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December 19, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: The Functioning of the International Monetary System - Proposals in the G-10 and G-24 Reports - Their Interrelations and Plans for Examining Them

Attached for consideration by the Executive Directors is a paper on the proposals and recommendations set forth in the G-10 and G-24 reports, which has been scheduled for discussion on Wednesday, January 29, 1986.

Mr. Crockett (ext. 8982) for Sections I-V and Section VII and Ms. Kelly (ext. 8374) for Section VI are available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

The Functioning of the International Monetary System

Proposals in the G-10 and G-24 Reports: Their Interrelations and Plans for Examining Them

Prepared by the Staff

December 18, 1985

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Proposals in the G-10 and G-24 Reports: Their Interrelations and Plans for Examining Them

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I. Introduction

This paper is intended to provide Executive Directors with a comprehensive statement of the various proposals and recommendations set forth in the Reports of the Group of 10 and Group of 24 (hereafter the G-10 and G-24 Reports.) 1/ It also indicates how these proposals and recommendations are likely to be brought forward for consideration by the Executive Board and the Interim Committee, in the light of the agreement reached on the current Work Program of the Board. It will be recalled that the Chairman of the Interim Committee has agreed to discuss with the Chairman of the Development Committee "to what extent arrangements could be made for cooperation on matters pertaining to development." 2/

For the most part, the present paper does not enter into a substantive appraisal of the proposals made in the two reports, as such an appraisal can be more effectively undertaken in the other papers being prepared for Board consideration. The plan of the paper is as follows: Section II contains a brief description of the background to the two reports, and an analysis of the interconnections among the various specific issues they cover. The next four sections cover, in turn, the four major topics that are common to both reports. These are: the functioning of the exchange rate system; surveillance; liquidity and the SDR; and the role of the Fund. The concluding section deals with the proposals on debt and the transfer of resources made in the G-24 report. In each of these sections an attempt is made: (i) to present the recommendations that are contained (either explicitly or implicitly) in the reports; (ii) to identify areas of agreement and disagreement; and (iii) to describe the sequence of papers and discussions by which it is suggested that progress be made in moving toward a resolution of the issues.

1/ "The Functioning of the International Monetary System: A Report to the Ministers and Governors by the Deputies of the Group of Ten," June 1985 (circulated as EBD/85/154, Supplement 1). "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," August 21, 1985 (circulated as EBD/85/228).

2/ Communique of the Interim Committee of the Board of Governors of the International Monetary Fund, October 7, 1985.

II. Background

The G-10 and G-24 reports arose out of a concern over certain perceived shortcomings in the functioning of the international monetary system. The G-10 report had its origins in the Williamsburg Summit of 1983. The Summit communique contained the following paragraph:

"We have invited Ministers of Finance, in consultation with the Managing Director of the International Monetary Fund, to define the conditions for improving the international monetary system and to consider the part which might, in due course, be played in this process by a high-level international monetary conference."

Following this, at the time of the 1983 IMF/IBRD Annual Meetings, the G-10 Ministers and Governors instructed their Deputies to identify areas in which progressive improvements in the functioning of the international monetary system might be sought. The Deputies' report was transmitted to Ministers and Governors on June 1, 1985 and adopted by Ministers at their Tokyo meeting on June 21, 1985.

The G-24 Report was prepared by a working group established in May 1985 for the purpose by the Chairman of the G-24. This Report draws on an earlier document, the "Revised Program of Action Towards Reform of the International Monetary and Financial System" adopted by the Ministers of the G-24 in September 1984. The 1985 Report extends the analysis of the 1984 Revised Program in the areas covered by the G-10 Report, and also deals with the subjects of debt and the transfer of resources.

Both the G-10 and the G-24 reports recognize that the various issues related to the working of the international monetary system are closely interconnected. For example, procedural or institutional changes aimed at improving the functioning of the exchange rate system have major implications for the other subjects dealt with in the reports. Any changes in the operation of the exchange rate system, whether achieved through modifications in the system itself or through improvements in the mechanisms of policy coordination, would be reflected in the implementation of surveillance. This immediately raises issues concerning how proposed changes in the principles and/or procedures of surveillance can be designed so as to support whatever conclusions are reached on the operation of the exchange rate system.

The issue of liquidity also has important linkages with the exchange rate system and the operation of surveillance. The nature of the exchange rate system is a central determinant of how the adjustment process works, and thus conditions the overall need of Fund members for access to liquidity. For example, the adoption of some form of target zone proposal supported by increased reliance on the technique of exchange market interventions would presumably affect the demand of countries to hold reserves for this purpose. Strengthening supervision over banks operating in international markets, as proposed in the G-10 report, could affect the conditions under which developing countries have access to international capital markets. Accordingly, such strengthening has clear implications for liquidity in a system in which capital markets are accorded a major role in the reserve supply mechanism.

Questions of debt and the transfer of resources are affected by the manner in which the international monetary system works in other respects. Instabilities in the exchange rate system can complicate the management of external debt in a number of ways: by generating unanticipated fluctuations in interest rates and the terms of trade; by exacerbating protectionist pressures; by weakening incentives to invest in traded goods industries; by creating fluctuations in the value of external reserves; and by generating a loss of creditworthiness when unanticipated adverse developments occur simultaneously. The transfer of resources is an issue that is also closely related to the matter of debt and debt servicing, since inadequate resource transfers (or inadequately stable resource transfers) can undermine the growth prospects of member countries and create uncertainties about their ability to service smoothly their external debt.

Proposals made with respect to the role of the International Monetary Fund cover a number of particular aspects of the functions and purposes of the institution. In a general sense, however, the role of the Fund, as the central institution in the international monetary system, has to be conditioned by the membership's vision of how the system as a whole is expected to function and evolve. For example, the conditions that the Fund may require members to meet when using its resources will reflect aspects of the approach to surveillance, including the balance to be struck between financing and adjustment in responding to balance of payments disequilibria and the range of policies to be subject to international review. Indeed, conditionality, in addition to its role in relation to Fund programs, requires the overseeing of performance criteria that is itself a form of surveillance. A further example of how the role of the Fund is affected by other aspects of the functioning of the system is the relation between the conditions required of a user of Fund resources in a particular case, and the volume and type of liquidity available from sources other than the Fund.

