recent years, Senegal had experienced a number of exogenous shocks, including the recurring and disruptive drought. The problems associated with those shocks had been compounded in the late 1970s and early 1980s by the adoption of inappropriate domestic policies that had led to the emergence of severe economic difficulties, as evidenced most dramatically by the fact that external resource gaps had averaged nearly 15 percent of GDP in the five fiscal years through June 1983. The authorities' response to those difficulties had been remarkable. Since mid-1983, the authorities had been implementing a series of reform measures, which had served to reduce macroeconomic imbalances in the economy. In that respect, he took note of the indication that the performance criteria for end-December 1985 had been satisfied. More important, since many of the reforms had been adopted with a view to enhancing the supply side of the economy, the proper foundation was being laid for a return to sustained growth.

Despite the progress he had mentioned, much remained to be done, Mr. Suraisry continued. As the staff had noted, the economy continued to be vulnerable, and it was therefore important to capitalize on the gains achieved thus far so as to maintain the momentum already established. In that connection, a number of areas of policy formulation were of particular importance. The authorities had, for example, already adopted a courageous and comprehensive program of agricultural reform, the most notable element of which was the drive to ensure that agricultural producers received more appropriate prices for their products. Improved incentives to producers should enable Senegal to reduce its reliance on imports for certain foodstuffs, thereby conserving scarce foreign exchange. Furthermore, the adoption of appropriate pricing policies would greatly reduce the need for subsidies, thus alleviating fiscal pressures. In that respect, he welcomed the authorities' commitment to improve the operations of the CPSP.

The effort to improve the fiscal situation in Senegal had met with considerable success, Mr. Suraisry noted. The reduction in the size of the Government had resulted in a decline in the share of government expenditures in GDP from 32 percent in 1980/81 to 23 percent in 1984/85; and there had been a corresponding decline in the fiscal deficit. Those achievements were commendable, as they would increase public savings and, taken in conjunction with other measures, would stimulate private savings and investment over the medium term. He was therefore encouraged by the commitment of the authorities to continue their efforts to improve the fiscal situation. The one cause for concern on the fiscal front was related to the performance of tax revenues, which had not been particularly buoyant, notwithstanding recent discretionary tax increases.

Furthermore, a number of significant revenue shortfalls had occured that had required greater than anticipated expenditure cuts. While such cuts were not in themselves a bad thing, if they fell primarily on maintenance expenditures, they could lead to greatly increased outlays at a later date. It was important to ensure that the tax system was working efficiently, and he therefore welcomed the steps the authorities were taking to enhance tax administration and to revise the tariff code. It was notable that some two thirds of import tax collections were lost to preferential treatment schemes and exemptions; if those exemptions were scaled back, the result would surely be a broader and more buoyant tax system. As a final element in the fiscal reform effort, he welcomed the intention of the authorities to liquidate or privatize a number of enterprises in the near future.

The success that Senegal had had in the effort to diversify the export base had been striking, Mr. Suraisry said. The value of export diversification became clear in the medium-term scenario, where a projected strong performance in nontraditional exports, such as chemicals, was the main reason for an anticipated improvement in the trade deficit. He agreed with the staff that efforts to develop tourism further could also be very useful, and he welcomed the involvement of the World Bank in the process of structural reform. Also welcome was the close collaboration that had been maintained between the Bank and Fund staff on various aspects of Senegal's adjustment effort. The recent cautious stance the authorities had adopted was reflected in their policies toward external debt management, the objective of which was to keep nonconcessional borrowing to a minimum in 1985/86. That objective was appropriate, as was the commitment of the authorities to settle all verified arrears on external debt by end-June 1986. Senegal had made commendable progress on the road to adjustment, and the commitment of the authorities to continue the adjustment effort was encouraging. In conclusion, he considered that Senegal was among the best candidates for use of resources from the special disbursement account in future.

Mrs. Ploix welcomed the announcement that the end-December performance criteria under the current stand-by arrangement had been met. The program appeared to be on track and the authorities were continuing to adhere firmly to their commitment to adjust, as demonstrated by the additional measures recently implemented to offset unforeseen revenue shortfalls. The first part of the program had been particularly successful: the overall fiscal deficit on a commitment basis had been reduced from the equivalent of 8.2 percent of GDP in 1982/83 to about 1 percent of GDP in 1985/86; domestic savings had increased from 2 percent of GDP in 1983 to an estimated 3.7 percent of GDP in 1985; and the external current account deficit had been brought down from 14 percent of GDP in 1982/83 to 9.9 percent in 1984/85, with the projection for a further decline to 6.8 percent of GDP in 1985/86. Those developments reflected the major turnaround in economic and financial policies to which the Senegalese authorities had committed themselves since mid-1983 and which were beginning to bear fruit. It was worth noting in that regard that economic growth was picking up, albeit at a slow pace.

Despite the general improvements she had mentioned, the Government was again facing a revenue shortfall at the very time when it was making payments on its internal and external arrears, Mrs. Ploix continued. The staff report did not specify whether the shortfall could be ascribed to an overestimation in the program's projections, a decline in imports, or a decrease in the actual rate of customs duties collection, and clarification of that matter was important for the definition of future relations between the Fund and Senegal. Nonetheless, the authorities had responded by taking additional adjustment measures and had proceeded to make further cutbacks in the wage bill and outlays for equipment and supplies. Although their response was commendable and had allowed the program to remain on track, it was clear that caution should be exercised to ensure that the operating means of public services were not affected. The authorities should therefore give top priority to improving revenues, in particular by strengthening customs duties and tax collection.

Senegal enjoyed the advantage of exceptionally low import prices for rice and oil, Mrs. Ploix observed. As the consumer price for those commodities had not been adjusted downward, the sizable profits being generated remained in the hands of the state import companies. The authorities should not miss the opportunity to mobilize those surpluses and use them to support the Government's budget. In that regard, she would be interested in hearing whether the staff had assessed the amount of the windfall profits expected. On the broader issue of urging governments generally to make good use of the drop in oil prices, she would be interested in knowing how recommendations toward that end would fit with the traditional principle of passing on to the consumer any variations in price of imported goods.

She was happy to note that, since the previous Article IV consultation discussion, the World Bank had approved the structural adjustment loan for Senegal, Mrs. Ploix commented. Thanks to the close cooperation that had been established between the Fund and the World Bank, a common overall policy framework had been established. She hoped that continued close cooperation between the institutions would make it possible to enhance consistency among recommended policy measures. In that respect, the present strain on government finances and the weak balance of payments position called for a pragmatic approach to the situation that would arise when, in accordance with the World Bank recommendations, import liberalization and tariff schedule revisions were introduced in June 1986. In conclusion, she could support the proposed decisions.

Mr. Steinberg stated that, in view of the heavy schedule of the Executive Board and his general agreement with the staff appraisal and with previous speakers, he would offer his comments on Senegal to the staff and to Mr. Alfidja outside the Board room.

Mr. Foot remarked that the Senegalese authorities should be commended for their progress toward adjustment and for their willingness to face up quickly to the fiscal difficulties the economy had encountered. It was a pleasure to note that all performance criteria as of end-December had been met and that producer prices had been actively raised to appropriate levels. In an earlier discussion, he had requested a general paper on producer prices, and the contrast between the price situation in Senegal and The Gambia might well be the basis for a chapter in such a paper.

The degree of cooperation between the Fund and the World Bank in the development of the policy framework referred to by Ms. Lundsager and others was welcome, Mr. Foot continued. Moreover, he was happy to see that the staff had no difficulty with the foreign exchange system in Senegal. The economy was of course still vulnerable, and much remained to be done. Nonetheless, he was happy to support the proposed decisions.

Mr. Bengs stated that his chair, like others, was in full agreement with the staff appraisal and recommendations regarding Senegal. He was satisfied with the progress made thus far under the arrangement and he encouraged the authorities to proceed with their adjustment efforts, particularly in the structural area. In conclusion, he could support the proposed decisions.

The staff representative from the African Department remarked that the overall policy framework outlined on pages 16 and 17 of the staff report was a summary of the understandings that the authorities had reached so far with the staff of the Fund and the World Bank on the macroeconomic and structural adjustment policies to be implemented over the medium term. Agricultural policy reform, which had been initiated under the 1984/85 and 1985/86 programs, would be continued. The policy framework also included industrial policy reform, which would aim at lowering the existing rates of effective protection, rationalizing the export subsidy scheme, reducing wage and labor law rigidities, and progressively eliminating price controls. In the period ahead, when the staff would again visit Senegal, it would be working with the authorities on developing the various elements of the overall policy framework.

Directors had rightly stressed that one of the basic weaknesses in performance experienced in recent years in Senegal had been on the revenue side, the staff representative recalled. Of course, since mid-1983, the Senegalese authorities had effected a major fiscal adjustment, having reduced the overall fiscal deficit on a commitment basis from 8.2 percent of GDP in 1982/83 to 3.5 percent of GDP in 1984/85, with a further reduction programmed for 1985/86. Unfortunately, while revenue growth had been significant during the period, averaging more than 7 percent a year, it had lagged behind the increase in nominal GDP. As a result, the burden of adjustment had fallen mainly on expenditure. He agreed with Mr. Suraisry that further adjustments in expenditure, particularly for maintenance, in response to the revenue performance would entail a cost to the Government at a later date.

The slow growth in revenue relative to GDP had been due to a combination of factors, the staff representative continued. The decline in real incomes and imports in recent years because of the drought had tended to slow the growth in revenue. Also, despite the authorities' efforts to improve tax administration and enforcement, continuing problems with tax collection had made it difficult for the authorities to achieve their revenue targets. The authorities were keenly aware of the problems and were taking steps to resolve them on the basis of the recommendations of recent Fund technical assistance missions, as well as suggestions from the National Commission for Tax Reform. In that regard, the measures described on pages 21 and 22 of the staff report should help to improve revenue performance over the medium term. Of course, the area of tax exemptions should be looked at carefully, and the authorities would need to be particularly cautious in future in estimating revenue.

A number of Directors had commented on the planned mobilization of resources from the rice and oil sectors, the staff representative noted. In the past, the Government had contributed to those sectors when they had been experiencing deficits; at present, following the substantial increases in the consumer prices of rice and petroleum products that had been part of the adjustment programs of previous years, those sectors were generating significant surpluses, and the staff felt that it would be appropriate for the authorities to tap some of those resources to deal with the revenue shortfall. In the design of policy adaptations made in November-December 1985, the authorities' intention had been to mobilize some 50 percent of the total surpluses being generated in those areas. The intentions of the authorities had been discussed with the institutions concerned, and it seemed clear that it would be feasible to mobilize the resources in question without overtaxing the position of those institutions. It should perhaps be noted that a timetable for the mobilization of surplus resources in the oil and rice sectors had been established and, he understood it, respected.

On a related matter, the staff representative from the African Department recalled that Mrs. Ploix had asked whether, in view of current trends in world oil prices and exchange rates, reductions in those prices should not be passed on to consumers. Without answering that question specifically, he could say that it would be legitimate in any future programming for Senegal to take a hard look at the substantial surpluses that were being generated in the oil sector to see how they could best be utilized, at least in part, to support the budget. The possibility of channeling some benefits on to consumers or certain specific sectors was a matter to be explored, but the best place to begin was to ascertain the magnitude of the prospective surpluses as well as the magnitude of the prospective demands on the budget arising from adverse developments with respect to certain other commodities, notably groundnut oil and cotton, before taking any action.

The Chairman wondered whether privatization of the trading arrangements for rice would make it more difficult to capture windfall profits.

The staff representative from the African Department replied that the schedule for privatization of the rice sector had recently been revised, although progress was certainly expected. In the past, when the rice sector was making profits, those were collected by the Government through the CPSP. In future, the CPSP would no longer be involved in rice operations, and, hence, some kind of specific import tax or comparable measure would need to be introduced to ensure the same results. The nature and timing of such a measure was yet to be determined, but the World Bank and the Fund would certainly be involved in any decision on that matter.

