

MASTER FILES

ROOM C-120

04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/26

3:00 p.m., February 20, 1985

J. de Larosière, Chairman

Executive Directors

A. Alfidja
 J. de Groote
 H. Fujino
 E. I. M. Mtei
 P. Pérez
 C. R. Rye
 G. Salehkhov
 A. K. Sengupta
 S. Zecchini
 Zhang Z.

Alternate Executive Directors

M. K. Bush
 X. Blandin
 T. Alhaimus
 B. Goos
 Jaafar A.
 L. Leonard
 C. Robalino
 A. K. Juusela, Temporary
 A. Abdallah
 C. A. Salinas, Temporary
 J. E. Suraisry
 J. de Beaufort Wijnholds
 T. A. Clark

J. W. Lang, Jr., Acting Secretary

S. J. Fennell, Assistant

K. S. Friedman, Assistant

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2. Overdue Payments - Purchases from Fund Page 9

Also Present

African Department: A. D. Ouattara, Director; J. E. Greene. Asian Department: L. Mendras. European Department: B. Rose, Deputy Director; M. T. Hadjimichael, R. P. Hicks, S. M. Thakur. Exchange and Trade Relations Department: E. H. Brau, G. Begashaw, A. B. Petersen. External Relations Department: H. O. Hartmann. Fiscal Affairs Department: G. Blöndal. IMF Institute: O. B. Makalou. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, Ph. Lachman, A. O. Liuksila, S. A. Silard. Middle Eastern Department: F. Drees. Research Department: J. P. Horne. Treasurer's Department: J. C. Corr, D. Gupta. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: D. Hammann, K. A. Hansen, G. E. L. Nguyen, J.-C. Obame, P. Péterfalvy, G. W. K. Pickering, E. M. Taha, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, M. B. Chatah, J. de la Herrán, V. Govindarajan, G. D. Hodgson, Z. b. Ismail, S. Kolb, K. Murakami, E. Olsen, J. Reddy, D. J. Robinson, A. A. Scholten, A. J. Tregilgas, B. D. White, A. Yasserli.

1. AUSTRALIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/25, 2/20/85) their consideration of the staff report for the 1984 Article IV consultation with Australia (SM/85/30, 1/29/85; and Sup. 1, 2/15/85). They also had before them a report on recent economic developments in Australia (SM/85/35, 2/5/85).

The Deputy Director of the European Department, responding to questions from Directors at the previous meeting (EBM/85/25, 2/20/85), stated that the staff had not intended to be critical of the authorities' economic strategy itself, which was admittedly unconventional by Fund standards, but instead had directed its attention toward the implementation of the strategy. The staff had concluded that while the authorities' approach had been successful thus far, the future success of the strategy was uncertain. The staff and the authorities had some differences of view regarding the emphasis of economic policy. In particular, the staff had been concerned about the large budget deficit. In view of the expected healthy expansion of private demand in 1984/85, it considered that fiscal stimulus in the budget for 1984/85 should have been less expansionary in order to ensure a more sustainable recovery. In both 1984 and 1985 the economy was growing at a rate faster than potential GDP was rising. The staff had also felt that the task of reducing the fiscal deficit in 1985/86 would have been made easier if the 1984/85 deficit had been smaller.

The recovery since mid-1983, based initially on an increase in stocks and public demand, had been followed by a period of rising consumption and exports, the Deputy Director indicated. By the beginning of 1984, private business investment had begun to increase. Investment continued to increase in the current fiscal year, and the authorities expected the recovery to continue through 1985. The OECD had recently revised its forecasts relating to the Australian economy, and they were now more in line with those of the Fund. While there were still some differences regarding the likely rate of increase in consumption, the Fund and OECD forecasts on GDP, inflation, current account, and balance of payments were broadly similar.

As for fiscal adjustment and crowding out of the private sector, the Deputy Director remarked that the authorities and the staff shared the view that if the growth of the public sector was contained, the private sector would be able to grow more rapidly and overall output and employment would thereby be maintained. The authorities' expansionary fiscal policy was aimed at "kick starting" the recovery. The Prices and Incomes Accord did not rest on a continuously expansionary fiscal policy. While the 1984/85 deficit was not straining the financial markets to such an extent that interest rates were increasing rapidly, a smaller deficit might have been associated with a slower rise in interest rates. The authorities no longer distinguished quantitatively between a structural and a cyclical deficit, although the staff had used the standard methodology to calculate the cyclically adjusted deficit, which had shifted in an expansionary direction in the past two years.