The existence of major interconnections among the various aspects of the functioning of the international monetary system raises the question of the manner in which the various proposals in the G-10 and G-24 reports should be discussed. Are the linkages so close that it would be misleading not to consider the various subjects together? While interconnections are important, they do not appear to be of a character to require simultaneous discussion of the different topics. Thus, while an initial review by the Board of the reports as a whole could be useful in establishing a context for discussing individual proposals and recommendations, it seems both feasible and desirable for the substantive discussion of issues to start off around specific topics.

There is, nevertheless, a certain logical hierarchy in the issues to be decided. Views on the operation of the exchange rate system determine the form of the guidance given to members and to the Fund concerning exchange rate policies and the implementation of surveillance. Agreement on the future role of the SDR must await the emergence of a clearer view of the reserve supply mechanism. This, in turn, depends in part on the extent to which surveillance guidelines will attempt to influence the manner in which international capital markets are used to provide balance of payments finance to cover current account deficits and contribute to the provision of reserves.

The foregoing considerations, taken together, suggest the following broad strategy for work on the G-10 and G-24 Reports.

(i) Discussion of the various proposals in the two reports should be organized around the five main topic headings in the reports.

(ii) Discussions in the five areas should recognize the linkages among subject areas, where these are significant, but the discussions themselves can proceed separately.

(iii) The logical priority of certain topics should be recognized, and attention devoted to ensuring that progress in these areas does not fall behind that in others.

(iv) Subject to the consideration noted in (iii) above progress can be made in each subject area in parallel fashion.

III. The Functioning of the Exchange Rate System

The two reports agree that the variability of exchange rates, both in the short run and in the longer run, has been a source of concern. The G-24 report is, however, considerably more forthright in its criticism of the present system. It states (para. 2) "The experience with the present exchange rate system has not been satisfactory. Exchange rates of major currencies were characterized by a high degree of short-term volatility as well as persistent misalignment which brought about uncertainty regarding future exchange rates, discouraged investment and trade, and resulted in misallocation of resources." The G-10 report, by contrast, notes a number of strengths, as well as weaknesses, in the operation of the system. It considers that exchange rate flexibility has made a positive contribution to external adjustment and has enabled the system to withstand disturbances better than any feasible alternative. Furthermore, exchange rate flexibility has helped countries seeking to disinflate to insulate their domestic price level from inflationary disturbances originating abroad. Among the weaknesses of the system noted in the G-10 report is its failure to promote sound and consistent policies. As a result, inadequate policies and divergent economic performance have contributed to short-term exchange rate volatility, as well as to large medium-term movements in real exchange rates.

The difference in emphasis in the appraisal of the current exchange rate system is reflected in the proposals for modification that are made. Neither report suggests a return to fixed exchange rates. However, the G-24 report argues for according exchange-rate stability a greater and more explicit priority. The key proposal in the G-24 report is that a system of "target zones" should be established for the major currencies. Target zones are seen as providing the leverage needed to generate better policy coordination among major countries. The commitment to such zones would imply complementary use of monetary, fiscal, and other policy instruments, and would involve the use of intervention as a supplementary device. The specific characteristics of a target zone proposal are not spelled out in the G-24 report; further study is thus called for. In the meantime, the G-24 report says, a mechanism has to be devised to enforce policy coordination among major countries. For the most part, such coordination should be pursued through consultation in the Fund and the development of "trigger" mechanisms to provide for consultations when excessive volatility or misalignment among major currencies occurs.

The G-10 report, on the other hand, concludes that fundamental changes in the current exchange rate system are not called for, but that improvements should be sought within the framework of the present system. These improvements should be aimed at enhancing the appropriateness and mutual compatibility of the policies of members (both industrial and developing). The means by which this would be achieved are through "close and continuing co-operation among member countries," involving both the commitment to stable domestic policies and the willingness to give greater weight to international considerations in the formation of domestic policies. The G-10 report explicitly rejects the target zone proposal as being "...undesirable and in any case impractical in current circumstances" (para. 32). It is noted, however, that some G-10 Deputies held a contrary view, while others acknowledged that there could be merit in the target zone proposal and that the technical aspects of the approach should be further explored at an appropriate time.

To enable the Board to consider the proposals made by the two reports with respect to the exchange rate system, the work program calls for the staff to produce a paper for Board discussion in February 1986. This paper will review the strengths and weaknesses of the present system, as discussed in the two reports, and will consider a range of options for modifications in the present system. These options include the possible usefulness of target zones; the use of other forms of trigger mechanisms or objective indicators for initiating assessments of members' policies; and the use of consultative and judgmental mechanisms that do not rely on quantified estimates of equilibrium exchange rates or equilibrium settings of other policies. A supplementary paper will present the features of alternative versions of the target zone proposal, together with a review of their strengths and weaknesses.

It is to be hoped that the Executive Board discussion of these papers, together with the paper on Surveillance over Exchange Rate Policies, will enable the Interim Committee to be presented with some broad options for the future evolution of the exchange rate system (including, of course, the option of a system based essentially on present arrangements). The Interim Committee could then be asked for guidance as to which general approach appears most likely to be fruitful. In providing such guidance the Interim Committee might ask the Board to proceed to any decisions that the Committee might feel were warranted, or to examine any issues that it felt required further study.

IV. Surveillance

Both the G-10 and G-24 reports agree that the function of surveillance is central to the Fund's role. The G-24 report states (para. 9), "the surveillance function of the IMF is crucial for an orderly international monetary and financial system." The G-10 report says (para. 104), "In considering ways to promote the convergence of economic performances towards sustainable non-inflationary growth through the adoption of sound, compatible policies, the Deputies have agreed that surveillance, especially by the IMF, is the basic tool for moving toward these objectives."

