04

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/204

10:00 a.m., December 19, 1986

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

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	W. K. Parmena, Temporary
Dai Q.	Jiang H.
C. H. Dallara	M. K. Bush
	M. Lundsager, Temporary
J. de Groote	H. G. Schneider
	C. A. Salinas, Temporary
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
	A. Bertuch-Samuels, Temporary
	Khong K. N., Temporary
A. Kafka	H. A. Arias
T. P. Lankester	M. Foot
H. Lundstrom	
	D. McCormack
Mawakani Samba	
Y. A. Nimatallah	I. Al-Assaf
G. Ortiz	C. Noriega, Temporary
	S. de Forges
G. A. Posthumus	J. de Beaufort Wijnholds
	C.-Y. Lim
	G. K. Hodges, Temporary
G. Salehkhou	O. Kabbaj
	A. S. Jayawardena
	A. Vasudevan, Temporary
S. Zecchini	N. Kyriazidis
	F. Di Mauro, Temporary

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

Also Present

IBRD: N. Ramachandran, Latin America and the Caribbean Regional Office. African Department: M. N. Bell, A Tahari. Asian Department: P. R. Narvekar, Director; D. Ripley, D. A. Scott, B. J. Smith. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; G. Belanger, J. T. Boorman, H. Hino, P. J. Quirk. External Relations Department: D. M. Cheney. Legal Department: F. P. Gianviti, Director; J. G. Evans, Jr., Deputy General Counsel; R. H. Munzberg, J. V. Surr. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Berthet, J. E. Blalock, A. G. Chandavarkar, P. B. Clark, D. Gupta, R. B. Hicks, Y. Kawakami, B. E. Keuppens, Y. Ozeki, B. Von Numers, G. Wittich, B. B. Zavoico. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, J. Ferrán, T. Gudac, G. R. Le Fort, C. G. Muñiz, F. van Beek. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, M. B. Chatah, L. P. Ebrill, S. M. Hassan, G. D. Hodgson, K. Murakami, A. Ouanes, G. Pineau, I. Sliper, Song G., D. C. Templeman, K. Yao. Assistants to Executive Directors: M. Arif, O. S.-M. Bethel, W. N. Engert, R. Fox, V. Govindarajan, A. Iljas, O. Isleifsson, K.-H. Kleine, T. Morita, A. H. Mustafa, D. V. Nhien, L. M. Piantini, D. Saha, G. Schurr, E. L. Walker, D. A. Woodward.

1. GUYANA - 1986 ARTICLE IV CONSULTATION; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report for the 1986 Article IV consultation with Guyana (SM/86/285, 11/26/86), together with a paper reviewing for the third time the matter of Guyana's overdue financial obligations to the Fund following the declaration of Guyana's ineligibility to use the general resources of the Fund on May 15, 1985 (EBS/86/281, 12/18/86). They also had before them a background paper on recent economic developments in Guyana (SM/86/296, 12/8/86).

The staff representative from the Treasurer's Department said that the staff had received indications that a payment of SDR 420,000 was to be paid during the day in partial settlement of the overdue Trust Fund obligation of some SDR 985,000 due September 30, 1986.

Mr. Kafka made the following statement:

> At the outset, I wish to convey the appreciation of my authorities for the staff analysis and appraisal of the current economic situation and medium-term prospects in Guyana. The formulation of a medium-term adjustment program is now under active consideration by the authorities. Their conviction is that the measures already in place, and the far-reaching ones under consideration, are important steps to reverse the economic decline experienced over the past several years, to exploit effectively Guyana's considerable natural resources so as to generate sustainable growth rates, and to secure the external financial support without which it would be extremely difficult for Guyana to address successfully its substantial economic imbalances.
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> My authorities are of the view that the critical slide of the economy into the present financial and economic crisis had its main origin in the drastic deterioration of the external environment. At the same time, the 20 percent cumulative decline in the country's terms of trade during the period 1981-83 did not elicit the required adjustment effort. As a result, internal and external imbalances widened, reserves were depleted, inflationary pressures developed and external arrears, including overdue obligations to the Fund, accumulated. As net capital inflows dried up, a growing parallel economy emerged in the context of increasing constraints on foreign exchange availability. A process of deterioration began to set in as the economic infrastructure fell into disrepair. My authorities firmly believe that sole reliance on adjustment measures to correct, immediately and in full, the principal economic imbalances could not have been sustained. In their view, such a course of action would have aggravated an already difficult economic situation with serious implications for social order. For this reason, they have begun to implement within a medium-term horizon a combination of fiscal and monetary measures with structural policies to restore balance of payments viability, break the

inflationary trend, strengthen the savings performance of the economy, and increase efficiency as the means for setting the basis for re-establishing sustainable growth. Nevertheless, they are of the view that sustained external financial support is crucial to the successful implementation of this effort.

The authorities view a strengthened public sector resource mobilization effort as central to the medium-term economic strategy. They also see the reduction in pressures associated with financing high public sector deficits as critical and as a necessary condition for the fostering of private sector initiative. Under the impact of strengthened tax measures, current revenues are expected to show a relatively strong growth--15 percent nominal increase--in 1986. Commensurately, continuous review of current expenditure has resulted in significant savings and, with capital expenditure on the decline, the overall deficit of the Central Government is projected to decline to 40.5 percent of GDP in 1986, the lowest level since 1983.

Added to this is the ongoing process of reform and rehabilitation of the major public nonfinancial corporations. The results here have been encouraging. This sector is expected to generate the first operating surplus since 1980--3 percent of GDP--and therefore the financial burden on the National Government is being reversed. Given, however, the structural dependence of the major corporations on international trade--bauxite, sugar, and rice--and the possible secular decline in commodity prices, revenue and profits of these enterprises are subject to extensive variability. Additional efforts are required to ensure their long-term viability. The rehabilitation of these enterprises, therefore, is becoming ever more urgent, especially in view of the authorities' commitment to enhance export capacities and to achieve equilibrium in the current account position of the nonfinancial public sector. In the formulation of the medium-term adjustment program they are committed to limit the overall deficit of the nonfinancial public sector to an amount consistent with the availability of external resources.

The authorities are convinced that without the appropriate external financial support, their efforts to rationalize the operations of the main productive sectors would be futile. The funding requirements in the case of bauxite have already been identified. Modest financing has already been secured from the EEC and the World Bank. Technical and financial analyses of the sugar and rice sectors are in progress. The private sector is being encouraged to take advantage of opportunities in the development of manufacturing, rice, fisheries, timber, and nonbauxite mining. Agreements have already been concluded with various private sector firms, including foreign ones, for the exploration and development of resources where prospects are favorable such as gold, diamonds, oil, and nontraditional fishing resources for exports. The authorities are confident that the rehabilitation program as envisaged, and the coming on stream of the planned new ventures are key conditions for sustaining the modest economic expansion that began in 1984; it is worth noting, however, that overall economic expansion may have been higher than officially recorded given the scope of prevailing parallel economic activities.

The creation of an environment more conducive to diversification and recovery of exports is considered critical for an easing of the external position, thus making possible some reserve accretion. To this end, the authorities believe that an appropriate exchange rate policy must be an essential element of this outward-looking strategy. They are well aware of the substantial real appreciation of the exchange rate and its possible delaying effects on the realignment of relative prices; in the context of a comprehensive economic program, however, they are prepared to adjust the official exchange rate, and to unify the exchange rate system at a credible and competitive level. Following the adjustment and the unification of the exchange rate the authorties would adopt a flexible exchange rate policy. In line with this policy to initiate a restructuring of price relativities, a phased decontrol of prices is being implemented and wage adjustments are subject to continuous review. It is to be noted that the 1985-86 wage adjustment was less than the combined inflation and productivity growth rates.

The Guyanese authorities recognize the magnitude of the external financing needs, especially in the context of its relatively high overhang of external arrears, the substantial balance of payments deficit, and the low capacity utilization of existing stock. Guyana, however, is committed to a comprehensive economic program now in its planning stages. They consider that this program will be strong enough to elicit the appropriate external financing, including debt restructuring. In this connection, they view the discharge of overdue obligations to the Fund as a necessary first step toward the restoration of their international creditworthiness. They regret that since the declaration of ineligibility to use the general resources of the Fund their payments to the Fund have been small (SDR 1.5 million), but they wish to reiterate their unwavering adherence to the principle of total liquidation of all arrears at the earliest possible moment. However, my authorities wish to point out that an increase in their current debt service payments could have an adverse impact on the minimum operational requirements that are essential for the productive drive of the Guyanese economy and could lead to a deterioration in their capacity to continue to repay. Notwithstanding this, my authorities will continue to allocate foreign exchange to the servicing of the external debt. They think it necessary, therefore, to resolve this matter as speedily as possible in the context of the medium-term adjustment program appropriately financed.

Mr. McCormack made the following statement:

At the time of the 1985 Article IV consultation with Guyana, this chair assessed Guyana's severe economic problems at some length, focusing not merely on narrow, technical economic factors but also on more general social and political considerations. The central point argued at the time was that Guyana desperately needed to adopt, in its own interest, a comprehensive and strong adjustment program. This program would not be without some adjustment costs. However, given the existing state of deterioration, the costs of inaction, or of a very gradual and slow adjustment, were likely to be as high, if not higher. These themes were reiterated at the time of Guyana's declaration of ineligibility and at the July review. In the circumstances, the remainder of my intervention can be brief.

Exogenous factors, summarized in the drastic deterioration in the terms of trade in the early 1980s, undoubtedly played a critically important part in undermining the Guyanese economy. However, the domestic policy response was ad hoc and, in retrospect, clearly inadequate. I think the position is stated in a very balanced way in the staff paper in the first paragraph on page 2. The ultimate cause, or balance of causes, is, however, somewhat irrelevant by now. The basic point is that the present position, by common consent, is unsustainable. Policy needs to be fundamentally reappraised and radically reoriented. Without such a reorientation, the prospects for the Guyanese economy seem bleak.

It should also be noted that time is no longer on Guyana's side. Delay promises to exacerbate imbalances and further limit the Guyanese authorities' room for maneuver. A continuation of the status quo will inevitably lead to growing scarcities, accelerating inflation, faster growth of the parallel economy and a diminished likelihood that external assistance will be forthcoming. Delay, or inaction points in the direction of autarky and a progressive economic and financial isolation of Guyana. It would therefore seem to represent an important threat to the political and social fabric of Guyana.

In its report, the staff clearly identifies the key adjustment measures called for. Central to any realistic program must be the restoration of an appropriate structure of relative prices, reflecting relative scarcities. In particular, the staff report notes on page 24 that "It would be necessary to establish a credible and competitive exchange rate to restore productive incentives, to help incorporate the parallel economy into the official economy and to achieve a viable balance of payments." This process of price liberalization (in the broadest sense, since it includes the exchange rate and interest rates) needs to be supported by policies of monetary restraint and fiscal retrenchement to a level in line with the availability of external concessional resources. The policy measures required to make any serious impact on the imbalances in the Guyanese economy are clear, and have been so for some time. What is called for now is the political will to implement the required policies.