One demographic effect on fiscal policy, the Deputy Director indicated, was that the retired population as a ratio of the population of working age would increase from 19 percent in 1981 to 21.5 percent in 2000. He also noted that the increase of 2 percent in public employment in 1984 had been focused in the community services area.

The staff was concerned that the authorities, believing that the current behavior of the monetary aggregates was an imperfect guide to the stance of monetary policy and reflected structural changes that had been taking place in the financial system, had abandoned setting quantitative monetary targets for 1984/85, the Deputy Director remarked. Clearly, it was the stance of monetary policy rather than the establishment of guidelines for the monetary aggregates that was important. In the absence of quantitative projections for monetary aggregates, however, it was difficult to determine the authorities' intentions precisely. Given that monetary aggregates were expanding faster than the growth of nominal income, the staff felt that there was a strong case for maintaining a stricter monetary policy than the "neutral" policy being pursued by the authorities.

The behavior of the exchange rate in the past three weeks emphasized further the need for a cautious monetary policy, the Deputy Director went on. Even though the authorities had stressed their commitment to a non-inflationary monetary policy and had indicated that they would monitor key indicators closely, the financial markets and the general public might view the abandonment of the quantitative monetary targets as a shift in the Government's attitude, a perception which would make it difficult to maintain the necessary degree of restraint in the growth of labor costs.

He did not share the view of one Director that an increase in wage drift was unlikely given the high level of unemployment, the Deputy Director stated. The high unemployment levels in 1981 had not prevented wage drift. Press reports indicated industrial unrest in the public service on the issue of wage demands, and he hoped that the Government and the Australian Council of Trade Unions (ACTU) would work together to resolve that dispute. The staff was concerned about the increasing proportion of nonwage labor costs in total labor costs. A variety of views could be taken regarding the forthcoming claims for productivity-based wage adjustments, which would be a critical test of the Accord. At one extreme, a view could be held that because the increase in productivity had been "used up" toward a much needed improvement in profitability, no wage adjustment was justified. Mr. Zecchini's comment about the effect on real wages of a lagged adjustment of wages to inflation was well taken. Real wages could not continue increasing indefinitely unless the consumer price inflation declined indefinitely. However, the consumer price index was stabilizing in Australia, implying that average real wages over time would, with a certain lag, stop increasing. Mr. Zecchini had suggested that it might be worth considering lengthening to one year the lag with which wages were adjusted to prices. It was pertinent to note, however, that the ACTU would prefer to reduce the lag to three months.

The shift from equity financing toward debt financing, noted by a number of Directors, did not represent a change in the Government's policy, the Deputy Director remarked. He suggested that the attitude of overseas investors and financial institutions might have changed; they seemed to prefer lending financial resources, often on shorter terms than had been customary in the past, rather than risking equity investment. It was also possible that the Government's policy of limiting equity participation to 50 percent had discouraged foreign equity investment. Beginning in 1977/78, the external debt of the Commonwealth government agencies, whose overseas borrowing had previously been undertaken by the Commonwealth Government on their behalf, had been classified as private sector debt. These agencies did not use equity financing. This purely statistical factor had also affected the debt-equity ratio.

Responding to questions on the external debt, the Deputy Director indicated that the figures on external debt included in the staff report for the 1983 Article IV consultation with Australia had been incomplete, and the paper currently before the Board (SM/85/35) included a revised series. Particularly noteworthy was the proportion of short-term debt in total debt, which had been reported at 20 percent in 1984, rather than the 50 percent indicated in the previous staff paper. The debt scenario had been based on a number of underlying assumptions. Clearly, if domestic demand increased at a rate that was slower than the assumed 2 percent, a lower path of the current account deficit was likely.

The reference in the report on recent economic developments to the restrictions imposed on Australian exports by the EC had been based entirely on the long and detailed responses by the authorities to questions put forward by the staff on that matter, the Deputy Director of the European Department stated.