Mr. Alfidja stated that he would convey the comments of his colleagues to his authorities in Senegal.

The Chairman made the following summing up:

> Executive Directors concurred with the thrust of the views expressed in the staff appraisal, and commended the Senegalese authorities for the continued progress made toward economic and financial adjustment in 1984/85. Directors observed that the program had been adapted promptly to deal with an unforeseen drop in marketed output of groundnuts and a shortfall in government revenue, underscoring the authorities' commitment to adjustment, and that all performance criteria through the end of 1985 had been met. They noted with satisfaction that the overall fiscal deficit, on a commitment basis, which had been reduced from the equivalent of 8.2 percent of GDP in 1982/83 to 4.6 percent of GDP in 1983/84, had been lowered further to 3.5 percent of GDP in 1984/85, while the rate of domestic credit expansion had also been reduced substantially. Despite a shortfall in export earnings, the external current account deficit had been brought down from 11.7 percent of GDP in 1983/84 to 9.9 percent of GDP in 1984/85 because of lower imports of goods and services and a higher net inflow of unrequited transfers.
>
> Directors emphasized, however, that notwithstanding the considerable progress registered in recent years, Senegal still faces major structural and financial problems: the economy remains vulnerable; government finances are precarious; the parapublic sector is overextended; the external current account deficit is large; and the sizable domestic and external debt weighs heavily on the budget and the balance of payments. In view of these problems, Directors considered it essential for the authorities to fully implement their adjustment policies for 1985/86 and the medium term so as to remove the structural impediments to economic growth and improve supply conditions, while restraining aggregate demand to a level compatible with available resources.
>
> Directors attached importance to the implementation of the new agricultural policy designed to expand and diversify domestic production and reduce government intervention and subsidies. They commended the authorities for the actions already taken to strengthen production incentives in the groundnut and cereal sectors, and encouraged them to proceed with their plans to privatize the rice trade. Directors emphasized the need for the

World Bank to continue to assist the authorities in carrying out and financing the necessary structural adjustments in agriculture and other key sectors. In this connection, they welcomed the structural adjustment program developed by the authorities, in support of which the World Bank had approved in early February 1986 a financing package.

Directors considered that the authorities' program rightly placed major emphasis on a continuation of the fiscal adjustment, and they welcomed the projected further decline in the overall fiscal deficit to about 1 percent of GDP in 1985/86. However, they expressed concern about the unsatisfactory performance of government revenue in relation to GDP, and about the financial situation of the parapublic sector. Accordingly, they urged the authorities to improve tax administration and enforcement, and to raise the buoyancy of the tax system. At the same time, they stressed that, in view of the continued revenue shortfall, the mobilization of a large part of the surpluses being generated by the rice and petroleum sectors in support of the budget was very important. Directors commended the Senegalese authorities for applying a prudent spending policy, especially by strictly limiting the growth of the wage bill and reducing subsidies and transfers, while keeping capital outlays to levels consistent with the availability of appropriate financing. They welcomed the savings measures promptly introduced in late 1985 to cope with the revenue shortfall and to liquidate the arrears on external debt service payments by the end of June 1986. But they also cautioned the authorities against cutting too far into outlays for maintenance of investment, which could be costly in the long run. The continuation of fiscal adjustment to further reduce the overall government deficit and domestic arrears was seen by Directors as particularly important. The need for prudent debt management was also emphasized. Directors noted that in the period ahead Senegal will require concessional assistance and appropriate external debt relief from official and private creditors, in addition to domestic adjustment.

Directors welcomed Senegal's medium-term program of action, which has been developed in close consultation with the Fund, the World Bank, and the country's principal bilateral creditors. They warmly welcomed the commonality of views between the Senegalese authorities and the staffs of the Fund and the Bank on the medium-term policy framework, an agreement which they saw as a good harbinger for Senegal's future access to the structural adjustment facility. They voiced support for the key elements of the action program, namely, the promotion of private sector initiative through appropriate pricing and other incentive policies, particularly in agriculture and industry; and the achievement of greater efficiency in public resource management through improvements in the allocation and implementation of public investment, reform of the parapublic sector, and generation of government savings. Directors felt that this program could help Senegal achieve sustainable economic growth under conditions of broad financial stability over the medium term. They emphasized the importance of continued close collaboration between the Fund and the World Bank in assisting Senegal in its adjustment efforts.

It is expected that the next Article IV consultation with Senegal will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding 1985 Article XIV Consultation

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Senegal in the light of the 1985 Article IV consultation with Senegal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Senegal continues to maintain an exchange system which is free of restrictions on payments and transfers for current international transactions.

Decision No. 8232-(86/54), adopted
March 25, 1986

Review Under Stand-By Arrangement

1. Senegal has consulted with the Fund in accordance with paragraph 4(d) of the stand-by arrangement for Senegal (Attachment to EBS/85/45, 3/1/85) in order to reach understandings on the progress made in the implementation of the 1985/86 program and to establish suitable performance criteria as contemplated in paragraph 21 of the letter from the Minister of Economy and Finance dated December 3, 1984, attached to the stand-by arrangement.

2. The letter from the Minister of Economy and Finance dated February 4, 1986 shall be attached to the stand-by arrangement for Senegal, and the letter of December 3, 1984 shall be read as modified and supplemented by the letter dated February 4, 1986. Accordingly, the performance criteria referred to in paragraph 4(a) of the stand-by arrangement shall be those referred to in paragraphs 9 and 11 of the letter dated February 4, 1986 and specified in the table annexed to that letter.

3. The Fund decides, pursuant to paragraph 4(d) of the stand-by arrangement, that the review provided for in paragraph 21 of the letter from the Minister of Economy and Finance dated December 3, 1984 is completed.

Decision No. 8233-(86/54), adopted
March 25, 1986

3. ALLOCATION OF SDRS - CONSIDERATION IN LIGHT OF RECENT DEVELOPMENTS

The Executive Directors considered a staff paper on the question of an allocation of SDRs in light of recent developments in the world economy and in international reserves and liquidity (SM/86/44, 2/26/86).

Mr. Polak made the following statement:

The staff paper, like its many predecessors, presents the case for SDR allocation in a convincing way. The Netherlands authorities favor such an allocation, at a rate of SDR 4 billion per year, which would result in a modest increase in the ratio of SDRs to non-gold reserves over the next basic period. That statement would ordinarily be sufficient; however, as the Chairman implied at the end of the Board meeting on February 26, when Directors considered the role of the SDR, even the best restatement of a case that is convincing to the convinced will not bring about a sufficient majority to agree on an allocation. That will take, to use the Chairman's words, "political will" on the part of the countries that hold a negative view on the merits of SDR allocation. I see "political will" in this context not necessarily as a willingness to convert to a belief in the benefits of a greater role for the SDR in the world's reserve system, but at least to recognize the fact that a large part of the membership of the Fund continues to see definite merits in allocation, both for the system and for themselves.

I found in the staff paper a number of factual ingredients that could perhaps serve to carry our discussion of February 26 somewhat further. In the belief that these findings might also be of interest to other Directors, I shall spend a few minutes of the Board's time on them.

The existence of a persistent long-term demand for non-gold reserves at a remarkably stable ratio to imports--except for temporary deviations--becomes more firmly established with every successive tabulation; and that is both for the world total and for all major subgroups (Table 1). This trend demand forms the basis for the near certainty that reserves will continue to grow in the future as trade continues to grow, which would permit part of this global need to be met by SDR allocations.

Table 1 also shows that the countries with recent debt-servicing problems, which lost SDR 15 billion of reserves in 1981 and 1982, had made extreme efforts to restore their reserves, often by recourse to current account surpluses as bank credit dried up. The allegation that is sometimes made that developing countries would use allocated SDRs not to reinforce their reserves but to increase absorption would be difficult to reconcile, either with the evidence of these recent efforts or with the long-term rising trend in the reserves held by these countries.

The paper does confirm, however, the propostion that capital-importing developing countries, while building up their reserves, do not maintain their SDR holdings as such (Chart 3). Except during periods of allocation, these holdings have tended to be about 60 percent of allocations in the 1970s and have declined to about 30 percent of allocations in recent years and to less than 20 percent for countries with debt-servicing problems, even after these countries have rebuilt their total reserves in 1983/84. This points to an important flaw in the SDR mechanism that requires correction.

Chart 3 also shows another interesting fact. Even though the great majority of the LDCs tend to run down their SDR holdings, this does not impose on the industrial countries as a group the "burden" of holding SDRs significantly in excess of their allocations. The explanation of this apparent discrepancy lies mostly in the SDR holdings of the Fund and, to a small extent, in the relatively large holdings of the Middle East oil countries.

The low SDR holdings of the non-oil developing countries reflect unfavorably on the quality of SDRs as reserve assets in the opinion of these countries, an opinion that tends to be voiced more often by the industrial countries. Developing countries that take that view often find it possible to reduce their SDR holdings, either at times of need, through designation, or in the absence of need when payments have to be made to the Fund. I would not want to suggest that these countries' use of SDRs has been inappropriate or should be constrained; nonetheless, the striking disparity in relative SDR holdings shown in Chart 3 is not good for the SDR system and should be dealt with. And the designation process has not proven to be a suitable corrective device to remedy this situation.

Given enough time, the solution must lie in making the SDR a more attractive reserve asset, which would solve the problem without more rules on the holding of SDRs. I have made some suggestions to this end, but they are not simple and may well take considerable time to design, and even more time to change attitudes toward the SDR. In the meantime, specific action deserves to be taken to bring about a fairer distribution of SDR holdings among the members of the Fund.

One of the conclusions of our discussions on the role of the SDR was that attention should again be given to reconstitution, which is no longer operative but is still provided for under Schedule G of the Articles. The Fund's experience with reconstitution as applied in the past, under paragraph 1(a) of Schedule G--which aimed at members holding on average, in overlapping five-year periods, at least 30 percent of their allocation--was cumbersome and on the whole ineffective, and it is not certain that substantially better versions of this approach could be designed. In present circumstances, I would see better prospects in an attempt to give life--and "teeth"--to the reconstitution provision of paragraph 1(b) of Schedule G. That paragraph reads: "Participants shall also pay due regard to the desirability of pursuing over time a balanced relationship between their holdings of special drawing rights and their other reserves."

In its substance, the paragraph addresses the problem that is brought out by Chart 3--namely, that many members do not pursue a balanced relationship between their holdings of SDRs and their other reserves. It should not be too difficult to define a standard for a minimum balanced relationship. As a rule which members must comply with, the language of paragraph 1(b) is of course extremely mild, but I presume that the Fund, with a bit of goodwill, could find ways of giving this rule the necessary bite. I suggest this might be the way to go, in order to help make SDR allocation a more generally acceptable proposition.

Mr. de Groote observed that the demand for reserves was growing parallel to the expansion in world trade. In the circumstances, the increased demand for reserves should be met partly through an allocation in order to improve the quality of reserves through an increase in the proportion of owned reserves and in order to reduce the variability of reserves. It was clear that a decision not to allocate SDRs in no way prevented the stock of reserves from increasing in response to demand, but it would lead to a less satisfactory composition of reserves than if the allocation had taken place.

It was accepted by Directors that the inflationary risk of an allocation, which would be limited if it existed at all, could be offset by action on the monetary base, Mr. de Groote continued. It was also accepted that there was no risk that an allocation would lead to relaxation of ongoing stabilization efforts, given the dependence of new credits and reschedulings on the maintenance of adjustment policies and the observed practice or reserve reconstitution, even in the case of countries with limited access to the markets. The only theme that might have been more explicitly stressed in the paper was the role that SDR assets could play in a multireserve system as an instrument for exchange market intervention by the reserve centers themselves. As he saw it, circumstances would offer a supplementary justification for making available a sufficient amount of reserves in the form of SDRs.