After reading the staff report, I was frankly pessimistic about the prospects for the Guyanese authorities taking the requisite actions. However, Mr. Kafka, in his helpful and informative statement, has indicated that the formulation of a medium-term program is now under active consideration by the authorities. Moreover, in the context of a comprehensive economic program, the authorities are apparently prepared to adjust the official exchange rate and to unify the exchange rate system at a credible and competitive level. This seems to be a considerable step forward, and I welcome it. Moreover, I am encouraged to learn from EBS/86/281 that since the issuance of the staff report on the Article IV consultation the authorities have expressed a willingness to continue discussions with the Fund on the elements of a comprehensive economic adjustment program.

I strongly encourage continued dialogue between the Fund and the Guyanese authorities. The latter, it seems to me, are still quite hesitant about relying on the price mechanism. This is most clearly evidenced by their reservations concerning interest rates and the exchange rate. I agree thoroughly with the staff that in an economy with a flourishing parallel market, the once-for-all impact of a substantial exchange rate adjustment would not be as large as expected by the authorities on actual (as opposed to measured) prices.

The process of reaching understandings about the elements of a viable program will be helped by stressing the medium-term character of the program. If one has a short time horizon, every measure will appear to be fraught with difficulty, and only obstacles will be apparent. A primary merit of a medium-term perspective is that the mutual interrelationships and self-reinforcing character of the various measures can be appreciated. It is important to know that in recognition of these ideas, the authorities are now contemplating formulation of such a program.

The problem of Guyana's arrears is the single most clear-cut indication of how far short of international norms Guyana has fallen in the management of its economy. External arrears by the end of this year are likely to reach a level approximately twice that of measured GDP. But arrears are not only large in relation to the size of the economy; they are large in absolute terms at some US$880 million by end-1986. Arrears to the Fund alone are equivalent to some 25 percent of Guyanese exports. These are enormous figures.

> I should like to stress to the Guyanese authorities the seriousness with which we view this problem and the need for Guyana to fulfill its obligations--first to the Fund--promptly and in full. In this connection, I welcome the payment expected to be effected during the day as a token of Guyana's intentions. Implementation of a credible and comprehensive medium-term adjustment policy, along the lines described earlier, could make an important contribution to the clearance of Guyana's arrears. This would, in turn, facilitate Guyana's access to the general resources of the Fund. It would also serve as a positive indication to Guyana's creditors that it had embarked, clearly and irrevocably, on a process of economic adjustment. Finally, I can support the proposed decision.

Mr. Lankester observed that Guyana at present faced one of the most difficult economic situations of any Fund member: public debt was more than 350 percent of GNP; arrears alone were currently double GNP; and overall balance of payments deficits of some 25-30 percent of GDP were projected through 1991. Measured GNP, moreover, was growing only slowly, and the main growth sector appeared to be the underground economy. He agreed with Mr. Kafka that a major factor underlying the alarming situation had been external. Guyana had faced a serious decline in terms of trade between 1977 and 1983, and the market for its main exports remained weak. However, the depth and duration of the almost continuous state of economic crisis faced by Guyana had been made much worse than it needed to be by the authorities' failure to adapt their policies to a changing environment.

For many of the past ten years, economic policy had actually exacerbated the situation in Guyana, Mr. Lankester continued. The overall public sector deficit had been between 40 and 60 percent of GDP throughout the period 1981-86 and had been increasing through most of the period. Central government expenditure had actually exceeded recorded GDP in 1985, and the exchange rate, despite a devaluation in 1984, remained seriously and increasingly overvalued. The special rates established recently for restricted classes of trade were only limited steps toward a more credible exchange rate regime.

However, there were signs of movement in the right direction, Mr. Lankester remarked. The public sector deficit had been cut significantly, although it remained at 40 percent of GDP in 1986, and the current account of the public enterprises had been turned around to show a significant surplus. It would be interesting to hear staff comment on whether that positive trend was likely to be maintained in 1987. The rehabilitation efforts in key primary sectors, action to liberalize agricultural prices, and moves to increase private sector involvement in the production and marketing of rice were all signs of a more appropriate approach to economic policy. The authorities' acceptance of the idea that the official exchange rate was overvalued was also welcome, although their hesitancy in taking appropriate action was regrettable. A much greater commitment to adjustment was essential if Guyana was to achieve a sustainable economic position or to obtain the external financing necessary for development. So long as aid agencies felt that money granted or lent to Guyana would be used in the pursuit of substantially inappropriate or nonviable economic policies, they were unlikely to be forthcoming with new commitments. In that context, he welcomed Mr. Kafka's indication that the authorities were actively considering the formulation of a comprehensive medium-term adjustment program.

What was needed was a comprehensive overhaul of the country's economic policies, Mr. Lankester considered. The authorities simply could not continue with a public sector deficit of 40 percent or more of GDP, and a substantial cut in public expenditure must be effected. Central government spending, at more than 90 percent of measured GDP, must be urgently reduced to a more realistic level. Monetary policy must be tightened and interest rates should be raised to positive levels, taking into account the hidden inflation in the parallel economy. The exchange rate must be reduced to allow a reasonable degree of competitiveness, and the trade regime should be liberalized. Furthermore, the pricing system must be completely reformed, so that prices realistically reflected the costs of production and provided adequate incentives to ensure efficient resource allocation. Only in that way could confidence be restored and the underground economy be reintegrated into the mainstream of economic activity in Guyana, a development that should in itself make fiscal adjustment easier by broadening the tax base.

It was also essential that the authorities become current as quickly as possible in their external payments, particularly to the international financial institutions, Mr. Lankester remarked. Given the scale of the problem, it would inevitably take some time before arrears could be fully cleared. The first priority must be to regularize Guyana's position with the Fund. Arrears of more than 100 percent of quota accumulated over more than three years were wholly incompatible with the principles of the Fund. Once the overdue obligations to the Fund were cleared, the authorities should take the first steps toward regularizing their relations with commercial and bilateral creditors by adopting a Fund-assisted adjustment program on which rescheduling agreements could be based. Finally, he noted with concern the indication in the staff appraisal that the recommendations of the most recent Fund technical assistance mission to Guyana had not been followed up by the authorities. It was clear that while the Bureau of Statistics had received a favorable comment on the report from the Minister of Finance in May 1986, the mission had been informed by the chief statistician that no action for decisions had been taken to implement the recommendations contained in the report. As his colleagues had noted in a recent meeting, technical assistance was a valuable and scarce resource of the Fund. Unless Mr. Kafka or the staff could explain the reasons for the inaction of the authorities, it would seem to him that the technical assistance in the Guyanese case had been ill used.

Mr. Noriega made the following statement:

The protracted imbalances, both internal and external, which the Guyanese economy faces have been expounded upon at the Executive Board on previous occasions by the staff and by Executive Directors. In the past, this chair has also expressed its views, and as there are no significant changes in the outlook, we would not wish to repeat those views today. We are aware that the staff, in its discussions with the Guyanese authorities, has emphasized the need to liberalize foreign trade and domestic prices, reduce the fiscal deficit, and unify and liberalize the exchange rate. We agree with these recommendations, although we understand the reluctance of the authorities to adopt measures toward those ends in a short period of time. Liberalization of the economy is not necessarily a panacea, particularly when controls have been in place for a long time. The reaction of the economy could entail a loss in welfare and further delays in realizing the stated objectives of the policy.

It is a fact, however, that when imbalances exist, economic agents will attempt to evade controls, and the flourishing of a parallel economy in Guyana illustrates this point. Adjustments by the private sector are costly in terms of welfare and, in addition, they reduce the effectiveness of economic policy instruments. Thus, the current course of economic events in the country requires unavoidably a comprehensive economic program, regardless of the aim to resolve the standing foreign debt problems. The scarcity of resources makes it more difficult for the authorities to initiate such a program, but unless it is done, a vicious circle will ensue.

The milestone of an adjustment program should be to signal an assertive attitude by the authorities to redress current trends and recover the confidence of the private sector and the international financial community. The program, moreover, will have to tend toward liberalization, as there is no practical form to determine the path to be followed by the most important economic variables in the course of adjustment. A firm commitment by the authorities toward liberalization will ease foreign exchange constraints, allowing the country to reduce payments arrears and thereby reopen channels of foreign financing. We are satisfied with the indication that payments are being made and that the formulation of a medium-term program is under active consideration by the authorities. Still, we exhort the authorities to address the issues we have mentioned as soon as possible. We also support the proposed decision.

Mr. Hodges made the following statement:

The staff presents a gloomy picture both of economic developments in Guyana in the past year and of economic prospects if current policies remain unchanged. Despite measures taken by the authorities since the previous Article IV consultation and the prospect of some pickup in activity and reductions in the size of the budget deficit and the rate of inflation, Guyana's underlying economic performance continued to deteriorate over the past year.

External arrears are expected to increase by US$148 million in 1986 to a massive US$880 million (or more than twice Guyana's GNP) by the end of the year. The exchange rate remains seriously overvalued, and the parallel economy continues to flourish because of major price distortions. Despite some improvement in the public sector finances in 1986, the overall deficit remains unsustainable. Moreover, financing the deficit has been the major contributor to excessive domestic credit growth in recent years. A lack of external financing has led to import compression, pressures for trade and payments restrictions, and increasing use of countertrade and bilateral trade agreements. Moreover, the overall balance of payments continues to be seriously in deficit.

We agree with the staff that in the absence of substantive policy changes, Guyana's economic prospects are likely to deteriorate in the next few years. This is clearly borne out in the section and table in the staff report on the medium-term outlook for Guyana. We also agree with the main policy measures proposed by the staff to address Guyana's economic problems. The call for the authorities to adopt a comprehensive adjustment program to tackle these fundamental economic imbalances is not new. Many Directors who spoke at the previous Article IV discussion and at the regular reviews of Guyana's arrears to the Fund during the past year urged the authorities to adopt comprehensive adjustment measures.

The severity of Guyana's economic problems underlines the hardship the authorities face in trying to tackle these imbalances alone. As the staff notes, economic adjustment in one form or another will be inescapable, and postponing it, or opting for too gradual an adjustment path, is likely only to increase the eventual costs of the adjustment. The Fund can play an important role, even in cases of protracted economic difficulties, both as a source of financing and advice and as generator of other sources of external finance. The settlement of overdue financial obligations is an important prerequisite for Fund assistance, and we join other Directors in urging the authorities to adopt measures necessary for the prompt settlement of Guyana's outstanding arrears to the Fund. In this context, we welcome the authorities' willingness to continue discussions with the staff on developing a comprehensive economic program, and we support staff involvement in exploring the feasibility of obtaining sufficient external financing to support such a program. Finally, we have no difficulty with the proposed decision.

Ms. Lundsager made the following statement:

At our six-monthly discussion in July 1986 of Guyana's ineligibility to draw upon Fund resources, we had what we felt--and I am sure other Directors would agree--was a rather productive exchange of views with Minister Greenidge. At the time, it was accepted that the Fund and the World Bank, in their forthcoming missions, would hold intensive consultations with the Guyanese authorities with the aim of formulating a comprehensive macroeconomic and structural adjustment program that could reverse the deterioration of the Guyanese economy and generate the support of the international financial community, thus facilitating the elimination of arrears.