The reports agree that surveillance should be evenhanded and symmetrical, and that to achieve this in practice requires particularly close scrutiny of the policies of countries that are important in the international financial system. There is also agreement that surveillance has so far been less effective than desirable in influencing national policies and in promoting underlying economic and financial conditions conducive to exchange rate stability. This criticism is particularly strong in the G-24 report, which states, "Fund surveillance has to date been largely ineffective over the major industrial countries..."

To remedy these defects, the reports offer a number of procedural and substantive suggestions. These suggestions have implications for the 1977 and 1979 Board decisions on Surveillance over Exchange Rate Policies, as well as for conduct of Fund surveillance more generally. The G-10 report invites the Fund (para. 106) "to review the relevant decisions for invoking" supplemental surveillance procedures. This sentiment is echoed in the G-24 report (para. 85): "...the Fund may be allowed to make greater use of the supplemental surveillance procedures."

Several proposals made in the reports would seem to imply changes in the 1977 document on surveillance principles, even though neither report explicitly calls for a revision of the document. The endorsement by the G-24 of the target zone proposal would have to be given effect through changes in the guidance given, in the 1977 document, for the conduct of members' exchange rate policies. Consequential changes would be required in the procedures for monitoring exchange rate policies and for initiating supplementary consultations. The changes implied by the G-10 report would be less far-reaching since the report concludes that "no major changes are required in the present institutional setting for exercising surveillance" (para. 36). Nevertheless, the proposal that more attention be given to domestic economic policies and developments in assessing exchange rate trends might call for some modification in the language of the 1977 decision, which focuses on policies adopted "for balance of payments purposes." Modifications might also be required to give effect to the proposal that greater use should be made of supplemental surveillance procedures.

In developing suggestions for making the implementation of surveillance more effective, both reports draw a distinction between Article IV and multilateral forms of surveillance. (The G-10 report implies that these should be related but not closely integrated approaches, while the G-24 proposes they should be linked and sequential, with multilateral agreement on broad objectives providing an explicit framework for making recommendations to individual countries). Concerning Article IV (sometimes called bilateral) surveillance, the G-10 report makes at least nine proposals. First, governments should be involved in the consultation process at a senior policy-making level. Second, the possibility of greater publicity for the outcome of the consultation process should be explored. Third, "internal publicity" should be increased through bringing Fund reports and summings-up to the attention of key economic policy makers. Fourth, a confidential exchange of views between the Managing Director and the Finance Minister should be envisaged at the end of the consultation process for important countries (both industrial and developing). Fifth, more candid assessments of policies, with precise suggestions for policy changes, should be provided, and a follow-up report should be undertaken. Sixth, consultation reports should be used to identify necessary improvement in the scope, quality, and timeliness of data.

Seventh, improvements should be attempted in analytical techniques, which should be made more explicit and set in a medium-term context. Eighth, greater use should be made of supplemental surveillance techniques. Ninth, continued development of "enhanced" surveillance procedures should be undertaken.

The G-24 report is less comprehensive than that of the G-10 in exploring possible modifications in existing consultation mechanisms. This may be a consequence of the fact that it focuses on more far-reaching changes in the mechanism of exchange rate management and surveillance. Concerning two of the proposals listed above, however, it is in sharp disagreement with the G-10 report. The G-24 Deputies are not in favor of publicity concerning relations between the Fund and its members, and they are unwilling to see any extension of the technique of enhanced surveillance.

As far as multilateral surveillance is concerned, both reports see a continued (and intensified) role for the Fund's World Economic Outlook (WEO) exercise. The G-10 report proposes that there should be a "separate chapter" of the WEO devoted to "analyzing the repercussions of national policies of G-10 countries and of their interaction in the determination of exchange rate developments and international adjustment" (para. 51). The report proposes that the G-10 should review the conclusions of this chapter, when appropriate, at ministerial level. The G-24 sees the WEO as important not only in its own right, but as a basis for reaching judgments on the appropriate setting of policies by individual countries. An outcome of the WEO exercise would be the establishment of a set of "objective indicators" or "targets" for a few major industrial countries, such as the key-currency countries. This would then provide a basis for appraising the actual performance of the countries concerned.

The various proposals put forward in the two reports will be described and analyzed at greater length in the forthcoming staff papers reviewing the principles and implementation of Fund surveillance over exchange rate policies. Some of these proposals would involve significant changes in the 1977 document. Since such changes pose rather far-reaching issues, on which agreement may well be time-consuming, the initial staff paper on the subject will concentrate on setting out the nature of the issues involved and inviting reactions from Executive Directors. This would make it possible to present the Interim Committee with a more specific set of questions or suggestions on which guidance could be requested. Thereafter, if appropriate, the staff could propose to the Board amendments to the text of the surveillance decision, which could be discussed in the period between the April 1986 Interim Committee Meeting and the 1986 Annual Meeting.

Other proposals noted above could be adopted without any need to change the language of the 1977 decision. Some of these were already discussed on the occasion of the 1985 review of the implementation of surveillance (EBM/85/47-48 1/. However, all the relevant proposals will be set out in the forthcoming staff paper. In the light of conclusions reached during the course of Executive Board discussion of this paper, proposals relating to certain aspects of the future implementation of surveillance could be presented to the April 1986 meeting of the Interim Committee. The World Economic Outlook report that is due to be issued in March 1986 will be prepared in light of the recommendations in the reports; further modifications in WEO analysis and procedures will be considered on the basis of comments offered by Executive Directors.