Another issue brought into focus by the staff paper was the tendency of low-income countries to use their SDR assets more rapidly than their other reserve assets, a tendency not observed in the case of industrial countries, Mr. de Groote remarked. Mr. Polak had correctly interpreted that divergent behavior as the result of the imperfect reserve qualities of SDR assets. The central banks in developing countries wanted their limited reserves to remain fully available for immediate interventions, under conditions that could not be fully met with present SDR characteristics. Accordingly, those banks followed a rational pattern by drawing down their SDR assets more rapidly than other currencies through repurchases, a behavior that in no way indicated that they did not consider their SDR as desirable reserves but only that the reserve characteristics of those assets could be improved. Such improvement would induce the holders of SDRs to increase the share of the asset in their total stock of reserves and would encourage them to reconstitute. In the circumstances, the Board should give early consideration to the suggestions made by Mr. Polak and other members of the Board for improving the reserve qualities of the SDR.

Given the unwillingness of certain members to continue the dialogue on SDR allocation on the basis of the new information and new arguments put forward by the staff, the Chairman's required report to the Interim Committee on the state of discussions on SDR allocations might be viewed by some as an exercise in repetition, Mr. de Groote commented. However, as he saw it, the Managing Director would be justified in informing the Interim Committee that some progress had taken place in the discussions. He would recommend that the Managing Director take stock of the important and convincing conclusions proposed in the staff's latest paper on the observed long-term demand for reserves of members in general, and of less developed countries in particular, a demand that those countries had exercised at high cost in financial and real terms. The report might also refer to the interest shown by the Board in various suggestions put forward in response to some of the perceived shortcomings of an allocation, especially from the viewpoint of its distributional effects, as well as suggestions to improve the quality of the SDR. Those points in his view formed a good basis for further work on the SDR.

Mr. Suraisry stated that the position of his chair on the question of an SDR allocation had not changed since the previous discussion. He continued to support the resumption of SDR allocations at a moderate rate. The Executive Board had debated the matter of allocation on several occasions, most recently during the comprehensive examination of the role of the SDR in the international monetary system. As that discussion had shown, the evolution of the system had given the international capital markets a dominant role in the provision of international liquidity. While those markets had succeeded in providing liquidity, their efforts had uncovered a number of weaknesses in the system and had created serious uncertainties about the reliability of the markets as a source of liquidity. Commercial banks had scaled back their exposure even to countries that had been implementing effective adjustment programs. They had also made it clear that they were no longer interested in balance of payments financing but wanted to return to their traditional role of trade and project financing.

Even if one assumed that the banks would continue to provide liquidity, it seemed clear that the amounts would be insufficient to meet the needs, Mr. Suraisry continued. Many countries were in need of reserves but had no access to capital markets and thus had to rely on import contraction. Unfortunately, those countries had been relying on import contraction to acquire reserves for several years, and further dependence on that approach could lead to difficulties. First, successive reductions in imports jeopardized growth prospects; second, continued reliance on current account surpluses to acquire reserves would weaken the social consensus on the need for adjustment and, consequently, disrupt adjustment efforts. Even those countries that had access to the private capital markets faced problems; some of them had already accumulated a large stock of external debt and large debt service payments. Adding to that already large stock of debt might not be in the best interests of either those countries or of the system. It would be consistent with the current effort to improve the functioning of the international monetary system in general--and more particularly with the need to reduce the debt problem to a manageable level--if the need for borrowing by such countries could be reduced. SDR allocations could clearly play a role in reducing that need.

Judging from the current economic environment, it could be concluded with confidence that the inflationary impact, if any, of an SDR allocation would be negligible for the following reasons, Mr. Suraisry remarked. First, allocations, if resumed, would take place only at a moderate rate; second, inflation was no longer a threat to the system; and, third, the economic policies of the industrial countries were guided by medium-term considerations, which reduced the likelihood that the monetary base of those countries would be expanded as a result of new allocations. As the staff had pointed out, those considerations made the inflationary impact of SDR allocations insignificant.

Concerns about the impact of SDR allocations on adjustment were equally unwarranted, Mr. Suraisry considered. If SDR allocations were resumed at a moderate rate, they might even strengthen the adjustment process. A number of countries had relied on current account adjustment for several years but had reached the point where further adjustment was not feasible without additional resources. SDR allocations could provide support for those countries to continue with their adjustment effort. In any event, if the concern about the impact of SDR allocations on adjustment was the only roadblock to SDR allocations, it should be remembered that a number of Directors had offered proposals specifically tailored to address that concern. Apparently what was needed was the political will to act. In the absence of that will, no technical analysis by the staff would be sufficient. Indeed, the number of discussions already held on the subject of SDR allocations suggested that technical analysis might well have been exhausted.

Mr. Pérez observed that, as on previous occasions, the Board had before it a paper presenting statistical information, estimates and arguments justifying beyond any technical doubt the need for a resumption of SDR allocations. What the Board was exploring was the political willingness of member countries to proceed toward a new allocation. The position of his chair on the question remained unchanged; indeed, recent developments had only reinforced his conviction that an allocation was fully in conformity with the requirements for an allocation outlined in the Articles of Agreement.

The examination of the world economic outlook papers and the conclusions of the most recent discussion of the outlook showed that the projected expansion in international trade by comparison with projected financial flows called for a steady increase in nondebt creating reserves, Mr. Pérez continued. Relying solely on capital markets to satisfy the long-term global need for reserves could lead to a tight liquidity situation in the near term that would be incompatible with the projected expansion in world trade. Moreover, given the current attitude of commercial banks toward developing countries in general, and indebted countries in particular, it was easy to foresee that the bulk of the adjustment to the tighter liquidity situation would fall on debtor countries.

At the Interim Committee meetings in Seoul, Secretary Baker of the United States had made a proposal based on a cooperative and coordinated effort to help debtor nations facing balance of payments difficulties, Mr. Pérez recalled. Secretary Baker had asked for the collaboration of commercial banks in that effort, noting that the observed magnitude of financial flows from the private markets to indebted countries was incompatible with any realistic solution to the debt problem. That assessment had been widely accepted and, in that sense, both the shortage of liquidity faced by indebted countries and the inability of reserve system based on private lending to meet the need and distribute resources appropriately had been generally recognized. At the time, his chair had expressed concern at the apparent inconsistency between a request to the banking community to provide net new lending in addition to the voluntary financing flows to developing countries and the reduction in access to Fund resources. With the more recent broad support from the banking community for the Baker initiative, on the condition that all parties involved participate by doing their fair share, it was difficult to see how the Fund could justify saying that it was again not in a position to do its share in the task. A resumption of SDR allocations might reduce the vulnerability of the current reserve system by increasing the proportion of available reserves and reducing the pressure to generate current account surpluses. In that way, the achievement of an appropriate rate of growth, a precondition in the solution to the debt problem, would be better assured.

As the staff had rightly noted, there was no danger that the increase in owned reserves would lead to a resurgence in inflationary pressures or to a relaxation of the adjustment effort being pursued by the developing countries, Mr. Pérez remarked. Even if the SDRs allocated to developing countries were used quickly to increase demand of goods and services from developed countries, the potential expansion in international liquidity generated by a modest allocation could easily be accommodated in the rate of growth of monetary aggregates. As Mr. Polak had noted, it was difficult to reconcile the concerns of those who felt that an allocation would lead to a relaxation of the adjustment effort with the evidence that developing countries had worked hard to reinforce their reserve positions by running current account surpluses over the past few years, at a cost of lower rates of growth and higher unemployment.

During recent discussions on the future role of the SDR, his chair had stressed, inter alia, that the possibility of using the SDR as a safety net in the face of an acute liquidity crisis was contingent upon a reversal in the declining trend in the proportion of SDRs to total reserve assets, Mr. Pérez recalled. It would be disappointing to conclude the current fourth basic period without any allocation of SDRs or, worse yet, without a plan for what to do during the fifth basic period. In conclusion, he reiterated the basic position of his chair in favor of a decision to allocate SDR 10 billion per year in 1986 and over the next basic period, an allocation that would result in a modest recovery in the ratio of SDRs to non-gold reserves through the period to a level higher in 1991 than the peak reached in 1973. He was also prepared to consider some reduction in the amount of the allocation as a second best option, if that were to lead to the attainment of the necessary consensus among members.

Mr. Grosche stated that his position on an allocation of SDRs had also not changed since the previous discussion. The new data on international reserves and liquidity did not in his view demonstrate a long-term global need for supplementing existing reserve assets. Even though the other arguments put forward by the staff in favor of an enhanced role for the SDR might have merit, they were not a sufficient basis for a decision to allocate.

In previous discussions on SDR allocations, and more recently in the discussion on the role of the SDR, he had explained the view of his authorities at length and would therefore limit his intervention to commenting on a few points in the latest staff paper, Mr. Grosche said. While recognizing that the staff had made a serious effort to convince those who had reservations about allocations at the present juncture, he had missed in the data on recent developments in international reserves any discussion of the conversion rate. The revaluation of the SDR rate had markedly influenced the decline in reserves in SDR terms during 1985. As more than half of non-gold reserves were held in U.S. dollars, a case could be made for looking at reserves in dollar terms, an approach the staff had taken in its monthly report on international reserves (EBD/86/46, 2/24/86), where it had been shown on page 19 that total non-gold reserves had increased in 1985 by $41 billion while developing countries had increased reserves by no less than $9 billion.

He saw no reason to base important decisions on SDR allocations on the recent slight decline in the ratio of total non-gold reserves to imports, Mr. Grosche remarked. After all, the ratio for developing countries remained above the average of previous years, and he continued to have serious doubts about the usefulness of that particular ratio for reasons he had explained on previous occasions.

The staff seemed to be suggesting that a global need for reserves supplementation through allocations existed because of the uneven distribution of reserves, Mr. Grosche noted. It had been stated that "the rebuilding of holdings of reserves for countries without access to international capital markets required adjustment in policies to generate current account surpluses in excess of those necessary to service external debt positions." The implication seemed to be that losses of reserves, often the result of inappropriate policies, should be replaced by SDR allocations, but that idea was not grounded in the Articles of Agreement.

On page 15 of its report, the staff had referred to the G-10 "safety net" idea but had been overly selective in quoting from the G-10 report in support of the idea, Mr. Grosche commented. It was worth noting that the G-10 deputies had not agreed that the safety net would be desirable or appropriate at the present stage. Moreover, it was important to note that even an SDR allocation for "safety net" purposes had to meet the most important criterion of a long-term global need for reserves supplementation. Also on page 15 of SM/86/44, the staff had observed that the SDR, defined as a basket of currencies, was a reserve asset whose value was likely to show less variability than any of the component currencies in the basket. Apart from his view that such an argument should not be given any weight in a decision of whether or not to allocate SDRs, it was clear from the facts that central banks were not necessarily attracted by that feature of the SDR. As Mr. Polak had explained, the low level of holdings of SDRs by the non-oil developing countries showed that those countries did not seem to be convinced of the quality of the SDR as a reserve asset, a point to which he would draw his authorities' particular attention.

The medium-term projections outlined in the staff paper suffered from a number of serious drawbacks, Mr. Grosche considered. For example, as they did not project the supply of reserve assets from other sources, they could not help to determine the gap to be filled by SDR allocations. Besides, a comparison with the projections in the previous staff paper on allocations (SM/85/219) showed how volatile such projections could be. In August 1985, the staff had calculated that the total demand for non-gold reserves by all countries would grow to SDR 735 billion by end-1991; in the latest paper, the projection was for demand of only SDR 568 billion, a rather remarkable difference in his view.

Mr. de Groote said that he had found confusing the conclusions that Mr. Grosche had drawn from the calculating reserve demand in U.S. dollars rather than in SDRs. If reserve demand in dollar terms appeared higher than reserve demand in SDR terms, the proper conclusion was that the need for an allocation was greater rather than smaller, since there would be, correspondingly, an increased need for improved composition of a higher total.