Six months have passed, both missions have returned, and it appears that little substantive progress has been achieved, which leaves us particularly disappointed. The Fund and the World Bank have, in our view, gone out of their way to provide detailed assistance; in response, the Guyanese authorities have adopted what appears to be a piecemeal approach to rationalization of their economy. Let me add that we noted that in a few areas, some degree of progress has been recorded: the public enterprises are running an operating surplus; rice prices have been adjusted; some other prices have been decontrolled; and various incentives have been provided to encourage the private sector. However, the beneficial effects of these steps could very likely be overwhelmed by the remaining distortions in the economy.

The staff report makes it clear that the priority need of Guyana is to restore an appropriate set of relative prices. Indeed, the Guyanese case is a clear example of the point that we were making in our recent discussions on the theoretical design of adjustment programs and performance criteria. In those discussions, we suggested that a focal point of adjustment programs should be the restoration of market-oriented pricing signals, including the exchange rate, domestic consumer and producer prices, and interest rates. Supportive fiscal and monetary policies, as well as institutional reforms, are also very important, but we argued that without the attention to pricing signals, real activity in the economy would not respond sufficiently and growth might not be restored. These are the very arguments being made in the staff report and, in fact, these are the changes that virtually all members in the Board have been urging upon the Guyanese authorities for the past several years.

The areas of needed policy change are perfectly clear, and the time is right for the authorities to implement the required measures; further discussions on the precise degree of adjustment needed in particular areas are not necessary to begin the process. In fact, the authorities would be well advised to rely to a great extent upon markets to help determine the appropriate prices.

Such comprehensive action could assist in mobilizing the sought after foreign assistance, but until the authorities make these concrete moves, we surmise that the multilateral institutions and bilateral donors will be reluctant to provide meaningful support. Specifically, we noted that earlier this month the World Bank placed Guyana's loans in "nonaccrual" status due to nonpayment, and we would appreciate World Bank staff comment on the implications of this move for World Bank relations in general with Guyana. As we noted last summer, a major World Bank loan to Guyana would be viewed as problematic by our authorities in current circumstances.

Finally, we understand that the Guyanese authorities have been honoring some of their commitments to other external creditors, which raises some concern in our mind regarding the intention of the authorities to clear their arrears to the Fund. We did note the recent payment that eliminated arrears in the SDR Department, and we welcome the latest indication of further payments. Also, Mr. Kafka has provided some assurances in his statement that the authorities "view the discharge of overdue obligations to the Fund as a necessary first step toward the restoration of international creditworthiness." But at this stage, we are looking for more than commitments; prompt action is required on two fronts, namely, the implementation of a far-reaching restructuring of economic policies and the elimination of arrears to the Fund on a priority basis. In conclusion, we can support the proposed decision.

Mr. Di Mauro made the following statement:

Unfavorable external developments and overly loose economic management are the main causes of unsatisfactory performance by the Guyanese economy in recent years. Few data are necessary to depict the situation: the overall deficit of the public sector is estimated at 41 percent of GDP in 1986, while inflationary pressures are still high in an official economy that is growing only slowly. The deficit of the current account is 32 percent of GDP, and external arrears are increasing steadily. All these developments are occurring in an economic environment in which the exchange rate is clearly overvalued, domestic relative prices are distorted, and controls on external transactions and payments are widespread. In the circumstances, we share the view of the staff that the recent timid progress in 1986 in some areas--such as in the fiscal and balance of payments accounts--is insufficient to enable the economy to reduce its imbalances and settle its payments arrears in the medium term. Therefore, we urge the authorities to implement a vigorous and timely set of adjustment policies, along the lines suggested by the staff, aimed at correcting in a convincing way the current imbalances.

As we are in agreement with the staff appraisal, I shall limit my remarks to a few crucial areas. On fiscal policy, we must stress that the large public sector deficit represents a major constraint on monetary management and adversely affects the balance of payments outlook. Although an improvement in the financial position of the public enterprises in 1986 has led to some reduction in the overall public sector deficit, a major adjustment effort is still needed. In this respect, a level of current expenditures of more than 71 percent of GDP is not sustainable in a country whose level of current revenue--39 percent of GDP in 1986--can be raised only slowly because of the tax adminstration problems related to the large share of unreported income. Therefore, any adjustment should be mainly on the expenditure side. In this respect, we have noticed from Table 2 of the staff paper that the current expenditures of the Central Government were raised by 20 percentage points in relation to GDP between 1981 and 1986. More information from the staff on the origin of this drastic increase and on the specific measures the authorities are taking to reverse the trend would be welcome.

On external policies, we must say that the economy is showing preoccupying trends. The delay in redesigning the pricing policy and in readjusting the clearly overvalued exchange rate is creating distortions and widening the already large parallel market. Recorded imports and exports, which represented, respectively, 72 percent and 55 percent of GDP in 1982, are at 56 percent of GDP and 48 percent of GDP, respectively, in 1986. Moreover, the exchange rate is showing large premiums in the black market. The authorities are trying to deal with the situation by adopting a system of multiple currencies, which should guarantee a price stimulus to the export supply in addition to reducing the scope of trade and exchange rate transactions in the parallel market. However, like the staff, we are concerned about the further distortions that can derive from this practice. Moreover, we have noticed that there is no explicit timetable for the elimination of the multiple currency practice. Perhaps the staff or Mr. Kafka can offer information on the question.

It is with respect to the medium-term outlook that we are mainly concerned, especially because Guyana, given the current set of policies, does not seem realistically able to become current with its creditors, including the Fund, in the medium term. The balance of payments scenario in Table 7 on page 22 of the staff report is subject to the various uncertainties that are typical of exercises related to the evolution of world prices and to the amount of financing available. Still, the scenario seems clearly unfeasible. The value for imports--computed as residual, after taking into account available financing, possible buildup of arrears, and possible evolution of exports against the background of expected restructuring policies--is in fact too low to allow the country to grow and export at the projected rate. The logical question in the circumstances concerns the level of financing necessary to achieve a level of imports consistent with the export and GDP growth hypothesis. In other words, while we appreciate the efforts of the staff to construct a medium-term scenario and to point out the existence of a crucial inconsistency, we would like a quantitative assessment of the magnitude of the macroeconomic disequilibrium.

The continuing need for external financing should convince the Guyanese authorities to adopt a more drastic course of action to redress the economic imbalances and to induce confidence in the Government's economic policies. It was unfortunate in that respect that Guyana had obligations overdue to the Fund for more than three years and that, since the declaration of ineligibility, arrears to the Fund had increased. We urge the authorities to act promptly to correct the situation, and we welcome the latest announcement of payment to the Fund. In conclusion, we can go along with the proposed decision.

Mr. Salinas made the following statement:

Economic developments in Guyana during 1985 and 1986 have not significantly changed the difficult economic and financial situation that the country has been experiencing since the beginning of the current decade. As noted by the staff, total output remains below the level reached in the early 1970s. Moreover, the overall deficit of the nonfinancial public sector rose to the equivalent of more than 60 percent of GDP in 1985, the deficit in the current account of the balance of payments widened to nearly 33 percent of GDP in the same year, while external payments arrears increased further, reaching a new volume that represents at least three times the total annual value of Guyana's exports. Behind these developments is a drastic deterioration in the country's external environment, although the problems also reflect a lack of action on the part of the authorities to adjust in timely fashion to the changing external environment using appropriate policy tools.

The results of delays in the implementation of a strong and comprehensive adjustment program, including structural reforms, have been the continuation of a severely distorted price structure, the growing importance of a parallel economy, the development of inflationary pressures, and, as a general consequence, a further deterioration in the economy's ability to efficiently allocate resources.

In considering the various areas in which a major rehabilitation effort is needed, we would like, first, to offer a general comment on the emergence and development of Guyana's parallel economy. It is clear from the staff papers that the importance and scope of the parallel economy have been growing, developments that to some extent have contributed to a restoration of some flexibility in the economy. Our own view is rather less optimistic, however. As we see it, a parallel economy is, in most cases, nothing more than the outcome of the failure of the price system to effectively reflect opportunity costs of goods and services being produced domestically. While the parallel economy may add some flexibility to the price formation schemes, because of the uncertainties surrounding the functioning of such an economy, it may also further distort the set of relative prices in the overall economy while eroding the tax base and tax collection procedures, thus adding to the magnitude of the fiscal imbalances. As for its implications for the external sector of the economy, it is normal under a growing parallel economy for some trade and financial transactions to be diverted away from formal schemes, thus reducing the scope for the authorities to manage the scarce external resources available to the economy. As transactions taking place in a parallel economy are not recorded, official statistics give an increasingly incomplete picture of overall economic performance, making it difficult to assess the real magnitude of the imbalances which need to be corrected and to devise the appropriate policy instruments to cope with them. We therefore believe that the first step in the process of economic rehabilitation should be the restoration of an appropriate set of relative prices for the economy, including the exchange and interest rates and those prices that would continue to be administered by the authorities.

This in turn involves a number of policy actions in the key sectors of the economy. On the external front, a unified exchange rate aimed at ensuring the competitiveness of the economy and able to reflect the very weak condition of the external sector remains a requirement. The current overvaluation of the official exchange rate and the multiple exchange rate system already in place call for a more active exchange rate policy in terms of a prompt unification of the exchange rate at a level compatible with the goals of export promotion and a more viable external position. In addition, exchange rate policies should be sufficiently flexible to allow adjustments in the rate when warranted. A successful implementation of such a policy will contribute to restoring production incentives and will help to reintegrate the parallel economy into the official economy.

The efforts in the external area will need to be supported by additional measures on the domestic front, including a major price liberalization, adjustment of administered prices and tariffs, and the pursuit of restrained financial and incomes policies. In the area of fiscal policies, a strong fiscal adjustment remains of paramount importance, given the deterioration in the public finances evidenced in a large and unsustainable public sector deficit. Adjustment in prices of public enterprises and in tariffs, together with efforts to contain expenditures, would not only help the public finances but would diminish reliance on domestic credit expansion for financing, thus providing some room for private expansion. The incorporation of the parallel economy into the official economy, provided that the required corrective measures are adopted, will in turn contribute to an increase in the revenue base and should therefore alleviate the currently weak position of the public finances. The positive trends observed in 1986 in the outcomes of the public sector enterprises are most welcome and, like Mr. Lankester, we would welcome staff comment on the sustainability of that progress.

Finally, regarding the problem of arrears to the Fund, we welcome the latest payment by Guyana, although we note that total arrears have continued to increase during the past month. Therefore, we join previous speakers in urging the authorities to settle as promptly as possible all overdue obligations and to adopt, without further delay, a comprehensive adjustment program in order to redress the large imbalances currently affecting the economy and to generate some degree of confidence. In conclusion, we support the proposed decision.