V. Management of International Liquidity and the SDR

The G-10 and G-24 Reports generally agree on the nature of the factors influencing the demand for and the supply of international liquidity. Both reports note that the demand for reserves has not been significantly reduced as a result of the advent of floating exchange rates. Countries have continued to hold reserves for exchange market intervention, as a means of demonstrating creditworthiness, and as a precaution against exogenous shocks. International credit markets constitute an important source of supply of international reserves; the adequacy of international liquidity must, therefore, be measured not only by actual holdings of reserves but also by the availability of credit from private and official sources. Continued access to international credit markets requires that countries maintain their creditworthiness, which depends in large part on their own domestic policies and performance but also to some extent on those of the major industrial countries.

Both reports recognize that the workings of the present reserve system have not been entirely satisfactory. The G-10 report notes the view of some Deputies that the uneven expansion of international credit and sharp shifts in the terms and conditions on which international liquidity has been made available have not always been conducive to a gradual adjustment toward steady noninflationary growth. Limited access to market borrowing by certain groups of countries and abrupt market response to changes in creditworthiness are also noted in this context. Other G-10 Deputies are reported as ascribing the observed sharp shifts in liquidity to countries' failure to maintain sound underlying policies. The G-24 report also draws attention to the uneven development of international liquidity conditions, and considers that the present inadequacies in the mechanism for providing international liquidity cannot be

1/ See "Enhancing the Effectiveness of Surveillance: The 1985 Annual Review of the Implementation of Surveillance" (SM/85/65).

corrected or controlled through market processes. In the view of the G-24 Deputies, the conditions of supply of international reserve assets and the distribution of liquidity are more important determinants of the functioning of the international monetary system than the absolute size of global reserve holdings.

The two reports differ in their evaluation of the contribution of present arrangements to the provision of international liquidity and the functioning of the international monetary system. The G-10 Deputies note that international credit markets have been quite flexible in providing new channels for satisfying the demand for reserves quickly and efficiently for countries with access to those markets, albeit under terms and conditions influenced by the financial policies of the reserve currency countries. Countries that do not have access to international credit markets will require officially supported financing, but this should be provided on appropriate terms in support of sound policies that can help promote creditworthiness.

In contrast, the G-24 Deputies view the large role played by commercial banks in the provision of international reserves as having important drawbacks. The high cost of commercial credit has excluded a large number of developing countries from the market. Moreover, events since 1982 suggest that the opportunity to hold or augment borrowed reserves may be withdrawn when most needed. In the opinion of the G-24 Deputies, the restoration of creditworthiness should not be the only channel available to remedy the current inadequacy of reserve holdings of many countries. Improvement of creditworthiness, like the acquisition of earned reserves, depends on the ability of countries to strengthen their balance of payments positions; it is therefore importantly influenced by the domestic policies of major industrial countries, which have not been internationally consistent and coordinated.

Both reports set forth proposals for improving the management of international liquidity. These proposals may be classified under two headings: those intended to strengthen the international liquidity system in general and those put forward to change the role of the SDR in meeting world liquidity needs.

The G-10 report makes a number of suggestions under the heading of strengthening the system. First, improvement of the operation of financial markets in the provision of international liquidity can be sought through encouragement of the collection and dissemination of data used in the assessment of creditworthiness, through deregulation of capital markets and liberalization of capital movements, and through strengthened supervision of banks operating in international markets. Second, integration of surveillance over members' exchange rate policies and surveillance of international liquidity can contribute to a better functioning of the international monetary system. Third, the provision of official financing on appropriate terms to countries with limited access to private capital markets can help restore the creditworthiness of these countries. The G-24 report also supports stricter surveillance over exchange-rate and other macroeconomic policies, as well as surveillance of international liquidity, because "the scope for international liquidity policy is ... limited by the willingness of major countries to consider the international impact of their policies and to respond to the urgings made in the representative international fora" (para. 95).

As regards the role of the SDR in the provision of international liquidity, both reports note that the SDR has not played a major part in the international financial system. The reports differ, however, on the causes of this failure. The G-24 report ascribes it mainly to the meagerness of SDR allocations, i.e., to a limitation of supply. The G-10 report emphasizes that expanding international financial markets have become an efficient alternative source of reserves, while the characteristics of the SDR, particularly its restricted usability, has tended to limit the demand for this asset. As regards the future role of the SDR, the G-24 report sees a variety of important purposes served by SDR allocation and observes that "SDRs would provide stability to the international system more effectively than the multicurrency reserves" (para. 99). The G-10 report acknowledges that, because of its owned-reserve nature, the SDR "may still have a useful role in meeting the long-term global need for supplementing reserves in a system largely based on borrowed reserves" (para. 72). In this context, the G-10 Deputies considered the use of the SDR mechanism as a safety net for future contingencies, without, however, reaching agreement on the matter.

The G-10 report contains a number of suggestions that received some, but not full, support in the deliberations of the Deputies. These include the proposal for SDR allocation and, in particular, the suggestion to inject SDRs into the system in accordance with a steady quantitative rule designed to expand its share in total reserves in a gradual manner. Both of these proposals also received the explicit support of the G-24. On the other hand, the suggestion contained in the G-10 report for using allocated SDRs in the financing of Fund-supported adjustment programs was not favored by the G-24 Deputies. The concept of an IMF based entirely on the SDR is mentioned in the G-10 report but considered too far-reaching by most Deputies; it is not specifically mentioned in the G-24 report. The latter contains a proposal for a link between SDR allocation and development finance, for which there is no counterpart in the G-10 report.

A number of the proposals described above are dealt with in papers that have already been discussed by the Board, or are being prepared for its consideration. Encouraging the collection and dissemination of data used to assess creditworthiness, for example, is a topic that is dealt with in regular Reviews of Fund Statistics. (The next such review is scheduled for Board discussion on March 14, 1986.) Aspects of this issue are also covered in the paper being prepared on the implementation of surveillance. The suggestion that capital markets should be deregulated and capital movements liberalized can most easily be given content through reviews of individual countries' policies. Article IV consultations now typically cover such subjects in some depth. Strengthening bank supervision has been commented on in a number of contexts, including the annual survey of capital markets. It is not proposed to prepare papers on these specific topics for discussion in the context of deliberations on international liquidity.