Mr. Grosche replied that his intention had been simply to note that far more than half of total reserves were held in U.S. dollars, which seemed to imply that countries preferred holding reserves in that currency rather than in SDRs. By converting reserve holdings into SDRs for presentational purposes, as had been done in the staff exercise, the impression might be given that reserves had declined markedly, which was simply not the case.

The Deputy Director of the Research Department agreed that reserves were held to a great extent in the form of U.S. dollars, although the staff had witnessed over the years some movements in the ratio. In the past ten years, for example, the proportion of reserves held in U.S. dollars had declined from about 80 percent at the beginning of the 1970's to about 55-60 percent more recently. Of course, when the U.S. dollar strengthened against other currencies, as it had, then total reserves expressed in SDRs must have grown, as the value of the dollar against the SDR had risen. And if the dollar declined, the opposite tendency would be observed--namely, a declining value for the dollar would reduce the SDR value of given dollar holdings. One conclusion that could be drawn from that information was that if the value of reserves in dollar terms was higher than it was in SDR terms by comparison with some earlier period, then those who looked for maintenance of the proportion of SDRs in total reserves might argue that the need for an SDR allocation had increased.

Mr. Grosche stated that he had not meant for his remarks to lead to an argument of principle. He had simply felt that it was important to keep in mind that central banks tended to think in dollar terms when looking at their reserves and that, hence, it might have been helpful if the value of reserves in dollar terms had been included in the data in the staff paper to show that the movement in reserves from one year to the next had been affected not only by changes in the level of reserves but also by changes in the SDR rate.

Mr. Foot stated that he could endorse Mr. Grosche's remarks on the issue under discussion. As several speakers had already noted, SDR matters had been discussed several times in recent months, and on each occasion his chair had made it clear that the United Kingdom saw the main role for the SDR in the current situation as a safety net for the international monetary system in case a significant shortage of reserves arose. He did not see the value of linking the question of an SDR allocation to the issue of development finance, a point made on another occasion by Mr. Polak. However, that argument had apparently not convinced all Directors. In that respect, it would perhaps be fair to record in the Chairman's report to the Interim Committee that those in the Executive Board who favored an SDR allocation were split into two distinct schools of thought on the issue, with differences relating to the size of the allocation.

In its latest paper, the staff had attempted to move the existence of a global shortage of reserves by describing the way in which the stock of reserves had changed over time, Mr. Foot observed. Mr. Grosche's remarks on that point were well taken, and he had some additional thoughts on how those ex post figures should be interpreted. First, one could not, ex ante, establish a target level for, say, the reserves/import ratio; certainly that would not be the way his authorities would behave in attempting to judge the adequacy of their reserves in light of a range of factors, including the outlook for the balance of payments. There had been a sizable decline ex ante and ex post in the demand for U.K. reserves in recent years as the outlook for the United Kingdom's balance of payments had improved.

Another problem area concerned the interpretation of changes in the level of reserves, Mr. Foot commented. To the extent that a fall in reserves reflected inadequate policies, the appropriate response was to change the policies rather than to try to change the level of reserves, which were merely a reflection of an underlying disequilibrium. In that context, he felt compelled to repeat his argument that a significant number of Fund members would likely spend allocated SDRs, either immediately or at the first external shock experienced.

It seemed clear from the staff paper that, in relation to total imports, reserves for all the different groups of developing countries identified by the staff were toward the higher end of the range shown during the current economic cycle, Mr. Foot said. Some might argue that that was only because of the major import compression forced upon those countries by the lack of foreign exchange, but he found that argument to be further evidence that those developing countries would spend future SDR allocations.

A similar picture emerged if one looked at the ratio of reserves to total trade imbalances, Mr. Foot remarked. For most groups of countries, except that group of countries that had experienced recent debt servicing problems, reserve ratios seemed to be at historically normal levels; and, in many cases, inappropriate policies rather than an endemic failure in the system of reserve provision had been the main cause of the low level of reserves among the debtors. He could of course fully accept that there existed countries that had not regained full access to the international capital markets, despite the adoption of more appropriate policies. That problem was a matter that must be considered in the evolution of the debt strategy that had been discussed both in the Executive Board and elsewhere, and it was vital that that problem be tackled. However, even for countries in that difficult situation, his authorities were not convinced that an SDR allocation was the appropriate solution. When he viewed the SDR amounts that the middle-income, capital-importing countries would receive from an allocation of the size favored by speakers like Mr. Polak, he was rather surprised at the enthusiasm with which the idea had been endorsed. It seemed that the amounts involved were not sufficient to resolve the problems that had been described. His chair would argue for the maintenance of realistic policies, with due support from all parties concerned, including the commercial banks, as the appropriate way to achieve the goal of an increase in reserves. It followed that his authorities were not convinced that the existence of a global shortage of reserves had been demonstrated, and they remained opposed to an allocation of SDRs at present. Finally, unlike Mr. de Groote, he had not found any definable movement in the positions of Executive Directors at the current discussion.

Mr. de Groote said that Mr. Foot's remarks seemed to imply that it was accepted wisdom that an allocation would be justified only if it was never spent. His own view was that reserves should be spent when needed, and then reconstituted. The fact that certain countries had used their SDRs when in extreme balance of payments difficulties showed nothing more than that the SDR had properly been used as a reserve asset; the only question was to know whether the authorities would wish to reconstitute their SDRs after a period of time.

Mr. Foot stated that he was well aware of the specific needs about which Mr. de Groote was talking, but he felt there were more appropriate ways of fulfilling those needs, including the use of Fund's existing facilities.

The Chairman observed that the approach mentioned by Mr. Foot would have to be adopted in the context of the monetary character of the Fund, with limits on access and so on.

Mr. Grosche asked whether Mr. de Groote could explain why SDRs had not been held by certain countries.

Mr. de Groote observed that countries generally had many good reasons for holding reserve assets other than SDRs, not least of which were related to the reserve characteristics of the SDR itself. It was quite reasonable for central banks of developing countries to want to use their SDRs in repaying their obligations to the Fund while holding on to those reserve assets that were more readily usable elsewhere. The industrial countries had larger reserves in relation to their reserve needs and were thus not constrained in the same way; but they maintained a higher proportion of SDRs in an effort to adhere to the oft stated view that the SDR should be the principal reserve asset in the system. As a result, those countries sometimes faced a liquidity risk and other costs.

Mr. Grosche remarked that if Mr. de Groote's description were correct, one could not base a decision to allocate on the need to build up reserves.

Mr. de Groote replied that it was commonly accepted that a decision to allocate had to be based on reserve demand of member countries, a demand that had clearly been established by the staff in its latest paper. His only point was that it would be more rational to have a large share of SDRs in that total that was demanded by Fund members.

Mr. Kafka, recalling Mr. Grosche's earlier point about translating reserves in SDRs to reserves in dollar terms, considered the argument not to be a convincing one; if reserves were expressed in yen, for example, it would appear that reserves had fallen sharply in 1985, although that year was irrelevant. A better measure would be the ratio of reserves to imports. What was remarkable was that the relationship between non-gold reserves and imports had clearly fallen; indeed, in 1985, the ratio was among the 5 lowest that had been registered in the past 15 years. Moreover, the ratio of reserves to trade imbalances was also unusually low, even for industrial countries. Surely such ratios were more interesting than the absolute value of reserves, whether expressed in dollars, SDR or yen. Moreover, the criterion in the Articles for SDR allocations was not a shortage of reserves so much as the need to supplement reserves. He concluded in the circumstances that the arguments put forward by Mr. Polak and others supporting an allocation should stand, despite what had been said by the opponents.

Mr. Polak added that it mattered very little whether the ratios referred to by Mr. Kafka were particularly low; all that was important to make the case for an allocation was that those ratios had been relatively stable, since one could say with conviction that trade would increase over time and, hence, reserves must rise over time. While it was unclear by how much reserves would rise over, say, the next five years, the amount was certainly far larger than any possible SDR allocation on which the Board might reach agreement.

The Chairman noted that with relatively stable ratios for countries generally, it would be possible to get along without an SDR allocation; however, because a large number of members no longer had access to the private markets, which had been a source of reserve accumulation, an allocation could be seen as necessary. Otherwise, the only way to keep the ratios stable would be to compress imports further, an action that would introduce a recessionary bias into the mechanism of reserve creation.

Mr. Grosche agreed with Mr. Kafka and Mr. Polak that the ratio of non-gold reserves to imports was important, although he was concerned that the emphasis might be on a figure derived from experience in the 1970s when the international monetary system had not been functioning smoothly; moreover, it was not possible to say whether a particular ratio for a group of countries was the right one or the wrong one. Also, while he understood the difficulties experienced by certain countries in maintaining a given reserve level, he wondered whether an SDR allocation would resolve the problem, especially as experience suggested that the SDRs would be spent rather than held. Perhaps the effort to strengthen reserves could be more efficiently supported through bilateral aid or borrowing from the Fund.

Mr. Kafka replied that countries above a certain level of wealth would hardly receive bilateral aid. Moreover, access to Fund resources had been steadily falling, and even if a country could draw 50 percent of its quota in a given year, the amount in many cases would be no more than

2 percent of the country's trade. If that trade were growing at 5-6 percent--whether in dollar or SDR terms--the country would not be able to maintain an appropriate level of reserves through such borrowing.

Mr. Foot recalled that some had argued in favor of allocation by referring to the sharp deterioration in the various ratios listed in Table 1 of the staff paper. In fact, the sharpest deterioration had occurred in the ratio of SDR allocations to trade imbalances for the industrial countries, which seemed to prove his argument that such figures could not be used to make a case for an allocation. There was an acute imbalance of trade between the United States and other countries, but those countries had no reserve difficulties or any particular need for greater reserves.

Mr. Polak noted that the figures on trade imbalances had been introduced into the table by the staff because Directors from those countries objecting to SDR allocations had said at the time that ratios of reserves to imports had little meaning and that it would be better to look at the less precise ratios of reserves to trade imbalances. As he saw it, the ratios of reserves to trade imbalances were not particularly convincing one way or the other, while ratios to imports paralleled the use by many industrial countries of the ratio of money supply to GNP or the stock of money compared to the broad flow of transactions.

Mr. Grosche observed that the ratio of reserves to imports had little meaning in countries with strong currencies like the United States or Germany.

The Chairman recalled that the staff had been asked to provide some statistical measurement of the need for supplementing reserves, and it had done so. For Directors to tell the staff that those numbers were not significant because in some cases countries did not look at their imports to determine the level of their needed reserves was rather disconcerting. He had often heard that the figures provided by the staff did not give clear evidence of the need for increasing reserves, but he was rather troubled to hear that the figures themselves had no meaning at all.

Ms. Bush commented that her point--and perhaps the point being made by Mr. Grosche--was that ratio of reserves to imports in some countries were not as important in determining a need for reserves as it might be in other countries. Because the ratio had a different meaning for different countries, its more general use to prove a point might not be particularly appropriate.

The Chairman observed that some measurement of a global need to supplement reserves had to be found, and the Executive Board had asked that yardsticks to measure that need be developed. The fact that some countries did not view the ratio as significant, perhaps because they had other means of financing their balance of payments, did not obviate the requirement to establish some global measurement of reserve need. Certainly, it would be difficult to develop a mathematical mechanism that would operate differently with respect to different geographical areas; besides, such an approach might well lead to even higher reserve needs for some countries, which could again raise calls for separating allocations from quotas.

Mr. Grosche remarked that while he attached some value to the ratio of reserves to imports, he would caution against using it as a yardstick for determining the global need for reserves. Other factors such as the current account developments of reserve currency countries and the supply of reserves, must also be taken into account.

The Deputy Director of the Research Department noted that while the staff had been using the ratio of reserves to imports as an indicator of reserve needs for many years, it had also developed other measures of the growth of reserve demand. Indeed, the staff had developed reserve demand functions for various country groups and had written a paper on those measurements in the DM series (DM/85/62).