Mr. Bertuch-Samuels made the following statement:

As I am in full agreement with the staff report, and because the critical issues of current and prospective economic developments in Guyana have been adequately addressed by others, I can be brief. However, I must emphasize that we share the view that without a substantial and comprehensive reorientation of economic policies, Guyana's economic prospects are bound to remain poor; and the situation could well deteriorate even further. A policy reorientation would be in Guyana's own best interest by helping to pave the way for settlement of the country's external arrears--including those to the Fund--thus creating the conditions for a possible Fund arrangement that, in turn, could mobilize necessary external financial assistance. Against this background, I warmly welcome the indication by Mr. Kafka that his authorities are actively considering a comprehensive economic program incorporating the recommendations of the staff and of the Executive Board made on earlier occasions.

Welcoming the latest payment by Guyana in the SDR Department, and the news of an imminent partial repayment to the Trust Fund, I find it nevertheless disappointing that for more than three years, Guyana has been in arrears to the Fund without making any major progress in settling its overdue obligations. While this might raise questions with regard to the efficiency of our procedures in dealing with the arrears problem, the recent payment and the authorities' intentions to continue discussions with the Fund with a view to finding appropriate solutions to their economic problems are encouraging signs that need to be taken into account in deciding on further courses of action. It is to be hoped that speedy progress can be made in translating such good intentions into concrete action. On balance, and notwithstanding our serious concerns, the approach outlined by the staff seems appropriate, and I can thus support the proposed decision.

The staff representative from the Western Hemisphere Department noted in response to a query on the likely sustainability of improvements in fiscal policy that, assuming a willingness on the part of the authorities, it should be possible to continue to reduce the public sector deficit through cost savings in employment and other expenditures. However, in the absence of improved pricing policies, the adjustment was likely to be limited in scope.

The growth in central government expenditure had been related mainly to a growth in expenditure for goods and services and interest payments, the staff representative continued. The rapid growth in interest payments reflected both the deficits of the Central Government and the Government's equity contributions to help finance the large deficits that public enterprises had incurred in the past.

On the outlook for the balance of payments and the import level that might be compatible with the projected growth of output, the staff representative observed that the balance of payments projection provided by the staff was a passive one, in the sense that it presented what could happen under existing policies and the external financing that was likely to be available under those policies. As noted in the report, imports would decline substantially under the projection, a development that might not be sustainable, since it could lead to a situation in which inflationary pressures increased and the parallel economy widened, which in turn would affect the projected growth of exports.

The import level that would be compatible with better economic performance was difficult to define with any precision, the staff representative said. Any improvement in performance in Guyana would imply both an adjustment of the economy and a realization of productive capacity. The adjustment would, in principle, lead to a decline in imports; however, a substantial deterioration in capacity and a low level of inputs would mean in the short term, even under a substantive program, an increase in imports. The extent of the increase or decline would depend in large part on actions and measures that were still being discussed with the authorities.

Finally, recalling Mr. Lankester's concerns about the failure of the authorities to follow the recommendations of the recent technical assistance mission relating to the price index, the staff representative commented that the authorities had indicated that they had some difficulty in generating the additional resources necessary to finance the recommended measures. More fundamentally, the authorities felt that the time was not ripe for such changes in view of the distortions created by the parallel economy.

The staff representative from the World Bank observed that, as of December 1, 1986, Guyana's overdue obligations to the Bank had amounted to US$7.3 million. The implications for Bank operations were twofold. Technical assistance would continue; indeed, the Government had been told that the Bank would be happy to continue working with the authorities and the Fund staff on the medium-term adjustment program. However, the overdue obligations raised difficulties with respect to financing of any further operations by the Bank.

Mr. Lankester asked for details on the results of the joint Fund-Bank mission to Guyana in September 1986. Following Minister Greenidge's visit to the Fund, many Directors had held hopes that the mission would result in an early adjustment program; it was his impression, however, that not much progress had been made over the past few months.

The staff representative from the Western Hemisphere Department noted that during the consultation mission, the staff had discussed with the authorities the main elements of a program; and those discussions had been continued during the Annual Meetings. On both occasions, the authorities had given some indication that they might be more inclined than in the past to undertake certain substantive actions. Following the Annual Meetings, the staff had held further discussions with the authorities and had prepared an aide memoire reviewing the status of those discussions and outlining a framework for economic policies. The authorities had responded positively to the aide memoire by indicating their willingness to adopt certain policy changes; at the same time, they had made it clear that additional technical work would be required and that they would need to assess what external resources might be incorporated into a possible economic program.

The staff representative from the World Bank added that a special donors' meeting had been held in Paris in November, at which time the Bank-Fund recommendations on a possible program had been discussed. The results of those discussions had then been communicated to the Guyanese authorities. The hope was that they would agree to a special subgroup meeting at the forthcoming Caribbean Group Meeting, scheduled to take place January 26, 1987 in Washington. Their agreement would signal their willingness to realistically consider the recommendations of the Fund and the World Bank.

Mr. Kafka, noting that he would report the views of his colleagues to the Guyanese authorities, said that Minister Greenidge had wanted to be present at the discussion but was engaged in preparing the 1987 budget, which he hoped soon to submit to Parliament for approval in the first or second week of January.

The authorities had made it clear that they were deeply embarrassed about Guyana's arrears to the Fund, and they were doing their best to make payments, Mr. Kafka continued. The only constraints were on payments that would involve a reduction in exports or in exchange earning capacity.

His colleagues had rightly asked why progress toward adjustment had not been more rapid, Mr. Kafka recalled. One reason was that Guyana was a country in which associations, like agricultural producer unions, had considerable influence, and the Government was able to manage them only to a point. Before any major changes could be effected, those associations must be persuaded of the value of the change. The current President, Mr. Hoyt, must move carefully in order to obtain a consensus, without which no action could take place in Guyana. He himself was putting his hope in the discussions that had taken place between the Fund and the World Bank staffs and the Guyanese authorities. It seemed clear that the authorities were far more open than in the past to new ideas.

While a market-determined economy might not be possible in its purest form, the authorities were moving in that direction, Mr. Kafka continued; and they had already taken steps that only 18 months earlier would have been considered utopian. The improvements that had been made in the state enterprises were radical and evidence of a new spirit in Guyana. In that respect, he was happy that Directors had come out in favor of continued involvement by the Fund in Guyana. While patience would be necessary, the outlook would improve; indeed, it was already much brighter than it had been earlier. The staff, the Guyanese authorities, and the Guyanese people were all working toward the needed adjustment.

The Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal contained in the report for the 1986 Article IV consultation with Guyana. They noted that the policies followed by the authorities in recent years had continued to be inadequate to address the fundamental problems confronting the economy. The price structure remained severely distorted; the parallel economy appeared to have expanded further; external payments arrears had continued to rise to a level equivalent to about twice the GDP; and the public sector deficit remained at an unsustainable level. Directors recognized that exogenous factors had contributed substantially to the country's economic difficulties, but they were of the view that for the most part these difficulties reflected weaknesses in domestic policies over an extended period of time.

Directors emphasized that, in the absence of substantive policy changes, Guyana's medium-term economic prospects were likely to get worse. Hence, they reiterated the urgent need for a major reorientation of economic policies in the context of a comprehensive medium-term economic program. In this regard, Directors welcomed the recent statement by the authorities indicating their willingness to adopt a program of corrective measures, and they reaffirmed the Fund's readiness to assist Guyana in the design of such a program.

Directors considered that the prevailing price distortions were having adverse repercussions on the growth of output and exports and were a major cause of the country's problems. They stressed that an effective economic program would need to be based on the restoration of an appropriate structure of relative prices. In particular, Directors urged the authorities to establish promptly a realistic and competitive exchange rate to restore incentives for production and exports, to help merge the parallel economy and the official economy, and to help achieve a viable balance of payments position. In the view of Directors, such a currency adjustment would need to be followed by a flexible exchange rate policy and would need to be supported by the liberalization of private and public sector prices and of exchange and trade restrictions.

Directors acknowledged the authorities' efforts to reduce the public sector deficit in 1986, but noted that the deficit, at a level of around 40 percent of GDP, continued to be unsustainably large and remained a major factor behind Guyana's internal and external imbalances. They emphasized that a substantial fiscal correction was required to bring domestic spending to a sustainable path, and they recommended that the authorities adopt without delay the measures required to deal with the country's severe fiscal problem. Directors remarked that corrective action in the area of public sector prices would have a significant positive impact on the public finances, but they added that central government expenditure would need to be reduced sharply. Directors considered that fiscal restraint would help the Bank of Guyana to regain control over the expansion of domestic credit and, thereby, to control inflation and halt the accumulation of external payments arrears. A flexible approach to interest rates was also necessary to foster domestic savings and help protect the balance of payments.

Directors noted with great concern the substantial overall accumulation of external payments arrears by Guyana. While welcoming recent modest payments to the Fund, Directors remarked that it was a serious matter that Guyana's overdue obligations to the Fund had continued to build to a level that was in excess of Guyana's quota in the Fund. They emphasized that the resumption of normal financial relations with external creditors required the adoption of a comprehensive economic program that would enable Guyana to redress its economic situation and would permit the elimination of arrears to the Fund and to other creditors. Implementation of such a program should also help to elicit the external concessional assistance necessary to support the rehabilitation and liberalization of the economy.

Directors encouraged the authorities to continue their discussions with the staff with a view to developing a comprehensive medium-term economic program and to improving the statistical base. Time was not on the side of Guyana, Directors concluded, and further delays in adjusting would entail even heavier costs at a later stage.

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

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Guyana's continuing failure to fulfill its financial obligations to the Fund in light of the facts and developments described in EBS/86/281 (12/18/86) and SM/86/285 (11/26/86).

2. The Fund deeply regrets the continuing failure by Guyana to fulfill its financial obligations to the Fund and again urges Guyana to make full and prompt settlement of those obligations.

3. The Fund welcomes the authorities' indications of willingness to undertake policy changes and again urges the authorities to adopt a strong and comprehensive economic adjustment program without delay.

4. The Fund will again review the matter of Guyana's overdue financial obligations to the Fund within six months of the date of this decision.

Decision No. 8485-(86/204), adopted
December 19, 1986

2. JAPAN - BORROWING AGREEMENT; AND MANAGEMENT OF FUND LIQUIDITY - USE OF ORDINARY AND BORROWED RESOURCES UNDER POLICY ON ENLARGED ACCESS

The Executive Directors considered a paper on borrowing by the Fund from the Government of Japan (EBS/86/265, 11/25/86), together with a paper on management of the Fund's liquidity in connection with the borrowing agreement with Japan and the extension of drawdown periods under the borrowing agreements with the Saudi Arabian Monetary Agency (EBS/86/266, 11/25/86). They also had before them a paper on borrowing by the Fund from the Saudi Arabian Monetary Agency (EBS/86/250, 11/12/86; and Sup. 1, 12/8/86).

Mr. Fujino made the following statement:

It is a pleasure and an honor for me that the Executive Board is discussing today--my final office day in the Fund--the matter of borrowing from Japan.