Australia's imports of capital goods were expanding relatively rapidly as private investment increased. Prior to the float of the Australian dollar, private capital inflows had taken place for speculative reasons, sometimes to such an extent that Australia ran a large overall balance of payments surplus. The item "portfolio investment" in Table 34 of SM/85/35 reflected borrowing by Australian companies overseas, undoubtedly in reflection of interest rate differentials. Finally, the large percentage decline in imports from the Association of Southeast Asian Nations (ASEAN) in 1983/84 reflected the large drop in oil imports from Indonesia.

Mr. Rye agreed that the differences of view between the staff and the authorities were largely related to points of emphasis or concerns about the future, rather than to the substance of the economic strategy. Mr. Zecchini's description of the status of the Australian economy was interesting but did not accurately reflect the current state of affairs in the country. He did not agree that the authorities' policy approach was losing most of its effectiveness or that growth prospects had diminished. Recent figures indicated a strong increase in domestic demand, particularly in consumer spending and rising capital investment by the

business community. Employment had also been increasing, with 15,000 new jobs having been created in December. The staff had stated that the economy was growing at a rate that was above its potential. The authorities believed, however, that the mix of policies, especially the emphasis on incomes policy, was designed to raise that potential.

Those Directors calling for additional restraint by the authorities had not given due weight to the action already taken or the measures proposed for 1985/86, Mr. Rye stated. He recognized, however, that expenditure would have to be controlled if the Government was to meet its fiscal objectives. It was difficult to control state government expenditure and borrowing in a federation; the Central Government could not impose mandatory borrowing restraints on the sovereign states. In the long run, it could be argued that control over state expenditure could be improved by making the states fully responsible for raising their own revenue. The Federal Government planned to hold a conference on state taxing powers after the main tax summit in July. The surge in the state sector borrowing requirement in the early 1980s had reflected an investment cycle in the power industry. The borrowing requirement had declined in the previous fiscal year and was expected to drop further in 1984/85. The Prime Minister had indicated that more emphasis should be placed on indirect taxes and the currently high marginal income tax rates should be reduced.

He doubted whether the credibility of the authorities' monetary policy had been enhanced by the establishment of quantitative monetary targets that had rarely been met, Mr. Rye noted. Monetary policy and the need for M-3 projections would be reassessed in August 1985 in the context of the budget discussions.

He detected a strong feeling among Directors that the authorities' incomes policy was merely a short-term instrument, Mr. Rye stated. It was necessary to draw a distinction between the framework and detail of an incomes policy. In terms of detail, a rigid set of wage guidelines clearly could not be maintained in the long term. But the framework, which he had referred to in his opening statement as "the successful establishment and maintenance of the consensus technique, involving very close consultation and coordination with the trade union movement and with the business community," was a useful long-term instrument. The specifics of the incomes policy would be reviewed later in 1985, at which point the tax reform proposals would also be considered. Clearly, if the Government was to rely more heavily on indirect taxes, it would need to negotiate the extent to which the consequent changes in prices were to be reflected in wages.

On the prospective productivity-based wage increase, it could be argued, in contrast to the point made by the staff, that the primary purpose of economic growth was to allow real incomes to increase, Mr. Rye remarked. In the past, wages had been held down by the wage freeze and the arrangement under which wages had been linked to the consumer price index, which had been artificially depressed by changes in the health

care system. Consequently, real wages had fallen. Given the more stable relationship between wages and profit, a case could be made in favor of a productivity-based wage increase. The current industrial unrest would be a test of the strength of the Accord. A lack of industrial unrest, however, would not necessarily imply that the Accord's objectives were being achieved. It was heartening that, after some initial uncertainty, the Government had strongly resisted the pay claims put forward by the public service unions.