Mr. Grosche observed that the experience of the past 30 years was a demonstration of why such ratios could not be taken as conclusive evidence of global reserve need. If the United States had been running a surplus of $100 million instead of a deficit, the interpretation of the figures would be quite different.

The Chairman responded that whatever the attitude of Directors toward the ratios in question, it was clear that for the membership as a whole--both industrial and developing countries--the relationship of non-gold reserves to imports was relatively stable.

Mr. de Groote agreed with those who felt that the reserves to imports ratio could be complemented by other elements of information, including perhaps the relationship between reserves and current account imbalances, since reserves were needed to cover many payments.

The Deputy Director of the Research Department observed that the ratio of reserves to trade imbalances had been used in the staff paper because trade imbalances were available for a larger number of member countries than current account imbalances; ratios of reserves to current account imbalances could be produced but only for a smaller group of countries; and the picture that would be painted by such ratios would be similar to that painted by the ratio of reserves to trade imbalances.

Ms. Bush observed that the present discussion followed a relatively thorough review of the role of the SDR in the international monetary system. Throughout that and other discussions on the SDR, her chair had expressed the view that the evolution of the international monetary system had reduced the need for the SDR as a supplementary source of liquidity as the private capital markets had come to play a larger role in providing liquidity. For the foreseeable future, she saw the private capital markets continuing to be the main source of liquidity in the system.

She had not been able to determine from the data in the staff paper that there existed a long-term global need for creating SDRs to supplement world liquidity, Ms. Bush commented. The staff had pointed out on page 13 of its paper that it had become increasingly difficult to determine on quantitative grounds alone whether there was a long-term global need to supplement international reserves by an SDR allocation, and recent Board discussions on the issue had demonstrated that point even more clearly. Besides, since SDRs were allocated in proportion to quotas, an allocation would not provide countries facing large financing difficulties with sufficient additional resources to deal effectively with those problems.

As she and her chair had indicated on several occasions in the past, the current system could adapt flexibly to changes in members' external positions and financing needs, including through the provision of reserves, Ms. Bush continued. However, it was clear that some countries had not been able to rely on reserve build-up through private markets because of difficulties maintaining creditworthiness and because of the recent generalized reluctance of the private markets to increase their exposure in developing countries. As her chair had acknowledged in the Board discussion on February 26, the lack of access of some countries to international capital markets pointed mainly to the inadequacy of economic adjustment efforts in those countries. However, the markets for private financing had not always functioned optimally in generating the appropriate amount of global liquidity. Furthermore, Mr. Dallara had indicated in a recent Board discussion his concern with the lack of commercial bank lending to developing countries with debt problems during 1985 and the serious need for an increase in such lending to be accompanied by appropriate comprehensive macroeconomic and structural adjustment programs aimed at bringing about sustainable growth in a low-inflation environment. In that respect, she did not feel that the answer to the financing problems of the developing countries was an SDR allocation. What was important was that financing should be made available in support of comprehensive economic policies that would lead to a more stable financial environment and a more stable international monetary system that would generate liquidity when needed.

Mr. Ismael, noting that he was in full agreement with the staff's analysis and conclusions, said that he supported an early allocation of SDRs in the current basic period with the amount to be negotiated once a broad consensus had been reached on the need for an allocation.

The staff had examined five indicators of the adequacy of reserves in the effort to determine whether a long-term global need for reserve supplementation existed, Mr. Ismael continued. Each of the indicators in his view suggested that the system could benefit from an allocation of SDRs, and he believed that an allocation would be helpful even though reserve needs could to some extent be satisfied by the current financial system. In support of that belief, he noted that a significant number of countries did not have access to the commercial markets, and an allocation would be most valuable to that group of countries. Moreover, the availability of reserves was not reliable and could change drastically with shifts in the market perceptions regarding the creditworthiness of countries. The terms and conditions under which reserves were supplied could also change, and the need to refinance borrowed reserves might not always prove easy. An allocation of SDRs would overcome those weaknesses associated with excessive reliance on borrowed reserves and would allow developing countries to supplement their reserves without compressing imports and economic growth.

The argument put forward by some that an allocation would be inflationary and that it would remove incentives for developing countries to adjust had been found by the staff to have no justification, Mr. Ismael commented. Unfortunately, technical arguments were not likely to convince his colleagues who were opposed to an allocation; what was needed was the political will to reach a consensus so that the Chairman could report to the Interim Committee that there was broad support among the membership in favor of an allocation.

Mr. Sugita observed that the position of his authorities on the issue of SDR allocation remained unchanged. They considered that a case had not yet been established for a new allocation of SDRs. Given the availability of resources from international capital markets, the level of reserves of members was determined mainly by demand-side factors, insofar as the borrowers could maintain their creditworthiness. The staff had noted that "there is neither a shortage nor an excess of reserves in purely quantitative terms for the group of countries regarded as creditworthy." Instead of showing a quantitative shortage of reserves, the staff had attempted to establish a case for the long-term global need for reserves by stating that SDR allocations could help improve the quality of reserves by increasing the share of owned reserves. His authorities had reservations about such an argument.

In remarking on the holdings of SDRs by developing countries, the staff had pointed out that the recent decline in the ratio of SDR holdings to non-gold reserves in developing countries might be an indication of an unwillingness on the part of those countries to hold SDRs, Mr. Sugita continued. If so, it was all the more questionable whether SDR allocations could be justified, even on the basis of the argument that it would improve the quality of reserves.

Mr. Vasudevan observed that some countries, particularly the industrial countries, certainly held large amounts of SDRs. He wondered whether Mr. Sugita's argument could be turned around to use that larger holding by industrial countries as proof that the SDR was more attractive to those countries.

Mr. Foot replied that, at least in the case of his country, the holding of SDRs was a burden and was done mainly as a gesture of good will.

The Chairman said that he had certainly known central bankers who had been happy on some occasions to mobilize their SDRs in times of balance of payments difficulty, and he hoped that Mr. Foot's remarks would not be interpreted as suggesting that the SDR was a second quality reserve asset.

Mr. Foot responded that, whatever the attitude of member countries toward the asset, its attractiveness for some would certainly increase if the remuneration coefficient rose to 100 percent.

Mr. Kafka observed that in indicating that an allocation of SDRs would improve the composition of reserves, he had not intended so much to suggest that the liquidity characteristics of reserves would thereby on average be improved; rather, he had meant to suggest that an allocation would increase the proportion of owned reserves to borrowed reserves, a development that would not be precluded if a country exchanged its owned SDRs for owned dollars.

Mr. Suraisry agreed with the Chairman that the SDR was a good quality asset; however, when an effort was made to transform SDRs into other usable assets--say, U.S. dollars--into SDRs a loss could be incurred when the interest rate on the other usable asset was higher than that on the SDR. In that respect, substantial SDR holdings could be costly.

The Chairman replied that while a country might lose in terms of interest rates on occasion, it might also gain in terms of the solidity of the asset, as the SDR was defined against a basket of currencies.

Mr. Sugita commented in response to Mr. Vasudevan that the fact that industrial countries held SDRs was proof only of their willingness to cooperate to facilitate the use of SDRs, not necessarily of the attractiveness of the asset.

The Chairman noted that the acceptance limit on SDRs meant that members could not dispose of the asset for the sole purpose of changing the composition of their reserves. A balance of payments need was required for members to dispose of SDRs. He saw the use by developing countries of their SDRs as normal, since those were the countries that most often had balance of payments problems; it was not certain that countries were disposing of SDRs because of the less favorable characteristics of the asset.

Mr. Vasudevan stated that his views on the issue of the allocation of SDRs were well known. He required very little persuasion to agree that the quality of reserve assets would improve if owned reserves increased at a faster rate than borrowed reserves. It was also clear that international financial markets did not provide funds as easily as they had in the 1970s and that supplies of reserves had shown sudden and marked shifts. In view of the generally limited availability of borrowed reserves, it had become necessary for most countries to build up owned reserves. It was difficult to accept that owned reserves of developing countries could be built up by severe adjustment without restricting imports. The world economic growth rate had not been sufficiently high to boost the volume of exports of developing countries, and low commodity prices and deteriorating terms of trade had been to the disadvantage of most developing countries. In addition, protectionism existed in a number of forms. In the circumstances, export growth had been constrained by a less than hospitable international economic environment, with the result that reserves of developing countries had dwindled over the past year.

Some countries experiencing serious difficulties in making debt service and amortization payments required periodic refinancing, which could not be met in the short run by asking countries to adjust further in current economic and trading conditions, Mr. Vasudevan noted. Their need for refinancing had to be met by a mechanism such as regular allocations of SDRs, a point clearly reflected in the Chairman's proposal in an allocation for the Third Basic Period.

An SDR allocation at present would satisfy the long-term reserve need shown by the decline in the ratio of non-gold reserves to imports since 1978, when the previous allocation in the Third Basic Period had been agreed, Mr. Vasudevan continued. He had taken note of the remarkable stability in the ratio of non-gold reserves to imports over the past ten years, a stability that reflected a demand or need for reserves. He had also noted the staff's projection of reserve needs through end-1991 and could accept the staff's assumptions about the growth rates of imports over the next five years, the projected average ratio of reserves to imports for all countries, and the view that there would be an additional demand of SDR 171 billion of non-gold reserves at end-1991. He could also support the staff's suggestion that the demand for reserves by industrial countries would rise by SDR 105 billion, and by capital-importing developing countries by SDR 50 billion, in the next five years. Surely those projections established a long-term global need for reserves.

The estimate of SDR 50 billion in reserve demand years by capital-importing developing countries was not even sufficient to meet the reserve requirements of some of the indebted developing countries among them, Mr. Vasudevan considered. Mechanisms must therefore be created to resolve the problem of reserve inadequacy of highly indebted countries with serious reserve shortages. In that context, Mr. Sengupta had made a suggestion during the Board's discussion in January on the role of the SDR, a suggestion that he hoped would receive the support of the Executive Board.

The argument that a larger SDR allocation would increase the share of SDRs in total non-gold reserves and contribute to the efficiency and stability of the international monetary system was well known, Mr. Vasudevan noted. In that context, the Group of Twenty-Four had suggested an annual allocation of SDR 15 billion. As he saw it, such an allocation of SDRs would provide strong incentives to developing countries to adopt and sustain adjustment measures, in view of the growing restrictions on access to financial markets and the falling commodity and oil prices. An allocation would not have an inflationary impact, not only for the technical reasons shown on page 16 of the staff paper but also because there was a growing awareness among industrial countries of the need to coordinate their policies toward sustaining price stability and economic expansion. Finally, growth in the share of SDRs in the total of non-gold reserves was important to facilitate the attainment of the Fund's major purposes--namely, balanced growth of international trade, a stable system of exchange rates, and the avoidance of competitive depreciations. He strongly encouraged his colleagues to agree quickly to a substantial allocation of SDRs along the lines suggested by the Group of Twenty-Four.

Mr. Weitz stated that he also strongly supported annual allocations of SDR 15 billion as a minimum. Such allocations could change the current imbalance between borrowed and nonborrowed reserves, an imbalance that was an important factor in the current fragility of the international financing system and imposed a heavy burden on countries that had no access to capital markets, or that could gain access only by paying higher spreads.

Most of the arguments for a new SDR allocation had been carefully analyzed in the staff paper and in previous discussions on the role of the SDR, Mr. Weitz continued. Nonetheless, some points should be highlighted. First, according to Table 1 of the staff report, the international reserve position of developing countries in 1985 had deteriorated, as non-gold reserves had declined by 4 percent in those countries. The decline had been even sharper in the case of capital-importing countries experiencing debt-servicing problems, as those countries had seen their stock of reserves decline by 11 percent. Recent developments confirmed his belief that one of the most serious deficiencies of the system under which countries relied on borrowed reserves was that commercial banks--which were responsible for the supply of those reserves, tended to withdraw just at the moment when their resources were most needed. Since 1982, most indebted developing countries had had to face such behavior by the commercial banks. Second, the relevant concept of liquidity did not include only the monetary authorities' holdings of reserve assets; it also included credit arrangements that permitted the acquisition of borrowed reserves. Thus, the actual scarcity of liquidity in many developing countries had been underestimated in Table 1, which covered only reserve assets held by the monetary authorities and did not reflect the decline in or lack of access of most developing countries to private capital markets since 1982. Third, since the availability of borrowed reserves depended on access to private capital markets, the major difficulty in the present system was the distribution of international liquidity. Many developing countries that had adopted strong adjustment policies in the past few years had not recovered their creditworthiness and, hence, were unable to obtain the minimum reserves required to make compatible their ajdustment efforts with their urgent need to grow.