Certain other proposals that are mentioned in the G-10 and G-24 reports under the heading of international liquidity will in fact be dealt with in other papers coming to the Board on topics raised in the reports. For example, the idea that stricter or more effective surveillance would improve the working of mechanisms for the provision of liquidity involves actions that will arise for discussion in staff papers on surveillance.

In dealing with the question of the SDR, it would seem desirable first to clarify the potential role of the SDR in the present international monetary system and only at a later stage to consider specific proposals for altering the character and uses of the asset. For that reason, the approach to considering the issue of international liquidity that was endorsed by the Interim Committee was for the Fund Board to press ahead with its planned program of studies on the SDR. These studies would have as their objective to improve understanding of the present and prospective role of the SDR. A first study, on "Implications of Changes in the International Monetary System for the Role of the SDR" is scheduled for Board consideration on January 31. Two further papers, one covering the potential contribution of the SDR to improving stability in the system, and the other presenting a comparative study of the SDR and the ECU, are scheduled for discussion on February 26. These Board meetings will provide a further opportunity for Directors to offer views on the relationship of the Program of Studies on the SDR to the analysis and proposals contained in the G-10 and G-24 Reports.

VI. The Role of the Fund

1. Conditionality

The reports agree that the Fund plays a central role in supporting adjustment programs by providing its own finance and by catalyzing finance from other sources. However, they disagree on the extent to which the Fund has been successful in promoting adjustment. Implicitly, the G-10 report concludes that, in some cases, too little emphasis has been placed on adjustment and too much on financing. On the other hand, the G-24 report concludes that financing has been inadequate and the required adjustment too great.

In coming to its conclusion, the G-10 report stresses the revolving character of the Fund's resources, the temporary nature of its financial support based on quotas, and the linking of that support to policies designed to correct payments problems over the short to medium term. The report states that the substantial increase in Fund financial support of external adjustment programs during the past twelve years has been valuable in restoring confidence and balance of payments viability. However, it is concerned that inadequate policy adjustments in some countries could delay return by the Fund to its traditional role. In particular it notes that "in some cases countries with balance of payments difficulties have not adopted adequate adjustment policies early enough, or have adopted policies that were insufficiently rigorous and comprehensive" (para. 84). This has been one factor leading to longer adjustment periods and more extended use of IMF credit.

The G-24 report, on the other hand, concludes that the Fund has not been successful in developing countries; program periods have been too short, the amount of financing has been inadequate, and insufficient attention has been given to the effects of adjustment measures on growth, income distribution, and short-term inflation. It argues that often Fund programs are designed inappropriately in that too much emphasis is placed on demand constraint and too little on structural policies needed to address the nature of underlying payments disequilibrium in developing countries. The recent decline in the use of extended arrangements is cited in support of this view. The report also concludes that increased conditionality and lower access limits under the Compensatory Financing Facility (CFF) in recent years were "retrograde steps imposed at a time when developing countries were exceptionally short of liquidity" (para. 114).

The differences in the appraisal of the appropriateness of current conditionality practices are reflected in the proposals of each report. Both reports stress the need for comprehensive programs including measures to tackle structural problems. However, while the G-10 report stresses "the need for ... measures ... to be undertaken promptly in order to allow balance of payments difficulties to be dealt with efficiently and quickly" (para. 89), the G-24 report states that "persistent deficits ... require both large-scale financing and adjustment" and that "the reorientation of conditionality criteria from demand deflation to growth-oriented structural adjustment implies a need to lengthen program periods, and to increase the level of financing" (para. 120). It calls for greater use of the EFF and liberalization of criteria applied to CFF drawings. In particular it proposes extending the CFF to cover a deterioration in the terms of trade, basing CFF drawings on the amount of the shortfall rather than on quotas, and making access to the CFF virtually automatic.

The issues on conditionality raised in the G-10 and G-24 reports are covered in the staff papers prepared for the Board discussion of the 1985 conditionality review. 1/ These papers deal with issues related to program design, implementation, and the appropriateness of the current guidelines on conditionality. Particular attention is paid to the policy content of programs, the timing of policy actions, the reasons underlying the declining use of the EFF, and the trade-offs between adjustment and financing.

2. Policy on the use of Fund resources and access limits

The reports disagree on the appropriateness of current access limits and on the need to continue the enlarged access policy. These differences stem from different assessments of the appropriate balance between adjustment and financing, the adequacy of IMF quotas, and the criteria required to activate the General Arrangements to Borrow (GAB).

The G-10 report emphasizes the need to undertake adjustment measures promptly to ensure that balance of payments difficulties are dealt with quickly and efficiently. It stresses the temporary nature of the enlarged access policy and "reaffirm(s) that the policy should be phased down and terminated as soon as the external payments situation permits" (paragraph 88). A phasing down of enlarged access is considered possible because the recent increase in IMF quotas and the enlargement and expansion of the GAB are considered adequate to enable the Fund to fulfill its responsibilities over the next few years.

The G-24 report views the present access limits as being too low given the financing requirements of developing countries. In this context it notes that reduced drawings by Fund members in 1984, as compared to 1983, did not reflect reduced need, but rather a tightening of conditionality by the Fund. The report views current quotas as being too low and implicitly it regards the criteria for activating the GAB as being too strict. Thus it is proposed that the policy of enlarged access be

1/ "Issues in the Implementation of Conditionality: Improving Program Design, and Dealing with Prolonged Use" (EBS/85/265, 12/5/85), and "Aspects of Program Design: A Review of the Experience in the 1980s of Countries with Upper Credit Tranche Arrangements Approved in 1982" (EBS/85/277).

continued without dilution and that present access limits be increased until an appropriate relationship is re-established between Fund quotas and the size of the world economy. In addition it suggests relaxing the criteria for activating the GAB.