As a way of contributing to the alleviation of currently difficult circumstances, Minister Miyazawa proposed to lend to the Fund an amount of SDR 3 billion as a temporary measure to strengthen the financial position of the institution. The offer was prompted by a consideration that under the present uncertain prospects for the world economy, some developing countries may face increasingly serious balance of payments difficulties and financing requirements in the period ahead. And the Fund, in applying its present policies, may in especially severe circumstances deem warranted financial support beyond the amounts ordinarily available.

We are pleased that our offer was favorably accepted by member countries of the Fund. The Interim Committee communiqué spared one sentence on the issue noting that "the Committee welcomed the offer made by Japan to provide the Fund with SDR 3 billion to enhance its ability to support members' adjustment efforts." I thought it was important to make the proposal operational as early as possible without losing the momentum of the initiative.

Since then, we have worked on the provisions of the lending agreement and on the possible use by the Fund of these resources in close consultation and cooperation with the management and staff. I particularly appreciate the Managing Director's personal involvement and helpful suggestions in this matter, without which it would have been very difficult to bring this issue to the Board for early discussion. My gratitude also goes to Mr. Habermeier, Mr. Finch, and their colleagues for their devotion, professionalism, and efficiency in cooperating with us.

For our part, I tried my best to accommodate the needs of the Fund as flexibly as possible within our legal and administrative constraints. The provisions set out in the lending agreement represent the maximum efforts of my authorities, which manifest themselves particularly in the provisions related to the drawdown period, maturity, and interest rate. I believe that these conditions best serve the interests of the Fund and its members. My authorities have also refrained, as much as possible, from narrowing the scope too much for the use of the resources and have allowed the Fund to decide, in light of its financial position and requirements, on the most effective use of the resources in accordance with the general purposes outlined by Minister Miyazawa. Specific proposals by the staff on the use of the Japanese loan as contained in EBS/86/266 are the result of extensive discussions and broadly conform to our intentions. The proposal to change the mix of ordinary and borrowed resources under the enlarged access policy, which is also included in EBS/86/266, is a conceptually separate matter on which I shall speak at a later stage of the discussion.

Finally, I should like to draw the attention of the Board to an important point, namely, that the offer of this loan does not imply any change in our position that the Fund's resources should be primarily based on quota subscriptions. The loan from the Government of Japan should not in any way detract from the need for an in-depth review of the adequacy of quotas and for the implementation of the next quota increase.

Mr. Nimatallah made the following statement:

I welcome the proposal of the Government of Japan to lend to the Fund. I am certain the Board and the membership of the Fund are appreciative of the extent to which this positive gesture represents a significant degree of cooperation with the institution. Therefore, I can endorse the borrowing agreement with the Government of Japan. I have no difficulty with the terms of the agreement as expressed in the attachment to the staff paper. I understand the Japanese position in limiting the maximum maturity period to five years, but I hope that if an extension is needed, the Japanese authorities will respond positively at the time.

On the utilization of the loan, I support the idea of maintaining flexibility. The loan may be used for more than one purpose, but the amounts and proportions should be subject to continuing review. I agree that the proportion of purchases of ordinary resources to be financed with the loan from Japan should be reviewed regularly on the occasion of Fund liquidity reviews. As for the charges on purchases financed by the loan from Japan, I find option 1 more appropriate under present circumstances. It will be a smoother operating approach and perhaps less costly to borrowers, as long as the overdue payments problem exists. Because of overdue payments, and according to footnote 2 on page 7 of the staff paper, the cost of borrowed resources will be less than that of ordinary resources. Therefore, I support option 1.

As I am worried that the quota review might be protracted, I think the Fund should look again at the mix of ordinary and borrowed resource utilization under the enlarged access policy, at least for the next couple of years. It would be prudent to speed up the utilization of borrowed resources for two reasons. First, it is uncertain whether the Government of Japan and the Saudi Arabian Monetary Agency (SAMA) will continue to have favorable balance of payments positions. Second, some countries' legislative bodies might find a good excuse to delay approval of the quota increase if the borrowed amounts sit untouched, together with GAB resources. Therefore, I think it would be helpful to both the Fund and its borrowing members to begin using the borrowed resources as early as possible and to change the ratio of the present mix of one part ordinary resources and one part borrowed resources to a mix of 1:2 for all relevant purchases under the enlarged access arrangements. In the meantime, I hope the quota review will be initiated and concluded as planned without any delay. I have no difficulty formalizing the illustrative draft decisions, as they reflect my position on these matters.

Mr. Salehkhou made the following statement:

I welcome the initiative of the Government of Japan to offer a loan of SDR 3 billion to the IMF and the initiative of the Government of Saudi Arabia to extend the drawdown periods on existing loans. I fully appreciate the efforts made by the two countries to help the Fund cope with the existing difficult world financial situation. I hasten to say that I have no problem approving all the technical and financial clauses incorporated in the proposed agreements, and I wish to thank the management and staff of the Fund as well as Mr. Fujino and Mr. Nimatallah for their commendable efforts in securing these arrangements.

However, I cannot go along with the proposals on management of the Fund's liquidity in connection with these agreements, as set forth in EBS/86/266, although this is without any prejudice to the proposed agreements. As a general proposition, I feel that we cannot take decisions on these important issues on the basis of a paper which does not contain the usual comprehensive elements of a Fund liquidity paper. My preference, therefore, would be to postpone the discussion on this part of today's agenda, it being understood that we would go along with the proposals on the agreements with Japan and the Saudi Arabian Monetary Agency. We would then conduct a full discussion on the management of the Fund's liquidity sometime in January after the staff prepares a paper containing all relevant elements.

On the issues raised in the paper before us, I am surprised by the proposed approach leading to a major change in the mix of resources used in stand-by and extended arrangements. At the time of the Annual Meetings, I understood from the statements by Japanese officials that the proposed loan was intended to allow the Fund to expand its enlarged access policy and, at least implicitly, to relax somewhat the actual implementation of access policy. This paper (EBS/86/266), however, focuses on the utilization of the Japanese loan together with the remaining resources from the SAMA agreements in lieu of ordinary resources. The arguments presented implicitly limit any real increase in Fund lending to hypothetical events such as a major world financial collapse or to special cases.

It is ironic that a generous move by two member countries willing to help debtor countries should lead to an increase in an already high debt service to the Fund, because of tight financial considerations and a narrow and commercialized approach to the problems of developing countries. These countries are faced with tremendous debt servicing problems, and the figure of 0.45 percent increase, considered by the staff as insignificant, would be burdensome for them, the more so since other creditors are being asked by the Fund at the same time to decrease the amount of interest that they charge. Moreover, this is happening at the same time that the World Bank is going to again decrease its interest rate; and even commercial banks have understood that their high spreads should be reduced. The Fund's charges are already at commercial levels, and increasing them again in these circumstances would in my view be unjustified, counterproductive and ill-timed.

From a liquidity point of view, our approach to these problems seems to me difficult to understand, as it would no doubt be to any financier, not to mention the political circles in our countries. We have a stock of usable resources of SDR 30 billion, which did not decrease in the recent past despite the pessimistic projections presented to us time and again. There has been no "falling of the sky," as the saying goes. We have not yet been able to draw on SDR 3.5 billion from an agreement with the Saudi Arabian Monetary Agency, while those resources are supposed to be fully utilized by May 6, 1987. And it is not that they were not used because of "a reduction in demand from the earlier projections"; rather it was due to a deliberate policy of reducing effective access and sharply tightening conditionality in recent years. Today we are adding another SDR 3 billion to this pool, to which should also be added the SDR 18 billion of the General Arrangements to Borrow. Considering that we are supposed to have in place a quota increase by end-1988, I wonder what kind of management of liquidity this is if we are to lend less than we receive in repurchases. Clearly, there is an inconsistency between the policies of the Fund and the management of its liquidity. Since the borrowing countries are those that, in the final analysis, bear the brunt of these costly policies, we would like to suggest that we take a serious look at these questions. Further, in managing the liquidity of the Fund, we should fully take into account the costs to the membership. I regret to say that living with margins of tens of billions of SDRs is not the best way to do it. I also believe that member countries with existing stand-by or extended arrangements with the Fund should in any case have the option of accepting or rejecting any change in the mix of resources. Otherwise, solutions like the one suggested under option 1 would be a unilateral decision by the Fund, which would go against the cooperative nature of the institution.

This serious review should normally point to a larger use of ordinary resources, rather than the other way around; and, if we really do not need borrowed resources, we could either politely decline to accept them or keep them as reserves against world catastrophes, as we do with the resources of the General Arrangements to Borrow.

Mr. Grosche made the following statement:

Let me begin by expressing our deep appreciation to the Japanese authorities for their lending offer. I should also like to congratulate the staff and Mr. Fujino for having successfully concluded discussions on a complicated issue in such a short time. The amounts involved are generous and the terms are favorable. I welcome, in particular, the reserve character of these resources. Considering the drawdown period of the SAMA loans and possible difficulties in concluding the Ninth General Review of Quotas, it is reassuring to have another "reserve against the contingency of unforeseen shocks." Therefore it is with great pleasure that I approve the agreement for borrowing from the Government of Japan.

With regard to the Fund's liquidity in connection with the Japanese borrowing agreement and the extension of drawdown periods under the SAMA agreement, the staff has brought forward a number of arguments in support of its proposal to mix ordinary and borrowed resources in a manner that would tend to conserve ordinary resources. I sense, and welcome, the Treasurer's attitude to err on the side of prudence in attempting to conserve our ordinary resources. On the other hand, I feel that the Fund's liquidity situation in 1987 will remain reasonably comfortable. The conservation of ordinary resources seems not to be a matter of high priority, at least at present; and my judgment is influenced by our basic attitude to Fund financing, which relies on the principle that Fund resources should come mainly from quota subscriptions and that we should use these quota resources first, particularly in implementing our regular policies.

I do see, however, possible delays in the next quota review, and I acknowledge that ordinary resources must be used to repay loans maturing before the corresponding repurchases. Therefore, I should like to see the use of the Japanese loan, particularly its potential use for the replacement of ordinary resources, to be kept under regular review. Primarily, and as long as the liquidity situation with respect to ordinary revenues remains as comfortable as it is at present, I believe the Japanese loan should be used for the same purpose set for the SAMA loans, mainly, for beefing up our resources under the temporary policy of enlarged access, including possible demands for financing "in exceptional circumstances." I can also go along with proposals to change the mix between ordinary and borrowed resources under that policy from 1:1 to 1:2, and I would not object to using the Japanese loan for partially offsetting the "mismatch," i.e., the cumulative use of ordinary resources in repayment of borrowings. This issue is mentioned by the staff on page 3 of EBS/86/266.

Even if the Board were to adopt the staff proposal--either today or later--Directors would still have to answer one or two difficult questions. First, with regard to the alternatives for use of the loan in financing purchases that would otherwise be financed with ordinary resources, I am in favor of the first alternative. This approach is simpler than the second, and it would avoid the difficult legal question of whether a member country, in making drawings within the regular credit tranches, could actually be forced to partially draw on the more expensive, borrowed resources. The second question relates to the operational budget. Option 1 would basically result in a replenishment of the Fund's ordinary resources in the same way that applies to amounts borrowed under the General Arrangements to Borrow. But I wonder whether this also means that the use of the loan would increase Japan's reserve tranche position as is intended for use of GAB loans. I refer to Decision No. 6772-(81/35) of March 3, 1981 and specifically to Section (2), paragraph (d) of that decision. It would be helpful if the staff could confirm that, as far as this provision is concerned, the Japanese loan is treated in the same way as the SAMA and the BIS loans.