The vigorous adjustment efforts of the developing countries, together with a decline in capital inflows and high interest rates, had resulted in a massive resource transfer from developing to developed countries, Mr. Weitz observed. In that context, the rebuilding of reserves to reduce the vulnerability of developing countries to external shocks and increase their creditworthiness could be accomplished only by deepening the negative resource transfer that undermined the prospects for investment and growth in the developing countries. Appropriate allocations of SDRs, by fostering the growth of output and trade, would not lead to a relaxation of the strong adjustment efforts being undertaken by many developing countries; on the contrary, allocations would help to make those efforts more feasible and sustainable from an economic, political, and social point of view.

As he had noted in previous discussions, there were neither shortages nor excesses of reserves for those countries able to borrow reserves in the capital markets, Mr. Weitz remarked. However, an urgent and acute need for reserves existed among those indebted developing countries unable to borrow in the markets. That asymetrical situation raised once again a good argument for the link between allocation of SDRs and development financing.

At the present stage of discussions on the role of SDRs and on new allocations, the Executive Board should attempt to devise new procedures that would enable the Fund to change the distribution mechanism for SDRs, without damaging the unconditional character of the asset, so as to take into account the particular needs of different countries at the time of the allocation, Mr. Weitz said. Finally, he joined others in noting that, since 1980, the Executive Board had held a great many discussions on the question of an allocation in the Fourth Basic Period. It was time for action rather than for more studies, and there was no question in his mind that the time was ripe for all countries to show their political willingness to stabilize the international monetary system. His authorities urged those few countries that continued to have doubts about the beneficial effects of an SDR allocation to reconsider their position before the next Interim Committee meeting.

Mr. Leonard agreed with others that there was little new to be said on the subject of an SDR allocation. The arguments both for and against an allocation had been made on any number of occasions in the past, and discussions on the role of the SDR earlier in the year had permitted an even more thorough airing of views. As the Chairman had noted during the most recent of those discussions all that remained was for members to muster the political will to make a positive decision. Without that political will, the technical arguments that had been advanced by the staff and the proposals that had been put forward by a number of Directors--eloquent and reasoned though they might be--would not bring the membership any closer to a positive decision on allocations.

In the past, his chair had argued for a modest allocation of, say, SDR 5 billion a year, Mr. Leonard recalled. He would not repeat the arguments in favor of that position and would only say that the majority of countries in his constituency continued to favor an allocation. In present circumstances, his Canadian authorities did not wish to press for an SDR allocation; however, they would not oppose it if the required majority for an allocation could be achieved. If after the present discussion there was still no consensus in favor of an allocation, it might be wise to let the matter rest for a time.

Mr. Coumbis agreed with others that the staff had again made a convincing case for a further allocation of SDRs as a way of supplementing the supply of international reserves. The present discussion should perhaps be viewed against the background of earlier discussions on the role of the SDR and its contribution to the stability of the international monetary system. While it was widely recognized that the question of SDR allocations was viewed more from a political than from a technical or economic point of view and that what was required was the political willingness of the unconvinced to accept the merits of an SDR allocation, he saw the issue as closely connected with the future of the SDR. The question was whether Directors were willing to accept the decline and inevitable disappearance of the asset in members' reserves or whether they continued to envisage a function for it. The position of his chair on that question was clear and pragmatic. Even if he did not see the SDR as a devise for immediately resolving all the problems of the international monetary system, he strongly supported a gradual increase of SDR holdings in members' reserve portfolios. As he had noted in previous discussions, such a gradual increase would contribute to strengthening the control of the international community over the supply of reserves and would enhance the stability of the system by increasing the share of owned reserves in total reserves. The strategy of increasing owned reserves should, however, be supported by a serious effort by all Fund members to make the instrument more attractive to hold and easier to use.

On the issues raised in the staff paper, Mr. Coumbis observed that while reserve holdings had tended to increase in the period 1970-85, a modest decline in the absolute value of reserves had been registered in the period 1982-85. For various subgroups of developing countries, the decrease in reserves had been substantially different, with the largest decreases concentrated in countries with recent debt-servicing problems; and those decreases reflected the response by the financial markets to the external payments difficulties experienced in many developing countries. The developing countries with debt-servicing difficulties had been able to restore their reserves in 1983 and 1984, a development that tended to debunk the allegation sometimes made that developing countries would use allocated SDRs to increase absorption.

The ratio of non-gold reserves to imports had remained stable since 1974, especially for the industrial countries, Mr. Coumbis observed. One could expect, therefore, that total reserves would continue to grow in accordance with the growth of trade. In passing, he noted that the more sophisticated methods used by the staff for determining reserves in the medium term would probably give similar results, although he would appreciate comment from the staff on that point as well as some elaboration on the equations used and on the stability of the functions.

As he had stressed in other discussions, the market evaluation of the creditworthiness of countries was not always a reliable mechanism for efficient and satisfactory distribution of reserves among countries, Mr. Coumbis said. The most serious deficiency of the present system was that the availability of borrowed reserves had been unreliable during periods of the greatest need for reserves. Furthermore, as noted by the staff, "uncertainties about the terms and conditions under which reserves would be available have led countries to try to increase their owned reserves even though this has often required a sharp contraction of imports." It should be noted that net lending to developing countries in 1984 had risen marginally and in 1985 was expected to be near zero. Another source of instability in the present system was connected with the multicurrency structure of reserves and the sudden shifts in preferences of reserve holders in currency composition. The SDR certainly had an important role to play in improving the quality of reserves and could make a significant contribution to the efficiency and stability of the international monetary system. A continuous and smooth process of allocations conducted in a long-term perspective could contribute to stabilizing the global supply of financing while avoiding distributional asymmetry. The role of the SDR as a safety net for the international financial system had been recognized in the G-10 report; and since the SDR was defined as a basket of currencies, its value was likely to show less variability than any one of the component currencies. Unfortunately, however, there were constraints on the utilization of the SDR in its present form that tended to limit the attractiveness of the asset. The evidence presented by the staff in Table 4 of its paper confirmed that view.

In February 1986, the Board had extensively discussed the function of the SDR as a unit of account and as a numeraire as well as ways and means of improving its characteristics, Mr. Coumbis recalled. In that regard, he reiterated a proposal his chair had made in the past for a study of the prospects for a triangular procedure involving commercial banks, monetary authorities, and an international institution--like the BIS or the Fund--acting as a clearing house to mobilize official SDR holdings in the private markets.

The issue of reconstitution had recently been discussed in international fora, Mr. Coumbis noted. He would be interested in a further study by the staff on that subject, provided that his colleagues, including those presently opposed to SDR allocation, could support such a study. More generally, however, he continued to favor proposals that more directly addressed the problem of attractiveness of the SDR, even if their review required more time.

Mr. Huang expressed his disappointment that the question of a new SDR allocation had been discussed for a number of years without producing agreement among members. He hoped that the present Board discussion would result in some positive progress toward agreement. One of the fundamental objectives of the Fund, embodied in its Articles of Agreement, was to make the special drawing right the principal reserve asset in the international monetary system. However, since the first allocation of SDRs in the early 1970s, little progress toward that end had been made, and the ratio of allocated SDRs to non-gold reserves had failed to increase. Indeed, it had fallen from a peak of 8.4 percent in 1972 to 5.4 percent in 1985; and the latter figure would have been even smaller if SDRs had been looked at in relation to total reserves. The very small share of total

SDR allocations in non-gold reserves and the recent slowdown in the rate of reserve accumulation adversely affected the sustainability of the ratios of non-gold reserves to imports considered desirable by many countries. They also indicated the need for a new SDR allocation to build up reserves to an appropriate level and make the SDR the principal reserve asset in the system and, ultimately, to meet the growing need for reserves as a result of the expansion of international trade projected in the world economic outlook.

It was clear from the staff paper that the holdings of non-gold reserves by all countries had grown roughly in line with world imports throughout most of the period since the early 1970s, Mr. Huang continued. However, one should not get the impression from that development that the ratio of non-gold reserves to imports would be appropriate only if the historical averages were met, especially in view of the variable ratios and different degrees of demand for non-gold reserves among different groups of developing countries. It was also important to note that any small improvement in the level of reserves by the developing countries had been achieved by sacrificing imports and long-term economic development; therefore, the non-gold reserve ratio would be smaller and the need to increase the level of non-gold reserves would be larger than those numbers indicated by the staff if import cuts by developing countries were taken into account.

In spite of some improvement in the balance of payments positions of many developing countries in recent years, their trade deficits and financing needs continued to be very large, Mr. Huang commented. However, unstable prices on world commodity markets--particularly the recent fall of oil prices--and the emergence of protectionism in the major industrial countries had made it more difficult for developing countries to generate current account surpluses to build up their reserves. The financial markets had also proved to be an unstable source of borrowed reserves for many developing countries. Those countries facing serious debt problems had little access to financial markets and, more important, large proportions of their export earnings went toward repayment of the debt. It was unrealistic to expect those countries at present to increase their reserves through current account surpluses. In addition, the high interest rates prevailing in the industrial countries had led to large capital flows out of the developing countries and had reduced the resources available to countries in real need of reserves and liquidity. High interest rates aimed at maximizing profits and the failure of market allocations of resources to meet the real financing needs of countries indicated not only the need for a new SDR allocation; they also showed that something was wrong with the present system.

The Articles of Agreement provided that SDRs should be allocated in proportion to members' quotas, Mr. Huang observed. However, the demand and real need for SDRs by industrial and developing countries, both in the past and at present, were not equal. Data in Table 4 of the staff paper showed that SDR holdings by the developing countries in 1985 accounted for only 47.5 percent of cumulative allocations, while SDR holdings by the industrial countries had remained above 100 percent, except in the years of quota subscription, thus reflecting less need by those countries for reserves and liquidity. It seemed reasonable in the circumstances for developing countries to call on the developed countries to forego their shares in a special SDR allocation as proposed by the G-24 Ministers in their latest communiqué.

Welcoming the Fund staff's support for a new allocation in the Fifth Basic Period, Mr. Huang said that he supported the conclusion that a long-term global need for reserves existed, that the inflationary danger of increasing the SDR component of reserves was minimal, especially at present, and that there was little likelihood that allocations of modest amounts through the Fifth Basic Period would induce delays in necessary balance of payments adjustment. Once a positive decision to allocate had been taken, the magnitude of the allocation could be further discussed. In conclusion, stressing that a new SDR allocation was primarily a matter of political will, he hoped that progress toward a new allocation could be made during the year.

Mr. Alfidja observed that the position of his chair on SDR allocations had not changed since the previous discussion. His authorities continued to support an allocation of SDRs, particularly in light of the recent discussions on the role of the SDR in the international monetary system. The series of studies undertaken by the staff on that subject had led him to conclude that, if the SDR were to play a meaningful role in the system, serious consideration must be given to the supply aspects of the instrument. Allocations that were consistent with the stability of the world economy and with the growth of world trade could alleviate some of the systemic weaknesses of the present mechanism of reserve creation and distribution. However, some Directors holding a substantial share of voting power in the Fund questioned the usefulness of allocations and continued to believe that the time for them was not yet ripe.