A preliminary discussion of the Fund's policy on enlarged access and access limits for 1986 was held by the Executive Board on September 13, 1985. 1/ This provided a basis for the Interim Committee discussion on access policy and limits in Seoul, Korea, on October 6-7, 1985. During these discussions, the Committee agreed to continue the enlarged access policy, with modest downward adjustments in both annual and cumulative access limits to the Fund's General Resources. 2/ Present access limits under special facilities were to be retained. The necessary decisions were adopted by the Fund's Executive Board on December 9, 1985. 3/ The Board will hold a preliminary discussion on access limits for 1987 prior to the fall 1986 Interim Committee meetings.

3. Prolonged use and arrears to the Fund

The reports agree that the Fund's operations are dependent on the revolving character of its resources and recognize prolonged use and arrears to the Fund as problems that need to be addressed. However, the reports differ in their proposals for addressing these problems.

The G-10 report notes that prolonged use of Fund resources threatens the revolving nature of its resources and the universal character of the Fund and may weaken members' willingness to provide resources to the Fund. It calls "for a systematic examination by the IMF of the issues of prolonged use of its resources by some members and of the arrears it is owed [and considers] that steps should be taken to deal with these problems" (para. 89). It relates the extended use of IMF resources and requests for additional resources to ineffective adjustment and notes that "Recourse to frequent increases in resources, including borrowing, on the one side, and less effective adjustment on the other, tend to confuse the IMF's functions with those of a development finance institution" (para. 84). While the report does not explicitly propose measures

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1/ "Access Limits for 1986--Preliminary Policy Considerations" (EBS/85/174, 9/9/85) and "Review of Access Limits for Special Facilities" (EBS/85/187, 9/9/85). See also "The Chairman's Concluding Remarks on the Discussion of Access Limits for 1986" (EBM/85/138, 10/11/85).

2/ Communique of the Interim Committee of the Board of Governors of the International Monetary Fund, October 7, 1985.

3/ "Extension of Enlarged Access Policy and Access Limits for 1986--Proposed Decisions" (SM/85/311, 11/19/85). See Decision No. 7841-(84/165) and Decision No. 8147/(85/177).

to deal with prolonged use and arrears, implicitly it suggests that these problems be addressed in part by making conditionality more effective in achieving adjustment, and not through measures that would increase the amount of Fund financing.

The G-24 report, on the other hand, emphasizes the need for additional financing. It states that "in view of the particularly difficult structural problems of [low-income countries], it is essential that the Fund provide larger and longer-term financing in support of their structural adjustment programs than has been done so far" (para. 122). It notes that "some Fund programs have broken down in recent years because of excessively rigid performance criteria, which were not revised in light of unforeseen developments beyond the control of the borrowing country" (para. 123) and argues for greater flexibility in the use of such criteria. It also states that the mechanical application of sanctions available under the Articles of Agreement against countries that do not repay the Fund according to schedule would be self-defeating if adverse exogenous factors make it virtually impossible for the country to pay. Instead the report proposes "more flexible application ....of Article V, Section 7(g), which provides for postponement of obligations 'because discharge on the due date would result in exceptional hardship to the member'" (para. 123). It also suggests that the Fund help these countries become more current in their obligations by evolving new mechanisms "in collaboration with the World Bank and regional development institutions, to provide longer-term assistance for orderly adjustment of these countries" (para. 123).

The issue of prolonged use was reviewed by the Executive Board in June 1984. 1/ This issue is also dealt with in papers prepared for the 1985 conditionality review. In particular the staff papers discuss the trade-off between adjustment and financing in countries that are prolonged users of Fund resources, and examine ways in which program design could be improved to promote speedier and more sustained policy implementation, and to provide a better link between the disbursement of Fund resources and effective adjustment. The Board discussion of these papers should provide a basis on which the Interim Committee can consider these issues and determine whether further studies or a change in Fund policies or conditionality guidelines is necessary in light of problems of prolonged use and arrears.

1/ "Prolonged Use of Fund Resources" (SM/84/91, 4/27/84) and "Supplementary Material for Prolonged Use of Fund Resources" (EBS/84/104, 5/4/84), discussed by the Executive Board at EBM/84/94 (6/15/84). See also Chairman's Summing-Up, Buff 84/98, 6/28/84.

The Executive Board has considered the problem of arrears to the Fund on a number of occasions, most recently in the context of a series of staff papers reviewing the general policy of the Fund to prevent and eliminate arrears, including the possibility of imposing special charges on members' overdue obligations to the Fund, and reviewing the effects of overdue obligations on the Fund's financial position. As a result, the Executive Board has decided to take a number of steps to strengthen the Fund's policies and procedures in an effort to contain and resolve the problem of arrears. In the course of its discussions, the majority of Executive Directors did not support recourse to the provision of the Articles relating to postponement and expressed strong reservations about such an approach. 1/ The Executive Board is involved intensively and on a continuing basis with the range of issues relating to arrears, both of a general policy nature and concerning relations with individual members. Papers on these matters will be forwarded to the Board as the situation requires.

4. Collaboration between the Fund and the World Bank

Both reports recognize that although the Fund and the World Bank have common objectives and closely interconnected activities in developing countries, their responsibilities and functions differ. Coordination between the two institutions must therefore ensure that these separate mandates are respected. The reports agree that collaboration between the two institutions is essential to achieve their common objectives but they differ in their views on the nature and the extent of such collaboration.

The G-24 report suggests that coordination "should not lead to cross-conditionality but should help further their mutual objectives of providing resources to developing countries" (para. 137). While closer contacts between the management and staff of the Fund and Bank could help the institutions understand each other's point of view, "it would not be advisable to seek some kind of uniformity of advice" (para. 137). The report suggests that such a step could dilute the responsibilities of the two institutions.