Mr. de Forges made the following statement:

In September 1986, the Interim Committee welcomed the offer made by Japan to provide the Fund with SDR 3 billion to enhance the Fund's ability to support members' adjustment efforts. I am pleased to take this opportunity to thank the Japanese authorities for having followed through on their offer by working out the details of an agreement. I support the decision proposed in EBS/86/265 since I am satisfied with all the technical aspects of the arrangement. I should like to commend the Japanese authorities, Mr. Fujino, and the staff for having constructed a fair and flexible agreement. In our opinion, this agreement is the perfect example of a "safety net" for a financial institution, and the Japanese Government must be commended for that.

On the management of the Fund's liquidity in connection with the Japanese borrowing agreement, let me first quote from some texts that are the reference for the use by the Fund of borrowed resources. The preamble of our guidelines for borrowing by the Fund states that "quota subscriptions are and should remain the basic source of the Fund's financing; borrowing by the Fund provides an important temporary supplement to its resources." This point was taken up again last year by the Group of 24 and the Group of 10. The G-24 report stated that "the Fund resorted to borrowing to supplement its own resources and to provide financing to borrowing members," while the G-10 report indicated that "the IMF has borrowed substantially from official sources to supplement its quota resources." The G-10 report went on to reiterate that strengthening the role of the IMF requires, inter alia, "that the Fund normally finance its lending from quota resources," that "quotas should represent the basic source of IMF financing and that recourse to borrowing to supplement these resources should be made only in exceptional circumstances." In our view the actual use of the Japanese line of credit must be examined in light of these quotes, and my authorities wonder about the necessity of drawing on the Japanese resources as early as proposed in the paper.

According to the latest data available, for the time being the Fund's liquidity position seems to be satisfactory. Unless there are major changes in policy or in the world economic environment, the Fund does not seem to be faced with major difficulties in the foreseeable future, as far as its liquidity is concerned. On the contrary, available forecasts for 1987 indicate reductions in the net use of both ordinary and borrowed resources, probably leading to a smooth revolving use of the Fund's resources. Later on, the next quota increase might change our perspective.

We think that borrowing by the Fund should not be considered in the same way as borrowing by other financial institutions, which are basically in search of a continued increase in their liabilities. This is not the aim of the Fund. So far, our loan agreements have been set up as bridging devices made necessary by urgent needs for liquidity. In that respect, drawings on previous loans were postponed when they became unnecessary. I also wish to recall that the purpose of the General Arrangements to Borrow was to forestall or cope with exceptional circumstances that might endanger the stability of the Fund's financial resources. In sum, there could be a need for a safety net, but we are not convinced that it should be used now. Potential resources should be matched to eventual circumstances. In this context, the proposals in EBS/86/266 to use the Japanese loan to finance purchases that would otherwise be financed by ordinary resources are rather surprising. These proposals tend to alter the way the Fund's financing is managed, since the adjustment of the resources to the uses would no longer bear on the borrowed resources but would bear on the ordinary resources. My authorities consider that the staff paper does not contain all the data necessary to modify as fundamental a matter as the mix of resources, since this modification might have an impact on the cost of the Fund's assistance to debtor countries. I must also add that, given the current projections, my authorities would have spontaneously assumed that, if the mix were to be modified, it should be done with a view to increasing the share of ordinary resources. Therefore, I am not today in a position to support the decision proposed in EBS/86/266. However, as I noted earlier, I can support the agreement with Japan, and I reiterate my authorities' gratefulness for the commendable offer made by the Japanese Government.

Mr. Lim made the following statement:

We join other Directors in welcoming the offer by the Government of Japan to provide resources to the Fund. This is another indication of Japan's objective of playing a major role in promoting international cooperation through organizations like the World Bank and the International Monetary Fund. Their objective is much supported by this chair. We would like to formally record our appreciation to the Government of Japan for the generosity of this offer and the cooperative spirit in which it has been made. Nevertheless, the proposal does have some major implications for the management of the Fund's resources. In our view, the primary source of resources should be members' quota subscriptions. We would therefore like to think more carefully about the proposal to combine borrowed with ordinary resources for normal lending.

We would also like to explore with the staff and management the implications of the Japanese borrowing agreement for the proposed quota increase and whether this borrowing would delay the timing for the Ninth Quota Review that is currently envisaged. In sum, we feel this is a generous offer by the Government of Japan but one that has major implications for the management of the liquidity of this institution. In the circumstances, it would be inappropriate to rush a decision. We would therefore like to suggest that the draft decision on the proposed use of the resources from the Japanese borrowing agreement be deferred until early 1987. This would allow Directors to hold further discussions with their authorities.

Mr. Noriega made the following statement:

This chair wishes to join others in expressing appreciation to the Government of Japan for its offer of a loan to this institution. It is reassuring for member countries to know that there exists a source of financing to correct external imbalances, especially when the medium term offers a high degree of uncertainty. It is also reassuring that the Japanese authorities recognize the creditworthiness of this institution.

We thus welcome and endorse the proposed decision concerning the agreement for borrowing from the Government of Japan, and as we are broadly in agreement with the views of others, I can be brief. The enlarged capacity of the Fund to support economic programs will certainly enhance its effectiveness in dealing with balance of payments crises. I would only invite the staff to comment on the convenience of requesting from the start the extension for two more years of the period during which drawings could be made. This question derives from the fact that the Fund's holdings of usable ordinary resources seem to be adequate for its immediate and prospective needs.

With regard to the paper on the Management of the Fund's Liquidity in Connection with the Borrowing Agreement with Japan and the Extension of Drawdown Periods under the Borrowing Agreements with the Saudi Arabian Monetary Agency (EBS/86/266), a minor point concerns the references to the relative charges on ordinary resources and on resources obtained from the Japanese loan. Even if on average interest rates have been lower in Japan than the SDR interest rates during the past, this relationship could be inverted in the future. Similarly, variations in the yen/SDR exchange rate would be reflected in variations in the cost of servicing the Fund's debt, and indirectly in charges to member countries. Thus, the intended use of this loan as a safeguard in times of uncertainty could adversely affect users of these resources, and the cost comparisons presented in the text could well vary in the future.

Another point which is not addressed in the document but which because of its importance warrants further reflection by this Board concerns the mixing of funds from the Japanese loan with other resources. According to the draft decision, members applying in the future for stand-by and extended arrangements would be required to draw part of the resources from the Japanese loan. However, if the Fund's holdings of ordinary resources are essentially adequate for effective performance of this institution's functions, then this new requirement in future arrangements does not seem to be fully satisfactory.

As the loan will only be a temporary extension of the Fund's liquidity, more cumbersome arrangements would need to be devised in order to maintain a degree of fairness in charges and risks assumed by users of resources. The proposals contained in the document may be considered as risk-sharing schemes, which are probably not the most efficient forms for allocating resources. In the case of enlarged access arrangements, the mix between ordinary and borrowed resources and, within the second one, the mix between different origins of the resources could create a controversy, as charges on resources vary according to their origin. (If we believe in financial liberalization, we should expect that cheaper funds will command a higher demand.) Still, it might be that the most convenient use for the Japanese resources is in the enlarged access arrangements, whereby member countries could voluntarily assume greater risks and perhaps greater costs when requesting larger amounts of financing. Therefore, it would seem to be preferable that the decision concerning the use of, and charges for, these funds be taken when the topic of enlarged access policies is brought to the Board.

Mr. Mawakani made the following statement:

I support the proposed decision that authorizes the Managing Director to borrow the equivalent of SDR 3 billion from the Government of Japan. These additional borrowed resources are welcome at a time when the prospects for improvement in the financial situation of many member countries are uncertain and when the demand for Fund resources is likely to increase. I commend the Japanese authorities for their contribution and for the flexibility in the terms and conditions of the proposed borrowing agreement. Noteworthy also are the short period required to make drawings and the provision allowing the Fund to make repayment in any convertible currency.

With regard to questions on the utilization of resources from the borrowing agreement, I do not share the staff view that the loan from Japan should be used partly as a substitute for ordinary resources in financing purchases under Fund arrangements; nor do I endorse the recommendation to alter the mix of ordinary and borrowed resources in financing under the enlarged access policy. My position is based on the fact that the Fund's financial situation is comfortable at present. Therefore, these additional resources from Japan should be used to increase borrowed resources, thereby enhancing the ability of the Fund to provide financial assistance to member countries.

Mr. Vasudevan made the following statement:

We warmly welcome the offer of the Government of Japan to lend the equivalent of SDR 3 billion to the Fund. As Directors are aware, the Executive Director from my constituency had, at the discussions on the previous Article IV consultation on Japan, argued that Japan should utilize its current account surplus for the benefit of developing countries whose external positions have become very difficult in the face of falling commodity prices and in the absence of a buoyancy of demand from industrial countries. He followed up this argument with a public call for Japanese surpluses to be used for the benefit of developing countries.

There is no doubt that the loan from Japan would increase the total stock of resources at the command of the Fund; and we are glad that the Fund and the Japanese authorities have reached an understanding that "the loan from Japan should be used in support of Fund policies on access." Indeed, the Japanese loan, as the staff paper notes, could be used to expand Fund financing not only within the current access limits but also for exceptional financing beyond the current maximum access limits.

The paper (EBS/86/265) also states that the Japanese authorities "have indicated their strong preference that the use of the funds be related to the use of Fund resources subject to the credit tranche policies." The paper goes on to say that "the authorities have also expressed their wish that the Fund decide, in light of its own financial position and prospective requirements, on the most effective use of the funds for this purpose, in conjunction with stand-by or extended arrangements, whether involving enlarged access or not." This is an important statement. For, rightly, the Japanese authorities do not insist on how the loan should be used; it is for the Fund to use in the light of its own liquidity situation and demands in future for Fund resources. The fact that there is a Japanese loan that can be drawn upon gives the Fund a cushion to meet any emerging situations.

The provisions of the draft of the proposed borrowing agreement are modeled in many respects on the 1984 agreement between the Fund and Japan; but, as the paper has pointed out, the main differences relate to the drawdown period, maturities, and interest rate. Here, the focus is placed on the interest rate, which is proposed to be based on the combined domestic rate for six-month maturities. This is a welcome change from the past position and perhaps reflects the authorities' recognition of the need for reducing the interest burden on countries that borrow from the Fund. The current perception that the interest rate proposed is favorable would remain valid so long as international interest rates remain low. Yet, it could be argued that this by itself does not imply that there would be an additional concessionality in the resources that the Fund makes available to the countries in need. In this connection, Directors would recall that Mr. Sengupta had made pleas in numerous interventions in the Board for providing finance at concessional rates to countries that need structural and large external adjustments.