A shift away from equity financing toward debt financing did not reflect a change in government policy, Mr. Rye commented. The shift was perhaps due to the cautious approach of foreign investors in a more competitive world environment, particularly, one in which the prices for Australia's principal mineral resources were low. The authorities did not view the floating exchange rate as a tool that would allow them to take a carefree approach to domestic policies. The move to a floating rate reflected their experienced view that government intervention in exchange markets was often counterproductive and seldom achieved the intended results. The recent surge in imports, particularly of computers and other advanced technology goods, was closely linked to the rise in investment. He agreed with Mr. Templeman that the recent depreciation of the Australian dollar did, to some extent, correct an earlier overvaluation, although the adjustment had been more sudden than had been wished. The current account deficit was close to \$A 12 billion on an annual rate, reflecting the rapid growth of imports, the depressed world commodity prices for some of Australia's major exports--especially coal and iron ore--and a substantial increase in the invisibles deficit. Higher freight costs, increased imports, high corporate profitability--which had increased retained earnings on dividends and profit remittances abroad--and higher private sector debt-servicing commitments explained the wide invisibles deficit. The current account deficit was, however, expected to decline in coming months. Furthermore, the authorities believed that some of the forces contributing to the growth of the current account deficit in the current year might moderate in 1985/86: defense imports would be lower, export prices might increase, and retained earnings and profit remittances were expected to grow more slowly.

The Chairman made the following summing up:

Executive Directors noted with satisfaction that since the last consultation the Australian economy had made a strong recovery from the deepest postwar recession. Output had grown very rapidly, employment had risen, and the rate of unemployment had declined by more than a percentage point from its peak. At the same time, the underlying rate of inflation had declined sharply to about 5 percent at the end of 1984, marking a significant narrowing of the gap which has existed for some time between the rate of inflation in Australia and that of its major trading partner countries. Most Directors acknowledged that the recovery, while it was assisted by the upturn in overseas markets and the end of an extremely severe drought, owed much to the

authorities' economic policies. The economic strategy, which centered around an expansionary fiscal policy underpinned by a Prices and Incomes Accord with the trade unions, had clearly played an important role in promoting the recovery of activity and in bringing about a deceleration in the rate of inflation. Directors noted that the wage restraint brought about by the Accord had led to a moderation of the growth of labor costs. Corporate profitability, on a declining trend for several years, had shown a notable increase.

Looking ahead, Directors focused on the question of whether the recovery in activity could be sustained without a revival of pressures on costs and prices and strains on the external position. Directors reiterated the concern expressed at the time of the last consultation that an excessively expansionary fiscal policy and the resulting buoyant activity might precipitate slippages of wage costs. Noting the unsustainable level of the total public sector borrowing requirement, of the order of 7 percent in 1984/85, Directors welcomed the authorities' commitment to reduce the Commonwealth budget deficit, both absolutely and as a percentage of GDP in 1985/86, and thought that a reduction in the total public sector borrowing requirement was also desirable. Directors underlined the need to take early steps toward placing strict restraint on government spending.

Directors emphasized that without firm financial policies, the success of incomes policy, however skillfully implemented, ran the risk of being short-lived; and a number of Directors suggested that incomes policy should include some modification of present indexation practices.

While noting with satisfaction the considerable decline in the rate of inflation, Directors stressed that a firm monetary policy was essential for the continued success of incomes policy. In this context, Directors generally agreed with the authorities that the welcome measures of financial deregulation implemented by the authorities had complicated the interpretation of the monetary aggregates. Some Directors, nonetheless, expressed concern that the authorities' recent decision to abandon the monetary projection for 1984/85 might be perceived as weakening the credibility of their monetary policy. Directors stressed the pivotal role of a firm monetary policy in ensuring that the reduction in the rate of inflation was sustained, and a number of them suggested that Australia should reinstate some monetary targets in some form, perhaps of a broader nature, in the future.

Directors noted that Australia's deficit on the external current account had been relatively large in recent years and was expected to be about 4.5 percent of GDP in 1984/85. Admittedly, the weakness of world prices for many of its commodity exports and the strength of domestic demand had adversely

affected the current account position. While recognizing that Australia's net external debt was moderate and its credit rating in international financial markets was among the highest, many Directors noted the recent increase in the debt equity ratio and the burden of debt service. They felt that the external position had to be watched carefully and that developments in it further underlined the need to follow firm domestic macroeconomic policies.

Directors generally welcomed the authorities' decision to float the Australian dollar and abolish virtually all exchange controls. The decision to float the currency was thought to be helpful in increasing the effectiveness of monetary control.

Finally, the increase in trade barriers faced by Australia's exports was deplored. It was also felt that a reduction in the protection granted to the manufacturing sector in Australia was called for and would be in Australia's own interest.