The G-10 report, on the other hand, suggests that collaboration, while avoiding cross-conditionality, should encompass policy advice as well as financing issues. It states "that the main purpose of such cooperation should be to ensure that their financing programs provide a

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1/ See "Overdue Financial Obligations to the Fund--Six-Monthly Report" (EBS/85/245, 11/5/85) and the Managing Director's Summing Up in Buff Statement 85/206 (12/6/85); "Special Charges to Recover Costs and Losses Arising from Members' Overdue Financial Obligations to the Fund--Further Consideration (EBS/85/242, 10/29/85); and "Review of the Fund's Income Position" (EBS/85/258, 11/20/85).

comprehensive and mutually supporting approach to countries' adjustment problems and that they provide consistent policy advice" (para. 91). It notes that improved cooperation between the two institutions does not require institutional changes or formal rules or rigid procedures but rather a change in operational procedures.

Proposed changes in operational procedures include those that would achieve closer contacts between the institutions at both the management and staff levels, and those that would address the need for greater consistency in program objectives and instruments. The former includes proposals for representatives of one institution to attend Board meetings of the other, for staff of one institution to participate in missions of the other, for a continuous exchange of information on country analysis and activities, for occasional joint seminars of the two Boards on topics of common interest, and for the pooling of some facilities such as training, research programs, data bases and local representation. Regarding proposals to ensure greater consistency in program objectives and instruments, the report stresses that "it is important for the two institutions to contribute, each from its own standpoint, to a consistent assessment of medium-term projections of external financial positions and economic developments and policies" (para. 94). In this context it calls for greater coordination of financial support particularly where a reduction in access to IMF credit might be accompanied by increased IBRD lending.

Fund-Bank collaboration was discussed in detail by the Executive Boards of the two institutions most recently in late 1984 and early 1985. 1/ These discussions reaffirmed the need for close collaboration but emphasized that such collaboration must be consistent with the different mandates, functions, financial structures, and expertise of the two institutions. The need to avoid cross-conditionality was also stressed. A number of changes, similar to those contained in the G-10 report, aimed at improving coordination were also proposed. The Fund staff is currently preparing a further progress report on Fund-Bank collaboration for discussion by the Executive Board prior to the Interim Committee meeting in April 1986. A paper has also been circulated for Board discussion on January 22, 1986 on the use of the resources of the Special Disbursement Account (SDA), derived from Trust Fund reflows. 2/ This paper proposes measures consistent with the principles laid out by the Fund's Executive Board in November 1984 to further enhance and strengthen collaboration in the case of members utilizing SDA resources.

1/ "Fund-Bank Collaboration and the Adjustment Process--Issues for Consideration" (SM/84/242, 10/30/84), and "Fund-Bank Collaboration--A Further Progress Report" (SM/84/210, 8/27/84); and Correction 1, 11/15/84). See Chairman's Summing Up, Buff 84/195. See also the IBRD's paper "Bank-Fund Collaboration" (R85-30, 2/4/85, 12/6/84) and the President's summing-up (EBD/85/79).

2/ Use of Resources of the Special Disbursement Account (EBS/85/283, 12/17/85).

The Bank staff is preparing a report for issuance toward the middle of 1986 on the results of cooperative Fund-Bank work planning in eight countries, indicating lessons that have been learned and the possible expansion of coverage. A progress report on other developments in this area would be issued at the same time. The Bank staff is also preparing a paper for the Development Committee on how sustained growth can be achieved in developing countries. This paper will touch on some aspects of Bank-Fund collaboration.

5. Concessional lending

The G-10 report does not discuss the issue of concessionality in Fund lending. However, the G-24 report proposes reactivating the Trust Fund to make concessional loans to eligible countries. A preliminary Board discussion of the uses of resources of the SDA arising from the termination of the Trust Fund was held in September 1985. 1/ Based on this discussion the Interim Committee at its October 1985 meeting in Seoul, provided guidance on the amount available for disbursement to low-income countries, eligibility criteria and the conditionality to be attached to use of these resources and instructed the Executive Board to complete its work on this matter before its next meeting. Accordingly, as stated above, the staff has prepared a paper that will be discussed by the Executive Board on January 22, 1986.

6. Quotas and voting rights

The G-10 and G-24 reports agree that the ability of the Fund to continue its role in promoting adjustment and providing conditional financing depends, among other factors, on the Fund being able to command adequate resources. They also agree that Fund lending should normally be financed from quota resources. They disagree, however, on the adequacy of the current level of quotas.

The G-10 report states that, barring unforeseen circumstances, current quotas, together with the GAB, provide an adequate basis for the Fund to fulfill its role over the next few years. The report recognizes, however, that negotiations on quotas and borrowing arrangements are complex and time consuming. Thus it recommends that the "IMF undertake a study of alternative techniques that would provide resources to deal with exceptional circumstances without involving an immediate increase in members' subscriptions, thus adding to the operational flexibility of the IMF" (para. 87).

1/ "Use of Resources of the Special Disbursement Account Arising from Termination of the Trust Fund--Preliminary Considerations" (EBS/85/183, 8/6/85). See also Chairman's Summing Up, Buff 85/67, 9/19/85.

The G-24 report views the present level of quotas as inadequate. In this context it notes that the increase in quotas adopted under the Eighth General Review of Quotas (47.5 percent) was less than that favored by the majority of the membership (a doubling of quotas) and did not take into account the increased need due to balance of payments pressures in debtor countries from 1982 onward. The report concludes that there is a need for a substantial increase in quotas under the Ninth General Review. It proposes that this review be advanced. Furthermore, to avoid the political and procedural difficulties of negotiating quota increases, it suggests that it would be desirable to tie quotas to an appropriate measure of the size of the world economy. In the absence of such an automatic link, the report proposes reducing the normal interval of quota review to three years. Finally, the report recommends increasing the voting rights of developing countries to 50 percent under the Ninth General Review.

In accordance with the Articles of Agreement, the Ninth General Review of Quotas should be completed by March 1988. Preparatory work for this review will begin in late 1986, unless the Interim Committee advises that this timetable should be advanced. The question of voting rights, which is raised by the G-24 report (para. 139), could be considered in the context of the Ninth General Review.