The second paper (EBS/86/266) on the management of the Fund's liquidity in connection with the proposed borrowing agreement with Japan gives the impression that merely because there are funds made available by borrowing agreements, one should make use of them even though there is no liquidity problem at hand or in the foreseeable future, and even if it means bringing about changes in present policies. I have not seen any good argument in the paper in favor of changing the policies regarding the resource mix at this point in time. The argument that the use of the Japanese loan along with ordinary resources will not make a significant difference in the present rate of charge is patently wrong, for it assumes a certain rate of interest which need not materialize. Recently, when the Board had been discussing the midyear review of the Fund's income position, many Directors cited the difficulty in predicting the movements in future SDR interest rates. This argument was also suggested by the staff in that connection as a basis for deferment of the decision on the disposition of the excess income during the first half of FY 1987. Surprisingly, this argument does not appear in EBS/86/266. Suppose the six-month domestic rate combination moves up. Will not a rise in interest rates increase the rate of charge on the use of ordinary resources more steeply than at present under the staff proposal for utilizing Japanese loans in arrangements that envisage the use of ordinary resources?

There are other reasons why the proposal to mix Japanese loan resources with ordinary resources should be viewed with concern. It is disappointing to see no mention made in the paper of the effect of the proposal on the very concept of the IMF as a quota-based institution or even on the concept of international cooperation, which in my view could be regarded as an important international public good. We have to see that our quotas increase and that our lending policies improve to meet the challenges of external and structural adjustment. One does not need to change the existing policies and conserve the use of quota resources in order to accommodate loan offers; this is because the existing liquidity position is satisfactory and does not warrant such a step. The staff has not shown convincingly in its paper that there is a liquidity crunch in sight that requires a combination of borrowed and ordinary resources in arrangements making use of ordinary resources or in arrangements making use of a mix of resources. If such a problem arises, why should we consider only the Japanese loan offer and not other loan offers? This question has not been raised in the paper. The problem is a general one, however, and must be looked at with reference to liquidity considerations and possible increases in quotas.

The staff has made an attempt to work out the ratios in regard to the use of Japanese loans with ordinary loans in arrangements using ordinary loans and in arrangements involving a mix of resources. How these ratios are worked out and what liquidity considerations were involved in such calculations are not clear from the staff paper. The only justification for suggesting the proportions proposed is the concern that ordinary resources should be conserved. This concern is based on an assumption that quotas will not change, interest rates will not fluctuate, and the world at large will be static. As we all know, these are unrealistic assumptions and should be eschewed. For the type of problems we face, the answer lies in formulating fundamental remedies; and in the case of the Fund, as we all know, that means increases in quotas.

I have already pointed out that there are no clear-cut reasons why the use of the Japanese loan should be for purposes different from those which other borrowed resources serve, given the satisfactory liquidity position at present. I am also not convinced that the proposal would reduce the rate of charge on the use of borrowed resources in the near future. The staff does not want to use the Japanese loan in arrangements under enlarged access policy. The emphasis is initially placed on the use of resources available under the agreements with the Saudi Arabian Monetary Agency. I am also not convinced by the so-called mismatch problem, for the loans from Japan cannot be drawn upon to repay other lenders.

Finally, we welcome the offer by Japan to lend, and I support the proposed decision in regard to the proposed borrowing agreement between the Government of Japan and the Fund as outlined in EBS/86/265. However, I cannot go along at present with the proposals in EBS/86/266. These need to be more carefully studied. Ideally, the staff should have explored the possibility of using the Japanese resources within the existing policies. Therefore, I suggest that we take no decisions today in respect of the proposals in EBS/86/266.

Mr. Dallara recalled that a few weeks earlier the Board had endorsed the extension of the drawdown periods under the borrowing agreements with the Saudi Arabian Monetary Agency (SAMA); at the present meeting, the Board was apparently in the process of endorsing the Japanese loan to the Fund. It had been his impression from the staff paper on the management of the Fund's liquidity (EBS/86/266) that, given the extension of the drawdown periods but not the repayment periods on the SAMA loan, in the absence of a modification of the 1:1 ratio of ordinary to borrowed resources under the enlarged access policy, the use of the SAMA resources would lead to a mismatching of drawings and repayments, which would significantly reduce the potential utility of the resources to the Fund. He had the impression, perhaps incorrect, that there had been certain implications for liquidity management arising as a result of the terms and conditions negotiated for the two loan agreements. He would appreciate confirmation of his impression and clarification of the implications that flowed from the terms and conditions negotiated for the two arrangements.

The Treasurer observed that the staff was proposing to increase the ratio of borrowed to ordinary resources under enlarged access mainly to make more efficient use of the extended loan arrangements from SAMA. Even in the absence of a loan agreement with Japan, the staff would have given consideration to changing the ratio for the reasons pointed out by Mr. Dallara and reported in the staff paper. Specifically, "the use of ordinary resources was likely to increase in the forthcoming period, in the financing of purchases under arrangements, as a result of the repayment of short-term borrowings, and taking account of purchases under the special facilities." The "mismatch" to which Mr. Dallara had referred could result in a use of ordinary resources amounting to several billion SDRs. In effect, the Fund would be expending ordinary resources to repay short-term loans contracted from the BIS and certain member countries as well as SAMA under the 1984 short-term loan agreement.

It was in part because of the projected use of ordinary resources that the staff was suggesting drawing on the Japanese loan to help finance purchases of ordinary resources under arrangements relatively early, since such drawings would help to conserve ordinary resources, the Treasurer continued. It should perhaps be added that while there was no legal requirement to use the Japanese loan for any particular purpose, it was the staff's clear understanding that Japan would prefer that the resources not be used by the Fund to repay the short-term loans to which he had earlier referred. Therefore, the only way to alleviate the problems of the "mismatch" was to allow the Fund to use borrowed resources in the near term and in something like the proportions that the staff had suggested. In sum, the shortening of the maturities under the SAMA loan arrangements and the prospect of very large repayments of short-term loans coming due had led the staff to propose changing the ratio for use of borrowed resources under enlarged access and to introduce the use of the loan from Japan into the financing of purchases of ordinary resources. It should perhaps be noted that the actual amounts involved in the effort to conserve ordinary resources in 1987 would be small relative to the total of the Fund's liquidity, given the projected use of the Fund's resources and the amounts of the Japanese loan expected to be used for that purpose. To further ensure that the impact was not too great, the staff was proposing that the financing ratios be reviewed every six months.

He continued to hope that the maturities under the SAMA loan agreements might be extended, the Treasurer commented. That question had been discussed at the time of the extension of the drawdown periods, and there was nothing in the SAMA loan agreements that would prevent the Saudi authorities and the Fund from returning to the issue later. He would suggest that the question be raised in, say, a year's time. If the maturities were to be extended, the financing ratios could be considered again.

Mr. Dallara asked whether he was correct in assuming from the Treasurer's comments that the relative conservation of ordinary resources that would result if the recommended shift in the ratio was effected would of necessity be offset by the projected reduction in ordinary resources that would result from repayment of the short-term loans.

The Treasurer replied that Mr. Dallara was correct in his assumption; indeed, the conservation of ordinary resources that it was hoped to achieve through a change in the ratios would not be enough to fully offset the expected reduction in ordinary resources that would result from the repayment of the short-term loans.

Mr. Zecchini wondered whether, if the Fund followed the recommendations of the staff and changed the current mix of ordinary and borrowed resources, it would theoretically be possible ultimately to deal with the problem of the "mismatch" by replacing maturing resources from SAMA with borrowed resources from Japan. After all, the Japanese resources would seem to cost less than the SAMA resources. Was there anything to prevent the Fund from making such use of the Japanese resources in the management of its liquidity?

Mr. Fujino noted that his authorities were willing to be flexible and even accommodating with respect to the use of the resources offered by Japan. Their wish was only that the money should be used in the best interest of the institution. However, it would not be consistent with the spirit of the Japanese offer to use the resources directly to repay other loans. The Interim Committee had suggested that the resources would have value in supporting member countries' adjustment efforts, and it was his understanding of that view that the money should serve to effect credit tranche policy rather than simply as a financial replacement of resources.

Mr. Zecchini recalled that he had been careful to ask only whether the approach was theoretically feasible; he fully understood the concerns outlined by Mr. Fujino. In that respect, however, beyond the political aspects of the issue described by Mr. Fujino were the economics of the arrangment. While Japan was interested in not directly repaying or facilitating the repayment of other borrowed resources, a kind of financial recycling would, de facto, take place.

The Treasurer observed that the staff's suggestions had been formulated in an effort to remain consistent with the spirit in which the loan was offered. There was of course no question about the fact that the loan would generally strengthen the Fund's liquidity and would thus strengthen its ability to repay those shorter-term loans that would soon be coming due. If the Fund wished to achieve the theoretical effect outlined by Mr. Zecchini in a practical way, while remaining consistent with the spirit of the loan agreement, the Fund should use the loan from Japan to support lending agreements with debtors in serious difficulty. And that was the essence of the staff's proposal to accelerate the use of borrowed resources in the first instance from SAMA and, second, by inserting the Japanese loan resources in those lending agreements at an early stage in substitution of ordinary resources.

Mr. Kabbaj asked whether the mismatching of maturities would have occurred if more ordinary resources had been used. The Fund found itself in a difficult situation, as he saw it, because the institution had consistently overestimated the potential use of Fund resources; in that respect, he wondered whether the staff's proposal would resolve the problem. It might help for 18 months or two years, but the problem could be even greater beyond that period.

The Treasurer responded that he saw no connection between the mismatching and any mistakes that might have been made in estimating the use of borrowed resources. It was the Fund's policy to finance enlarged access with borrowed resources; and, unless there had been an actual need for use of such resources, the Fund would not have borrowed them. In other words, the borrowing had little to do with projections of use; resources were borrowed, as needed, to finance loans by debtors. It was only because the loans were short term in nature that a mismatch was created between the repurchase periods and the borrowing periods.

Another question raised by Mr. Kabbaj was whether by raising the ratio at present, a larger problem might not be created in future because the Fund was borrowing short term and might have to repay short-term funds in a larger amount earlier, the Treasurer continued. The calculation was certainly correct, but one was not dealing with purely an arithmetical matter in looking at the Fund's liquidity. It was a matter of judgment as to whether and when the liquidity position would change. The Fund knew for certain that the loan provided by SAMA would have an ever-shortening maturity, and if the intention was to use the resources efficiently under enlarged access, the Fund should begin to use those resources as soon as possible. The extent to which it should do so was an issue that was related to a number of other questions that were difficult to answer. One was whether or not SAMA would extend the maturities. It was also worth asking whether and when the resources from the Japanese loan should be used and, on a related matter, when the quota increase would begin to take shape. Finally, it was unclear what would happen to the Fund's liquidity beyond a period of, say, 18-24 months.