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

2. OVERDUE PAYMENTS - PURCHASES FROM FUND

The Executive Directors considered a staff paper prepared in response to a request by the Executive Board at EBM/85/7 (1/16/85) on the use of the Fund's resources by member countries that had overdue financial obligations to the Fund or were not meeting repurchase expectations pursuant to the guidelines on corrective action with respect to noncomplying purchases (SM/85/40, 2/4/85). They also had before them the staff paper on a member's right to make purchases while it had overdue financial obligations to the Fund considered at EBM/85/7 (SM/84/281, 12/27/84).

Mr. Sengupta recalled that during the discussions on misreporting, noncomplying purchases, and the guidelines on corrective action in October and November 1984, his chair had taken the position that a repurchase in respect of a noncomplying purchase should be an expectation rather than an obligation. That position was still valid; in his view, the decision on the guidelines on corrective action (EBS/84/196, Sup. 1, 11/16/84; EBM/84/165, 11/16/84) had inappropriately provided that any repurchase expectation in respect of a noncomplying purchase should be converted into an obligation.

The use of the Fund's general resources by members that had not fulfilled repurchase expectations had been discussed further at EBM/85/7, and the results of that discussion were reflected in SM/85/40, Mr. Sengupta noted. As he understood it, under Option A in SM/85/40 a member that was not meeting a repurchase expectation in respect of a noncomplying purchase would be prevented from making purchases under a stand-by or extended arrangement. However, the country would not be kept from negotiating or obtaining approval of a stand-by or extended arrangement or from receiving

approval for a purchase outside an arrangement. In addition, the Fund would not be able to rescind instructions given for the transfer of currency in connection with a purchase requested by a member that was not meeting a repurchase expectation.

Under Option B, as under Option A, Mr. Sengupta went on, a member country that was not meeting a repurchase expectation in respect of a noncomplying purchase would be prevented from making further purchases under a stand-by or extended arrangement. Under Option B, however, the member country could not negotiate or obtain approval for either a stand-by or an extended arrangement or a purchase outside an arrangement. In addition, the Fund would be able to rescind instructions given for the transfer of currency in connection with a purchase requested by the member country.

The staff had admitted that Option B would treat an unfulfilled repurchase expectation as if it were an overdue financial obligation, Mr. Sengupta noted. In strictly legal terms, an unfulfilled repurchase expectation would not be identical to an overdue financial obligation under Option B, but in practice the two would be equivalent. Under the Articles, an obligation to repurchase could be established only through a decision adopted by an 85 percent majority of the total voting power. As Article V, Section 7(c) stated:

A member that has made a purchase under Section 3 of this Article shall repurchase the Fund's holdings of its currency that result from the purchase and are subject to charges under Section 8(b) of this Article not later than five years after the date on which the purchase was made. The Fund may prescribe that the repurchase shall be made by a member in installments during the period beginning three years and ending five years after the date of a purchase. The Fund, by an 85 percent majority of the total voting power, may change the periods for repurchase under this subsection, and any period so adopted shall apply to all members.

In contrast, a simple majority of the votes cast was sufficient to establish an expectation to repurchase, as Article XII, Section 5(c) stipulated that, "except as otherwise specifically provided, all decisions of the Fund shall be made by a majority of the votes cast."

In practice, a repurchase expectation should not be converted into an obligation, Mr. Sengupta stated. Option B failed to distinguish between member countries that had unfulfilled repurchase expectations and those that had overdue financial obligations. Under Option B, the only difference between a repurchase expectation and a repurchase obligation would be that a failure to meet a repurchase expectation would not call for the application of the provisions of Article XXVI, Section 2, which dealt with an extreme situation that members would naturally wish to avoid--namely, compulsory withdrawal from membership. In all other respects, unfulfilled repurchase expectations would be reduced to the status of overdue repurchase obligations.

He doubted whether the nonapplicability of Article XXVI, Section 2 to an unfulfilled repurchase expectation was an adequate ground to conclude that Option B could be approved by a mere majority of the votes cast, Mr. Sengupta remarked. That legal interpretation should be further examined. When a member country believed that a legal interpretation was incorrect, the mechanism provided for under Article XXIX, Section (b) could be used. Finally, both Options A and B were unacceptable.

The Director of the Legal Department said that Mr. Sengupta's understanding of Options A and B was correct. A repurchase expectation was not a legal obligation under the Articles. Accordingly, a member with an unfulfilled repurchase expectation could not be declared ineligible to use the Fund's resources under Article XXVI and could not be expelled from the Fund.