As the Chairman had rightly pointed out in his summing up at the conclusion of the discussion on the potential contribution of the SDR to economic stability, "technical arguments would convince no one in the absence of political willingness to move ahead," Mr. Alfidja continued. Without questioning the validity of that statement, he would again urge those chairs that continued to oppose the allocation of SDRs to change their position to make an allocation possible.

Mr. Mtei remarked that the basic conclusion to be drawn from SM/86/44 and from other similar papers that had preceded it was that an allocation at present was not only justified under the Articles of Agreement but also made good sense in light of the current state of the world economy. If previous discussions on the issue of SDR allocations were any guide, the real task of Directors in the present meeting was to encourage those few countries that had thus far opposed SDR allocations to develop the political will to join the large majority of the Fund membership supporting allocations.

As the position of his chair in favor of an SDR allocation had not changed, he would limit himself to highlighting a few main points, Mr. Mtei continued. Many countries, especially the heavily indebted developing countries, faced a shortage of liquidity; in the absence of access to private financial markets, those countries could only increase their reserves by generating surpluses in the current account of their balance of payments. Such an approach often required a sharp contraction in imports and in economic growth and, ultimately, in the standard of living of the people. Allocations of SDRs would help those countries to build up their reserves without having to impose such high costs on their economies. Even if borrowing from the private markets were possible--as it was for some indebted countries--one must be concerned about the basic instability of a system in which the acquisition of reserves and an increase in indebtedness went hand in hand. At some point, as recent experience had shown, financing difficulties must develop. It was at the point of greatest need that countries realized that they could not rely on borrowed funds as a major source of their reserves. However, many low-income developing countries had no access whatsoever to private capital markets, and any increase in their reserves must be achieved through surpluses in the current account of the balance of payments.

It was clear from experience that drastic and unpredictable changes could occur in the terms and conditions on which international liquidity was made available through the borrowing mechanism, Mr. Mtei remarked. The problems and uncertainties associated with such changes would be greatly diminished, if not eliminated, if additions to reserves were made through an allocation of SDRs. In his view, an allocation was clearly consistent with the provision in the Articles requiring that the Fund seek to supplement existing reserve assets--as and when a global need for reserves arose--in a manner that would promote the attainment of its purposes. Those purposes were spelled out in the Articles and included a balanced growth in international trade, a stable exchange rate system, and the avoidance of economic stagnation as well as inflation in the world. Since an allocation would help countries to undertake adjustment programs without curtailing imports to the extent that many had been forced to do in the absence of adequate foreign exchange, it could not but facilitate the balanced growth of international trade.

The increased use of the SDR would also contribute to exchange rate stability, Mr. Mtei considered. Its value as a reserve asset was likely to show less variability, since it was defined in terms of a basket of currencies. Moreover, in response to those who were concerned about the inflationary impact of SDR allocations, the data presented in the staff report again made clear that, even if all allocated SDRs were monetized, "...SDR allocations designed to meet the long-term global need for reserves are not likely to be inflationary or to create expectations of high inflation." It was also not likely that countries pursuing adjustment programs would be tempted to relax their adjustment efforts because of SDR allocations. Since the amount of allocations that would be made available to developing countries would be insignificant in relation to members' total financing needs, those countries would have more to gain by remaining on an appropriate adjustment course--both directly from the implementation of reform measures, and indirectly by strengthening the confidence of the international community in their economies and thus inducing increased capital inflows--than by relaxing the adjustment effort.

Mrs. Ploix reiterated the position of her chair in favor of an SDR allocation. On the whole, she supported the arguments developed by the staff in its paper as well as those expressed by Mr. Polak during the course of the discussion. It seemed clear that the obligation of a country to acquire reserves through balance of payments surpluses could be an obstacle to growth, and flows of international aid were insufficient to meet the problem. Moreover, recourse to borrowed resources was sometimes impossible. It should perhaps be pointed out in that context that net withdrawal of commercial bank loans and net negative flows from the Fund were projected for 1986 and 1987 and that reserves were decreasing in countries in Latin America and were already at insufficient levels in Africa. Reliance solely on the capital markets for a regular supply of liquidity to the system was unsatisfactory, given the abrupt changes in that supply that could be provoked by the collective reaction of the markets to individual countries.

She continued to be unconvinced by the arguments of those who remained opposed to an SDR allocation, Mrs. Ploix continued. It was unlikely that an allocation would have any measurable impact on inflation, given the relatively small size of allocations being discussed and the reduced opposition to obligations of reconstitution. In response to those who felt that an allocation would lead countries to relax their adjustment effort, she considered that it was more likely that countries would stop adjusting if the effort was too costly, either politically or socially; some countries that had only recently moved to democratic systems still had fragile governments, the stabilization of which must be sought.

With regard to the various proposals aimed at allowing modifications in the use of SDRs among member countries following a new allocation decision, Mrs. Ploix observed that the view of her authorities was that the criteria should be tied to reserve situations and to quotas rather than to incomes or current account positions, since the problem was one of reserve instruments rather than of financial means. In that connection, some form of soft conditionality would be necessary, with a view to avoiding a weakening of the commitment of the authorities to the adjustment process in the beneficiary countries. Finally, she agreed with Mr. Alfidja and others that technical arguments in favor of an allocation would convince no one in the absence of political willingness to move forward.

Mr. Salehkhou recalled that in recent discussions on the implications of changes in the international monetary system for the role of the SDR, shortcomings and deficiencies of the present system had been recognized; the need to improve the functioning of the system had been generally agreed upon; and the asymmetries of the distribution of benefits and the costs of reserve creation had been discussed by Directors, who had been in broad agreement that private financial institutions--the main source of reserves--had in practice shown some weaknesses and even perhaps some reluctance in correctly assessing the creditworthiness of member countries and in responding in timely fashion to their reserve needs. In the subsequent discussion on the potential contribution of the SDR to economic stability, Directors had also considered the role envisaged for the SDR as a unit of account, a basket of currencies, and a safety net, as well as its contribution to the stability of the system, to increasing the proportion of owned reserves, and to the regulation of international liquidity. The latest staff paper on the SDR elaborated upon the requirements for an allocation in line with recent developments in the world economy and in the international reserves and liquidity situation.

Notwithstanding that the floating exchange rate system reduced the need for members to hold reserves, holdings had increased in line with import growth, Mr. Salehkhou observed. The adequacy of reserves could support the policy stance of member countries and, as a shock absorber, could protect them from uncertainties that existed in the international economic environment. The rebuilding of reserves by member countries was an important objective of Fund-supported adjustment programs, which seemed to give legitimacy to the demand for reserves. In that regard, while developed countries were in a position to satisfy their needs for sufficient reserves through easy borrowing, other countries without access to private markets must accumulate reserves mainly through balance of payments surpluses. As noted in the staff report, while the reserves of industrial countries had remained unchanged in 1985, those of the developing countries had declined by about 4 percent. It was also worth mentioning that while the ratio of non-gold reserves to imports by countries with debt-servicing problems had increased considerably, from 17 percent in 1982 to 30 percent in 1985, that apparent improvement partly reflected a compression in their imports. In the circumstances, the availability of the SDR as an owned reserve asset remained the most efficient way of contributing to the stability of the present system and meeting developing countries' needs for reserves.

The cost-benefit analysis of SDR allocations conducted by the staff clearly gave more favorable weight to allocations, Mr. Salehkhou commented. The concern raised by some industrial countries that an allocation could have inflationary effects in a multiple currency exchange system was not at present a matter of concern. Taking into account the size of the requested allocation in relation to non-gold reserves in the developing countries, together with the controllable inflationary impact on the monetary base of industrial countries, "especially in a situation where the monetary authorities generally achieved their announced monetary targets," the inflationary danger of an allocation had been considerably minimized and would not automatically lead to a corresponding relaxation of monetary policy.

Another argument raised by some industrial country members was that "SDR allocation might result in delaying necessary adjustment," Mr. Salehkhou recalled. That argument was also not convincing. The ratio of cumulative allocations to total international reserves and their distribution was not so high as to act as a disincentive for countries continuing the process of economic adjustment. In fact, the achievement of a more viable external position required an increase in reserves for almost all countries undertaking adjustment, and an SDR allocation would help them to acquire and hold necessary reserves and pursue orderly adjustment policies. It would thus be discouraging in the current period of uncertainty if the Fund were to abandon a means of reserve creation that could play such a meaningful role in the system.

The staff's quantitative assessment of the long-term global need for reserves provided strong evidence of a relatively stable relationship between non-gold reserves and imports, Mr. Salehkhou noted. Given the staff's projection in the current world economic outlook papers of the SDR value of imports during the Fifth Basic Period, there would seem to be a need for an increase in total non-gold reserves of SDR 171 billion by end-1991 in order to maintain the ratio at the average for the period 1974-85. The U.S. initiative to help developing country debtors resume economic growth supported a shift from austerity to sustainable growth and stressed the need for new money to be injected into their economies. Given the existing trend in the system that had global liquidity implications, and the lack of a timely response by private financial markets to developing countries' reserve needs, especially at a time when countries with debt-servicing problems were undertaking painful adjustment, a two-year special allocation with SDR 25-30 billion in the first year--with industrial countries foregoing their share--appeared justified. With such an allocation, which had been supported by the Group of Twenty-Four, the ratio of cumulative allocations of SDRs to total non-gold reserves at end-1987 would not increase significantly above its 1973 level.

At the Annual Meetings in Seoul, the Managing Director had taken note of the contraction of financial markets and had spoken of the Fund's role in providing liquidity to the system through the SDR mechanism, Mr. Salehkhou recalled. Moreover, as had again been stated in the summing up at the conclusion of the recent Board discussion on the contribution of the SDR to economic stability, "technical arguments will convince no one in the absence of political willingness to move ahead." In the circumstances, while welcoming the present discussion, he hoped that those few members who had found it difficult thus far to agree to an allocation would reconsider their position so that the Board could reach a consensus on a critical issue on which all technical arguments had already been heard. However, the present discussion gave him no reason to think that his hope would be realized.

Mr. Alhaimus stated that his chair had always endorsed a resumption of SDR allocations that could contribute to alleviating members' increasing need for reserves while having a positive impact on the system in line with the objectives of the Articles of Agreement. The long list of staff papers that had been prepared over the past few years on the question of an SDR allocation had clarified the issues and, on the whole, established a convincing case for further allocation. The latest paper provided a particularly useful analysis in light of recent changes in the world economy and the international monetary system. He strongly endorsed the staff's conclusions and associated himself with those Directors who had stressed that what was lacking at present was the political willingness, rather than additional technical arguments, for a resumption of allocations.

Mr. Lundstrom stated that he was in broad agreement with the arguments and conclusions presented in the staff paper (SM/86/44) and recalled that his chair had on two recent occasions provided a comprehensive account of its views on fundamental aspects of the SDR in the system. He favored a continued active role for the SDR, noting that the modalities of that role could be further discussed. In particular, he had observed that an increase in the proportion of SDRs in reserves tended to improve the quality of reserves. He had also argued that, at the same time, a case could be made for improving the attractiveness of the SDR as a reserve asset.

Regular allocations were a prerequisite for the credibility of the asset and for the continued role that the SDR should play in the system, Mr. Lundstrom continued. The staff had presented proposals for allocations of different size based on estimated developments of economic variables. He continued to favor an allocation of moderate size, although he believed that reaching a consensus on allocations was more important than the precise size of any allocation.

He was in broad agreement with the thrust of Mr. Polak's remarks as well as with his analysis and the conclusions he had drawn from it, Mr. Lundstrom continued. Those arguments, the staff paper, and the current discussion should enable the Managing Director to report to the Interim Committee that, even if positions had not changed, facts and findings were emerging that merited further consideration and that might, in the end, make it even more difficult not to change certain positions.

Mr. Romuáldez stated that, as was the case with other Directors, the position of his chair had not changed. As his constituency continued to reflect the same differences of view demonstrated in the Executive Board, he asked that his chair be recorded as unable to arrive at a consensus on the question.