VII. The Debt Problem and Transfer of Resources

Problems relating to external debt and the transfer of resources are not dealt with in the G-10 Report but are discussed in the G-24 Report. The debt problem is described in the latter document (paras. 140-149) as having arisen chiefly from various exogenous factors, compounded, however, by shortcomings in the policies of many debtor countries. A key aspect of the current problem is felt to be the "massive negative resource transfers from the developing countries"; these transfers, in turn, raise the question of whether it is possible to generate sufficient resources for expanding investment in export capacity and, in general, for assuring adequate rates of growth of overall output. At the same time, the Report says the strenuous adjustment efforts undertaken by debtor countries have resulted in a serious decline in their standards of living and a deterioration in their social fabric.

In dealing with these related difficulties, the G-24 Report lays considerable emphasis on the need for improvements in the external economic environment faced by the debtor countries. Since the deterioration in the global economic situation was caused by a combination of "excessive lending by the commercial banks, abrupt policy changes, and, in some cases, an unbalanced policy mix by industrial countries leading to historically high interest rates, as well as inadequate policies by many debtor countries," it follows that improving the world environment will require co-responsibility of debtors and creditors and symmetry of adjustment, processes in which debtor and industrial countries, commercial banks, and international financial institutions will all have to participate. With regard to the debtor countries, it is suggested that they "move toward a 'positive' type of adjustment, consistent with sustained growth of output in the medium and the long run."

Two other suggestions are made with regard to specific features of the economic environment underlying the debt problem. First, it is proposed that the problem of capital flight in debtor countries be dealt with not only by greater financial stability in these countries but also by developed countries, through their regulatory agencies, supporting efforts of authorities in developing countries to discourage capital outflows. Second, the developed countries should "roll back protectionist measures, refrain from introducing new restrictions, and improve access for exports of developing countries to their markets."

In dealing with existing indebtedness, debt restructuring over a long-term horizon is the general approach indicated. The report regards multiyear restructurings as a helpful development but one that still leaves debtor countries with a "major resource transfer problem." For this reason, "urgent consideration may have to be given to evolving mechanisms that would roll over or refinance a certain proportion of interest payments, i.e., those above the long-term real rate of interest." In the chapter of the report dealing with the role of the Fund, a new facility is proposed to provide financing for interest rate increases (para. 116).

Finally, looking to the future evolution of international resource transfers (paras. 151-158), the G-24 Report concludes from recent experience that short- and medium-term borrowing are inappropriate means of development finance, and that there is therefore "a need to design new financing mechanisms for orderly transfer of resources to developing countries" and, in particular, "to expand the resource base of existing financial instutions such as the World Bank, the regional development banks, and the IMF."

The section of the Report on "Transfer of Resources to Developing Countries" makes it plain that additional capital flows are expected to come chiefly from official sources. In particular, for the low-income countries it is considered unrealistic to seek commercial financing for developmental investment. The Report urges restoration of the IDA VII replenishment to US$12 billion and an early start for negotiations for IDA VIII, which should be "substantially larger" than IDA VI. Developed countries are urged to increase their efforts to reach the target of ODA equal to 0.7 percent of their GNP and, within that target, should attain the objective of 0.15 percent of their GNP as ODA to least developed countries; this objective was agreed upon at the United Nations Conference on the Least Developed Countries held in Paris in September 1981. In addition, increased funding for the Special Assistance Facility for sub-Saharan Africa is strongly urged.

Considerable attention is paid in the Report to the quality and form of bilateral aid. Donor countries are asked to make a binding commitment for the annual growth rate of official development assistance disbursements. ODA "should include program and quick-disbursing aid tailored to development and short-term requirements at macro and sectoral levels, respectively." According to the Report, it should cover local and recurrent costs; moreover it should be untied to the maximum extent possible and provided on an assured, continuous, and predictable basis. For low-income countries, terms of past bilateral official assistance should be adjusted so as to improve terms to the debtor.

Finally, considerable emphasis is laid on augmentation of flows from multilateral development institutions, especially the multilateral development banks. A general capital increase for the World Bank is proposed, as is an increase in the capital base of regional development institutions, and donor countries are asked to channel a greater proportion of their development assistance through multilateral institutions and reaffirm their commitment to multilateralism. Quick-disbursing structural adjustment lending should be made less conditional and program lending of these institutions should increase to at least 25 percent of total loans.

Further consideration of the debt and resource-transfer issues discussed in the G-24 Report will take place in several ways. As noted in Section VI.5 above, the decision giving effect to the Interim Committee's agreement that Trust Fund reflows should be used for concessional lending to low-income countries will come to the Board on January 22, 1986. The issues raised by Secretary Baker's proposals (announced at the 1985 Annual Meetings) were discussed by the Executive Board when it reviewed developments in international capital markets. 1/ Further consideration of these matters will take place when more progress has occurred in the implementation of the debt initiative.

Three further papers relevant to these topics are being prepared by the staff. A paper on export credit developments and prospects will be circulated to Executive Directors in mid-January. A paper on the issues involved in establishing a Fund facility to help members meet higher

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1/ See EBM/85/165 and EBM/85/166 (11/21/85). See also "International Capital Markets--Developments and Prospects, 1985" (SM/85/267, 9/27/85, Supplement 1, and Corrections 1 & 2); "International Capital Markets--Recent Developments, 1985" (SM/85/280, 10/17/85, and Supplement 1) and Chairman's Summing-Up (Buff 85/198, 12/3/85).

interest costs is under preparation. In addition, a paper on the progress made toward resolution of the debt problem is being prepared in the context of the forthcoming WEO. The analysis of the debt problem in this paper will be combined with the annual medium-term scenario for developing countries being prepared in connection with the World Economic Outlook exercise. The scenario analysis will focus in particular on the prospects of additional external financing and the impact of such financing on imports, growth, and the future external debt profile of the capital-importing countries.

Finally, issues related to the transfer of resources, especially to official development assistance, will be taken up at the meeting of the Development Committee in April, 1986.