In deciding whether or not to make its resources available to a member, however, the Fund could take into account a variety of factors, including actions of the country that were not in violation of the Articles, the Director commented. For example, a member's trade measures might not violate the Articles. However, they could undermine the country's economy and be inconsistent with the performance criteria under its stand-by arrangement and that fact could be considered in deciding on a request for a purchase under the arrangement. Similarly, the Fund could take into account the member's behavior vis-à-vis one of its creditors that affected its creditworthiness. If the Fund could take into account such factors, it should be able to take into account the member's behavior vis-à-vis the Fund, such as failure to meet repurchase expectations. Thus, while Option B would not convert an unfulfilled repurchase expectation into an overdue financial obligation, it would be taken into account when the Fund took decisions on the member's requests to use the Fund's resources. Because the proposed options would not transform an expectation into a legal obligation under the Articles, the proposed decisions could be adopted by a majority of the votes cast; there was no need for an 85 percent majority of the total voting power.

Mr. Pérez said that he supported Option A, which would not give equal treatment to situations that were different in many ways. There were several reasons for applying different rules to overdue financial obligations and unfulfilled repurchase expectations. The main reason was that unfulfilled repurchase expectations arose from misreporting, the nature of which could vary from one case to the next. Accordingly, such cases should be judged on a case-by-case basis, and the criteria used should leave room to judge whether or not the misreporting had been intentional. It would not be advisable to treat all unfulfilled expectations due to misreporting in the same way as overdue financial obligations.

Arrears to the Fund were easy to identify and constituted a clear failure by a member to fulfill an obligation to the Fund, Mr. Pérez remarked. Misreporting was not as easy to identify and could occur accidentally because of deficiencies in statistical reporting by the member country concerned. When the Fund concluded that misreporting had

occurred, a repurchase expectation arose automatically, and the country concerned had only a short period in which to react to the Fund's finding. It would be unfortunate if accidental misreporting were to cause a member country that was temporarily short of reserves to be treated as if it had an overdue financial obligation to the Fund and therefore could not negotiate or gain approval of either an arrangement with the Fund or use of the Fund's general resources.

Mr. Robalino said that he opposed both Options A and B. An unfulfilled repurchase expectation was different from an overdue financial obligation. As Mr. Sengupta had stressed, the proposed decisions would in practice convert an unfulfilled repurchase expectation into an overdue financial obligation.

The Director of the Legal Department, responding to a question by Mr. Clark, explained that under the guidelines on corrective action, a purchase became noncomplying only after a decision to that effect had been taken by the Executive Board. In that case, the member country concerned would be expected to make a repurchase within 30 days.

Mr. Clark considered that some of the concerns that had been expressed by previous speakers could be addressed at the time of the Executive Board discussion on whether a noncomplying purchase had occurred and whether an expectation of repurchase should be established. Once the decision establishing a repurchase expectation had been adopted, however, there was no need to go over the same ground again.

Mr. Sengupta said that a simple majority would be sufficient to determine the procedures once a repurchase expectation had been established by the Executive Board. His main objection was to the staff proposal that once a repurchase expectation had been established, the member would be treated as if it had a financial obligation to the Fund, rather than merely a repurchase expectation.

Mr. Clark remarked that the consequences of an overdue financial obligation flowed automatically from the existence of that obligation. In contrast, the discussion that the Executive Board held to consider whether a repurchase expectation should be established gave the Board an opportunity to take into account the special circumstances of each case.

Mr. Leonard said that his position was unchanged: a repurchase in respect of a noncomplying purchase should be regarded as an obligation. He supported Option B, which was closer to that position than Option A.

Mr. Suraisry considered that, in principle, a member that was failing to make payments owed to the Fund--whether in the form of overdue financial obligations or unfulfilled repurchase expectations--should not receive any new financial assistance from the Fund in any circumstances. That was the only sensible course of action for an institution like the Fund. Accordingly, he supported Option B, which would maintain the significant distinction between an unfulfilled repurchase expectation and

an overdue financial obligation for purposes other than the decisions proposed in SM/85/40. However, he could go along with Option A, provided that the wording made it absolutely clear that a member country with an unfulfilled repurchase expectation would not receive any new money from the Fund.