Mr. Kabbaj, clarifying his earlier question, noted that when the Fund had decided on the mix of resources, it had done so on the assumption of a certain use of Fund resources by certain borrowing member countries. When the Fund had proceeded with the borrowing arrangements, including the very short-term arrangment with the BIS, it had done so on the basis of certain expectations regarding enlarged access policy, expectations which had eventually changed. The decision to reduce access in nominal and effective terms had a bearing on the question; indeed, if Directors had known when the mix had been established that the use of resources would be far lower than expected at the time, they would probably not have agreed to a 1:1 ratio. The ratio might well have been 2/3 ordinary resources and 1/3 short-term borrowed resources. And it might not have even been necessary to draw on the short-term lines of credit from the BIS.

On another matter, he agreed with Mr. Vasudevan that the conservation of ordinary resources could create problems, Mr. Kabbaj remarked. For example, such conservation might lead to the conclusion that a quota increase was not needed; and that would be the wrong conclusion.

The Treasurer reiterated his earlier point that the matter of the mixing policy was not as simple as was being suggested by Mr. Kabbaj. The 1:1 ratio applied only to a small part of total lending under enlarged access; for example, purchases beyond the fourth credit tranche were made with borrowed resources. That left little room for the kind of flexibility that Mr. Kabbaj had suggested.

It should perhaps be noted in response to a point raised by Mr. Vasudevan that the staff was not concerned about the projected availability of the Fund's ordinary resources per se, the Treasurer continued.

Rather, it was concerned about the uncertainties faced by the Fund and its membership. The staff was not assuming that the world was steady and stable; indeed, it was assuming the reverse, and it was on the basis of that assumption that the staff had put forward its proposals for managing the Fund's liquidity in a particular way. Given the current instability in the world, the position of the Fund could change dramatically on both the supply and the demand sides in amounts equivalent to several billion SDRs. In that respect, the concerns of the staff were based on a strong desire for efficient management of the Fund's liquidity in the face of a wide variety of circumstances that could arise.

Mr. Vasudevan observed that in the August 13, 1986 paper on review of the Fund's liquidity (EBS/86/187), the staff had indicated that the financial position through end-1987 was likely to be satisfactory, despite some uncertainties. Moreover, it had stated that "if, contrary to current projections, there were a significant deterioration in the Fund's financial position due to unforeseen changes in the demand or supply of ordinary or borrowed resources, the staff would propose appropriate steps for consideration by the Executive Board, including possible consideration of the appropriate mix of the Fund's resources used to finance arrangements under the enlarged access policy." The question was whether a "significant deterioration" had occurred and whether there had been "unforeseen changes" in the demand for borrowed resources. In the absence of any proof of a significant deterioration in the Fund's financial position, he saw no reason for the staff to have proposed changes in the mix of the Fund's resources used to finance arrangements under the enlarged access policy.

The Deputy Treasurer replied that the intention in the paper to which Mr. Vasudevan had referred had been to say that if there were a substantial expansion of demand for Fund resources under enlarged access, the staff would have to return to the Board with proposals for the financing of that expansion, which might entail a change in the mix and perhaps additional borrowing.

Mr. Vasudevan commented that his main concern was that the staff had earlier defined certain "triggering" developments that would lead it to propose to the Board changes in the mix of resources used to finance arrangements under the enlarged access policy and had, in the absence of those triggering developments found some other vehicle for bringing the proposed changes to the Board.

Mr. de Groote considered that it was wrong to suggest that the loan agreement with Japan was needed mainly for the sake of the Fund's liquidity. The real need was to recycle the large Japanese surpluses. It was obvious that, in the face of surpluses in certain countries, other countries would need to draw more on the Fund, with of course some uncertainties related to those deficit industrial countries that might not use the Fund as much as they could. The Fund should not give the impression that it was in the midst of a liquidity problem and that an effort was being made to search out available resources; rather, one must perceive a set of imbalances among current accounts in the world and try to envisage the Fund as one of the many elements that could contribute to alleviating the problem.

Mr. Parmena made the following statement:

I welcome the proposed borrowing agreement with the Government of Japan and commend the Japanese authorities for their continued support of and cooperation with the Fund. The loan will no doubt enhance the ability of the Fund to respond favorably to the needs of many of its members that continue to experience persistent difficulties in their balance of payments positions. The availability of the loan should provide an opportunity to reverse the continuing decline in Fund financing, particularly for the small, low-income countries whose actual access to Fund resources has been constrained through restrictive application of access limits. Although the Fund's liquidity position was not a major factor behind the progressive reduction of actual access for many members, the availability of the loan from Japan should help to expand Fund financing within the existing access limits.

On the use of funds under the loan, I fully agree with the staff on the need for considerable flexibility in procedures to facilitate an efficient and effective utilization of the resources, particularly in view of the increasing uncertainties surrounding the balance of payments positions of many countries and the prospects for the world economy as a whole. However, I have difficulties with most of the views and specific suggestions made by the staff in EBS/86/266.

First, I do not share the view that a shift toward greater use of ordinary resources has been a major factor behind the high level of undisbursed borrowed resources. As stated by the staff on page 3 of the paper, "the Fund's holdings of usable ordinary resources (adjusted) stand at about SDR 30 billion," which shows no significant reduction in the holdings of ordinary resources. I believe that the high levels of both undisbursed borrowed resources and ordinary resources are the result of the continued contraction in Fund financing to low-income countries in recent years. With the holdings of usable ordinary resources of about SDR 30 billion, I find it difficult to accept the staff's argument that there is a pressing need to conserve ordinary resources.

Second, the stated objective of the loan is to enhance the Fund's ability to meet the increasing demand by members for its resources and to expand Fund financing even within existing access limits. This can best be served by using the loan to supplement the existing borrowed and ordinary resources. Accordingly, it becomes necessary not only to avoid displacing other borrowed resources but also to avoid substituting for ordinary resources. Therefore, the suggestion by the staff that the Japanese financing be concentrated primarily on those portions of arrangements that would otherwise be financed with ordinary resources is not acceptable. Such a policy will result in a higher rate of charge on the use of ordinary resources. Apart from this, the effectiveness of the Japanese loan in increased financing by the Fund will be reduced if the funds made available were to be used as ordinary resources to finance purchases. The view of this chair is that the resources available under the loan should be used only as borrowed resources to finance purchases under stand-by or extended arrangements, the same way that other borrowed resources are used.

My final point is related to the proposed change in the mix of ordinary and borrowed resources. It is important to stress here that the Fund is a quota-based institution and that quotas should remain the main source of financing. The proposals to change the resource mix, in my view, constitute a major change in Fund policy on the use of its resources; and before we can make such changes, a number of issues need to be examined. I think this is not the right occasion to introduce the proposed changes, and a more thorough consideration of the various issues involved is needed. Accordingly, while we support the proposed decision on page 6 of EBS/86/265, we find it difficult to accept the other two draft decisions proposed on pages 12 and 13 of EBS/86/266 as they stand.

Mr. Kafka made the following statement:

We endorse the principle of the proposed borrowing from Japan, and we note with particular satisfaction the extension of the drawdown periods under the borrowing agreements with the Saudi Arabian Monetary Agency (SAMA).

On the proposed Japanese loan, we would prefer the rate of interest to be equivalent to the combined domestic rate for three months' maturities. This would be in line with the calculation of the SDR interest rate. Resources derived from the Japanese loan should be available for financing of drawings at the discretion of the Fund.

Use of the Japanese loan should not displace other borrowed resources. The staff recommendation for a mix of ordinary resources with borrowed resources from Japan in the ratio of 2/3 to 1/3 is therefore acceptable to us. With respect to charges, considerations of administrative convenience, simplicity, and flexibility warrant the application of the Fund's established policies on charges and repurchases pertaining to the policy on enlarged access. Accordingly, alternative b(i) on page 11 of EBS/86/266 is preferable. Finally, we do not favor other changes in the mix of resources.

Mr. Zecchini stated that his authorities wished to commend the Government of Japan for offering to lend the equivalent of SDR 3 billion to the Fund. The offer was a significant step by Japan toward enhanced cooperation with the Fund. At the same time, his authorities hoped that Japan would continue to contribute to increasing the welfare of the world economy through other forms of contribution. In particular, it was to be hoped that Japan would continue to strive to create the conditions at home for a greater expansion of domestic demand, thereby helping to create a more balanced pattern of external accounts at home as well as abroad. Also to be appreciated was the skillful way in which the staff and the Japanese authorities had drafted the terms of the borrowing agreement.

As the staff recognized, the liquidity position of the Fund was broadly satisfactory at present and would continue to be so in 1987, Mr. Zecchini continued. The years beyond 1987--when the bulk of purchases linked to the sizable lending of 1982-83 would come due--were more uncertain. In light of the financial projections, the loan by Japan could be viewed as a form of insurance against the repayment risks, which were difficult to assess at present. He had no objection to the terms of the agreement, since the maturity of the loan and the cost seemed reasonable. Of course, the overall amount of credit available could be reviewed in light of emerging circumstances to see whether the amount was sufficient.

In reviewing the paper on the management of the Fund's liquidity, one must ask whether it was necessary to introduce adjustments in the use of ordinary resources for the purpose of achieving "a more desirable and effective pattern of use of the Fund's resources," Mr. Zecchini remarked. For several reasons, his authorities remained unconvinced that it was in the best interest of the Fund at present to introduce changes in the existing rules. First, it was not expected that any liquidity shortages or deficiency in ordinary resources would arise through 1987. Second, any change in the financing mix related to the use of ordinary resources could involve an increase in borrowing costs, although the increase was unlikely to be large at present. Third, the ultimate rationale for conserving ordinary resources by replacing them with borrowed resources from different sources was unclear. His authorities had always believed that the Fund was an intergovernmental institution based on quotas rather than on borrowed resources. Any attempt to change the character of the Fund by reducing quota-based resources should be carefully scrutinized and thoroughly discussed. On the basis of the considerations he had mentioned, his authorities did not wish at present to change the mix of ordinary and borrowed resources in the second through the fourth credit tranches. Should the need for such a change arise in future, they were ready to consider the question at that time, looking at all of the implications of such a move. However, if a clear and strong majority in favor of such changes should emerge at the present meeting, the preference of his authorities was for the first alternative mentioned on page 6 of EBS/86/266. As to that part of the financing under the enlarged access policy relating entirely to borrowed resources, he believed that the resources from the Japanese loan should be treated in the same way as SAMA resources.

The Executive Directors agreed to continue their discussion on the borrowing agreement with Japan and on the management of the Fund's liquidity in the afternoon.

3. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Jayawardena at the conclusion of his service on the Executive Board.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/203 (12/17/86) and EBM/86/204 (12/19/86).

4. STAFF COMPENSATION - JOINT BANK-FUND COMMITTEE - BUDGETARY RESOURCES FOR FY 1987 AND FY 1988

The Executive Board approves the recommendation of the Managing Director on the request by the Joint Bank-Fund Committee of Executive Directors on Staff Compensation for budgetary resources as set forth in EBAP/86/313 (12/12/86).

Adopted December 18, 1986

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/86/315 (12/15/86).

Adopted December 18, 1986

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/54 and 86/55 are approved. (EBD/86/325, 12/12/86)

Adopted December 18, 1986

7. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/86/316 (12/17/86) is approved.

APPROVED: August 5, 1987

LEO VAN HOUTVEN
Secretary