The Director of the Research Department observed that a number of Directors had referred to the statement on page 14 of the staff paper that "under normal conditions, there is neither a shortage nor an excess of reserves in purely quantitative terms for the group of countries regarded as creditworthy in international credit markets." Having remarked on that sentence, those Directors had gone on to suggest that there was only a distributional argument for the allocation of reserves. As he saw it, while a distributional argument might well be made, a systemic argument was also possible. The first element of that argument was the importance of owned reserves in the system, an issue to which the staff had given great weight. Second, it was crucial to the system that the needs of non-creditworthy countries were met. That was not to say that the need for reserves of those countries must be satisfied only by an allocation of

SDRs; but their reserve requirements must be satisfied in a manner that was not disruptive to the system, and he would argue that modest allocations of SDRs in present circumstances could make a contribution to the performance of the system. Third, it was important to the system to ensure that no deflationary bias derived from the necessary struggle for surplus positions that ensued in circumstances such as those pertaining at present.

It had been surmised by Mr. Coumbis that if the staff were to present its more sophisticated means of analyzing the demand for reserves, those analyses would show stability in the demand for reserves similar to that shown by the ratios of reserves to imports, the Director continued. In confirming Mr. Coumbis' assumption, he noted that equations pertaining to the demand for reserves in a recent departmental memorandum entitled "The Stability of the Demand for International Reserves" had been discussed and developed in SM/86/44. Those equations exhibited a stability revealed in the econometric features of the estimates of the parameters of the equations. The paper on "The Stability of the Demand for International Reserves":

> examines the recent stability of the demand for international reserves by comparing the estimation results obtained for a set of representative models of this demand for a sample period encompassing the 1960s and 1970s with the results generated by using an enlarged sample period including data from the early 1980s. These results are used to consider whether the relative importance of the various determinants of the long-run demand for reserves has changed over time and whether the speed of adjustment of actual desired reserves has been altered by the emergence of disturbances in international financial markets in the early 1980s.

Three general conclusions emerged from that paper, the Director of the Research Department noted. First, the shifts in the demands for reserves associated with the disturbances in international financial markets during the early 1980s for many country groups had been significant; indeed, they had been at least as significant as those experienced during the collapse of the Bretton Woods system in the early 1970s. Second, for the equilibrium formulations of the demand for reserves, the structural instability reflected an increase in the sensitivity of the demand for reserves to balance of payments variability and the economy's openness. Finally, for disequilibrium formulations of the demand for reserves, instability appeared to be more closely associated with changes in the speed of adjustment of actual reserves to the desired level than with changes in the structure of the long-term demand for reserves. Finally, and as a general matter, the fact that it was possible to estimate equations of the demand for reserves that exhibited good statistical qualities reflected a kind of stability in the demand for reserves.

The Deputy Director of the Research Department said that he had taken note of the emphasis placed by a number of speakers on the relationship between SDR allocations and the quality of the asset. In particular, those who were concerned that allocated SDRs would tend to be used and not reconstituted--and would thus represent a transfer of resources, which was contrary to the purposes of an allocation--would be reassured if there were an improvement in the quality of the SDR that would make SDR balances more attractive to hold. Of course, even if improvements in the quality of the SDR were made, SDRs could still be used by holders when needed, but they would then be more likely to be reconstituted.

It had been suggested by one or two Directors that the staff had not shown the existence of a global shortage of reserves, the Deputy Director continued. Mr. Grosche, for example, had suggested that the staff had projected a demand for reserves but had not projected a supply of reserves from other sources. He had gone on to note that, in the absence of a projection for supply, it was not possible to say that a future shortage of reserves existed that would warrant the allocation of SDRs. It should perhaps be noted that the Articles of Agreement did not call for SDR allocation to relieve a global shortage of reserves; they required only a global need for reserves supplementation. In other words, all that was required was that world economic conditions be such that an increase in SDRs would cause an improvement in those conditions. Of course, a shortage of reserves would call for reserves supplementation; but even if all the demand for reserves could be satisfied by other sources of reserve creation, there would remain the question of whether world economic conditions could be improved by an SDR allocation.

In commenting on reserve ratios and reserve functions, one Director had observed that particularly low reserve ratios for industrial countries--which had no difficulty in maintaining adequate reserves--tended to prove that the ratio was not particularly reliable as a measurement of global reserve need, the Deputy Director remarked. As he saw it, it was more important to look at global reserve ratios as reflecting the global demand for reserves; the ratios for individual countries might well be useful in other contexts, but not as a measure of global demand. Finally, Mr. Grosche was correct in noting that during 1985 non-gold reserves measured in U.S. dollars would be seen to have risen by more than $40 billion, or about 10 percent, while they had slightly declined when measured in SDRs. One reason for looking at the ratio of reserves to imports was to avoid the question of the valuation of reserves. In any event, the absolute amount of reserves was far less interesting than the amount in relation to some other relevant magnitudes.

Mr. Polak recalled that Mr. Grosche and others had asked whether, if reserves were always sufficient, they could ever be defined as being short. The answer to the question was that what was sufficient at present might not be sufficient in future. Reserves had to rise in order to remain sufficient; and it was that required addition that was clear from the various ratios put forward by the staff.

Mr. Grosche considered that the demand for reserves or its stability was not so important as whether a certain demand could be satisfied by means other than an SDR allocation. The idea that the supply of reserves had to steadily increase from one year to the next gave him some difficulty. In the 1970s, the supply of reserves had been abundant, but the demand for reserves had responded in a way that had done damage to the system. The real question was how a supply of reserves could be provided in a way that did not hamper the development of the international monetary system.

The Chairman, agreeing with Mr. Grosche, noted that a number of countries pursuing adjustment policies had a need to bolster their reserves but could not do so through bank borrowing. Thus, those countries were obliged to moderate the pace of their imports. That moderation led to a stability in the ratio of reserves to imports, albeit at the expense of growth in world trade.

Mr. Polak added that Mr. Grosche's concerns were perhaps related to the experience in 1971 and 1972, when the reserve ratio had shot up for all countries combined. That increase had represented the end of the fixed rate system, when dollars had been created on a large scale and had been purchased by all countries for their reserves. That occasion had been the only one he could recall when reserves had overshot demand and had produced inflation on a global scale; but that system no longer existed.

The Chairman made the following summing up:

Views expressed at Meeting 86/54 on the question of an allocation of SDRs reflect the positions on this issue that members have held for some time. Most Directors continue to favor an allocation of SDRs for the following reasons:

1. There is strong evidence, in their opinion, of a persistent need to supplement global reserves. The ratio of non-gold reserves to trade is seen as stable; thus, if trade is to increase, there is a systemic need to increase reserves.

2. Indebted countries have made considerable efforts to maintain or restore their reserve ratios or levels, sometimes at the cost of dampening import growth. Their action is not a sign of a tendency on their part to increase absorption.

3. The present financial mechanism whereby the commercial banks supply borrowed reserves is not able to furnish adequate liquidity to the international monetary system as a whole. Indeed, many countries, some of which are pursuing strong adjustment policies, have de facto no more access to financial markets.

4. In the absence of an SDR allocation, and given the stability of the reserve/import ratios, there is a real risk that a large segment of the Fund membership will be able to maintain levels of reserves only by import compression. The recessionary danger of such a situation should, in the view of those favoring an allocation, not be underestimated.

5. The need for an increase in owned reserves versus borrowed reserves is at the heart of the allocation question. Relying entirely on current account surpluses to increase reserves for a large number of members is seen as incompatible with the desirable expansion of world trade and the growth-oriented strategy.

6. An allocation of SDRs would not, in their view, impair the determination of countries to adjust. On the contrary, it would encourage the continuation of orderly efforts to adjust and would show the international community that the SDR system is being activated at the right time in the framework of a medium- to longer-term global effort to stabilize the functioning of the system and facilitate the implementation of the debt strategy.

The relative weights put on the arguments for an allocation varied among Directors, and the amounts of allocation which they favored differed correspondingly. One group looked toward an allocation of SDR 3-4 billion a year, while others expressed a preference for a much larger allocation of the order of SDR 15 billion. But, perhaps more importantly, a number of Directors stated that the exact amounts could be better negotiated once the decision of principle on an allocation had been taken.

Those few Directors who do not favor an SDR allocation at present made the following points:

1. They indicated that they are not convinced by the staff presentation of the existence of a long-term global need for reserve supplementation, with some doubting the validity of the global ratios used by the staff as an appropriate measurement of such need.

2. As the staff itself admits, there is no shortage of reserves in quantitative terms for creditworthy countries; thus, the problem is not a global shortage of reserves but a distributional problem. If noncreditworthy countries have little or no access to borrowed reserves, it is that factor that must be addressed and corrected; an allocation of SDRs, the largest part of which would be channeled to the countries that have no established need for an increase

in their reserves, is not relevant to the nature of the problem. Some Directors noted, in that regard, that more adjustment, more bilateral aid, and/or increased use of Fund conditional resources would be more suitable ways of solving the problem.

3. The experience, as shown in SM/86/44 (2/26/86), is that SDRs tend not to be held by the very group of countries whose need is cited as justification for an allocation; that persistent absorption of SDRs, if repeated following an allocation, would constitute a permanent transfer of resources and would thus be contrary to the very purpose of the SDR.

Having outlined the expressed positions of Directors on the question of an allocation of SDRs, I should perhaps make a few remarks on the matter. We have had a more lively discussion on the allocation issue than we have had for some time; and new facts and arguments have been aired today that I think must be conveyed to the Ministers. In that respect, I have the sense that the unwillingness to allocate SDRs that we have heard from speakers today is to some extent the manifestation of an unwillingness to hold SDRs. Not all those opposed to allocation made that point, but some stated it frankly.

Without a willingness to hold SDRs, there will be no allocation of SDRs. Hence the question to be answered is "how to improve the willingness to hold SDRs." We have toward that end already established the SDR yield at 100 percent of the basket interest rates, and we could perhaps look at its relationship to Euromarket rates. But I do not think the answer lies so much in a better yield as in a better "rotation." The persistent utilization of SDRs by one group of countries raises a rather fundamental point; and it might be worth examining the suggestion by one Director to put some "teeth" into the provision of the Articles that recommends a more stable relationship between holdings of SDRs and other reserve assets. In that respect, the use of a technique similar to "reconstitution" might help to reduce the persistent use of SDRs by some countries and might thus facilitate the effort to reach agreement on an allocation.

World economic conditions at present are uncertain and difficult for a number of countries, and international collaboration is a necessity. The SDR is one aspect of the collaboration mechanism. Even if there are some legitimate doubts on the technical arguments in favor of an allocation, I think it is important to show that there is a political willingness to go ahead. While the ideas put forward at our meeting by some speakers might not be shared by all, I think they could provide a way of looking at the allocation issue with perhaps greater realism and with better chances for progress.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/53 (3/25/86) and EBM/86/54 (3/25/86).

4. GUINEA - REPRESENTATIVE RATE FOR GUINEAN FRANC

The Fund finds, after consultation with the authorities of Guinea, that the representative exchange rate for the Guinean franc under Rule O-2(b)(i) is the fixed relationship of its official exchange rate to the U.S. dollar, which currently is US$1 = GF 300. The Central Bank of the Republic of Guinea will promptly inform the Fund of any change in this rate and will advise it immediately of any change in the exchange system. (EBD/86/76, 3/19/86)

Decision No. 8234-(86/54) G/S, adopted
March 25, 1986

5. EXECUTIVE BOARD COMMITTEES - NOMINATION

The Executive Board approves the nomination by the Managing Director of an Executive Director to assume the vacant position on the Committee on Interpretations, as set forth in EBD/86/81 (3/21/86).

Adopted March 25, 1986

6. EXECUTIVE BOARD - INFORMAL RECESS

The proposed period for the Executive Board's informal recess, as set forth in EBAP/86/66 (3/21/86), is approved.

Adopted March 25, 1986

APPROVED: December 18, 1986

LEO VAN HOUTVEN
Secretary