Mr. Jaafar said that he sympathized with Mr. Sengupta, who wished to continue treating a repurchase in respect of a noncomplying purchase as an expectation, rather than an obligation. However, as Mr. Clark had implied, Option A would provide sufficient flexibility to do so. Option A provided greater flexibility than Option B. It would be inappropriate to make a repurchase in respect of a noncomplying purchase an obligation, because such purchases were often due merely to technical problems.

Mr. Alfidja said that he could reluctantly go along with Option A.

Mr. Zhang inquired where the Fund would stand if neither of the proposed options were approved.

The Director of the Legal Department responded that under an understanding accepted by the Executive Board, if a member country had an overdue financial obligation, the Fund could not negotiate or approve a stand-by or extended arrangement for the member or the use of the Fund's general resources outside an arrangement. That understanding would remain in force if neither Option A or B were approved. Moreover, the Fund would continue to add to any new stand-by and extended arrangements a performance criterion under which further purchases would not be permitted while a member had an overdue financial obligation to the Fund.

Once the Executive Board had decided that a member had made a noncomplying purchase, the member would have 30 days in which to make a repurchase, the Director of the Legal Department continued. If the member did not make the repurchase within that period, the Fund could initiate procedures leading to a declaration of the member's ineligibility to use the Fund's general resources. The member's right to make purchases under an arrangement, or negotiations with it on a purchase, would not automatically be suspended once the decision establishing the existence of a noncomplying purchase had been made. Decisions imposing sanctions on a member with an unfulfilled repurchase expectation would be considered on a case-by-case basis. Under the proposed decisions in SM/85/40, there would be a general guideline under which stipulated procedures would be followed automatically once the Executive Board had decided that a member was not fulfilling a repurchase expectation.

Mr. Zhang remarked that it seemed preferable to handle countries with unfulfilled repurchase expectations on a case-by-case basis, similar to the handling of the debt problems of individual member countries.

The Director of the Legal Department said that if the proposed decisions were not adopted, the Fund could prevent a member country from making purchases under an arrangement under Article V, Section 5, which

stipulated that the Fund could declare a member ineligible to use Fund resources if the country had used the resources in a manner that was not consistent with the purposes of the Fund; but that course of action would not be automatic and would take time.

Mr. Fujino commented that unfulfilled repurchase expectations were a potentially serious problem, and Option B would help to enforce them. Under Option B, unfulfilled repurchase expectations would be treated like overdue financial obligations only with respect to a member's right to make purchases; in other respects, they would not be treated like financial obligations. Option B should be approved.

Mr. de Groote remarked that conceivably there could be a variety of cases of unfulfilled repurchase expectations. Noncomplying purchases could be the result of intentional misreporting. However, they might also occur if--as had happened to a country in his constituency--the authorities had submitted to the Fund data that were subsequently found to be incorrect. Given the variety of possible cases, the Executive Board might wish to agree that, when it considered a decision establishing a noncomplying purchase, it should also consider the appropriate procedures that would be followed after the decision was approved. Accordingly, if a member had explained to the Fund that it had found that it had provided incorrect information to the Fund, the Executive Board could adopt a decision establishing that a noncomplying purchase had been made but also merely instruct the staff to correct its statistics for the country concerned; the Board need not also establish a repurchase expectation. If a member was found to have deliberately misreported to the Fund, the Executive Board could adopt a decision establishing that a noncomplying purchase had been made and requiring the staff to take the steps proposed in SM/85/40.

The Director of the Legal Department remarked that under the present procedures, the Fund did not attempt to determine whether or not a noncomplying purchase was the fault of the member. The Fund merely decided whether or not a noncomplying purchase existed. When such a purchase was established by an Executive Board decision, the country was expected to make a repurchase within 30 days. The Board could conceivably decide that the circumstances of the country were such that a finding of noncompliance should not be made and a repurchase expectation should not be required. Accordingly, the possibility of preventing a country from negotiating or gaining approval of a stand-by or extended arrangement would not arise if the Fund found that the misreporting was caused by some misunderstanding on the part of the member.

Responding to a question by the Chairman, the Director of the Legal Department said that the initial step in the procedure was a finding by the Managing Director that a noncomplying purchase had been made. In reporting that to the Executive Board, the Managing Director, if he found that the noncomplying purchase had been caused by a country's unintentional misinterpretation of data reported to the Fund, could recommend that the member should not be held responsible for the noncomplying purchase, and that the finding of a noncomplying purchase should therefore be waived.

Mr. de Groote commented that he was worried that, under Option B, it would be presumed that a country had deliberately misreported to the Fund unless the Managing Director specifically explained in his report to the Executive Board that it had been an accident. Option B gave that impression because of the sanctions it would apply automatically, including the rescinding of instructions for a purchase and the prohibition on the member's use of the Fund's resources. The decision on a misreporting and a noncomplying purchase that was finally approved should clearly distinguish between intentional and unintentional misreporting. As it stood, Option B would automatically apply certain procedures to any country that had made a noncomplying purchase as a result of any misreporting to the Fund.

Mr. Sengupta remarked that as he understood it, the Managing Director reported to the Executive Board when he found that a noncomplying purchase had been made. The Executive Board then adopted a decision establishing the existence of the noncomplying purchase and the expectation that a repurchase would be made within 30 days. The main issue at hand was the steps that should be taken if such a repurchase expectation was unfulfilled. Under present procedures, the Executive Board discussed what steps it should take in handling a member country that had not fulfilled a repurchase expectation. In so doing, the Executive Board could consider the reasons why the noncomplying purchase had occurred. Under the staff proposals, the various procedures favored by the staff could be applied automatically.

Ms. Bush noted that consideration by the Executive Board of the Managing Director's finding of a misreporting did not in itself imply that the misreporting had been intentional.

Mr. Clark said that as he understood it, the period in which a noncomplying purchase was expected to be repurchased started on the day that the Executive Board adopted a decision establishing the expectation.

The Director of the Legal Department explained that when the staff learned that a noncomplying purchase had occurred, it would inform the Managing Director, who would submit a report to the Executive Board. In his report, the Managing Director might find that there was not a noncomplying purchase; or he could recommend a waiver that would prevent the establishment of a repurchase expectation. However, if the Managing Director made a finding and the Executive Board adopted a decision agreeing on the existence of a noncomplying purchase, the 30-day period in which the repurchase would be expected to be made would begin with the adoption of that decision. The Executive Board had agreed that in taking decisions on noncomplying purchases it would not attempt to make any distinction with respect to the member country's intentions behind its misreporting to the Fund.

As to Mr. Sengupta's comments on the distinction between the treatment of an unfulfilled repurchase expectation and an overdue financial obligation, the Director of the Legal Department added, under Option B,

an unfulfilled repurchase expectation would be treated as if it were an overdue financial obligation only for the particular purposes discussed in SM/85/40. Accordingly, as soon as staff and management learned that a member had an overdue financial obligation or an unfulfilled repurchase expectation, the country would be informed that it could neither make a further purchase under an existing arrangement, nor obtain a new arrangement.

Mr. Salinas noted that under present practice, the various steps the Fund might take in response to an unfulfilled repurchase expectation were the subject of a discussion by the Executive Board. Under the staff proposals, the Fund's response--spelled out in the proposed decisions--would be automatic.

The Director of the Legal Department said that Mr. Salinas' description of present practice was correct. Under the present guidelines, management would notify the Executive Board of an unfulfilled repurchase expectation and propose steps that might be taken in response to it, possibly including declaring the member ineligible to use the Fund's general resources. Under the proposed options, the consequences described in SM/85/40 would be automatic.

Mr. Clark considered that it was important to bear in mind that while an "expectation of repayment" arose automatically as soon as any payment became overdue, the comparable period for a noncomplying purchase did not begin until the Executive Board adopted a decision establishing that expectation. That kind of decision would not be adopted lightly. Once such a decision was adopted, the repurchase expectation should be treated as if it were an overdue financial obligation, in line with the provisions of Option B.

Mr. Goos stated that he agreed with Mr. Clark. The procedures that would be followed under Option B would give the Fund sufficient flexibility to respond appropriately to the particular circumstances of each case. Accordingly, the proposed procedures would be followed only after the Executive Board had agreed that a noncomplying purchase existed and the member country concerned was expected to make a corresponding repurchase. Under Option B, an unfulfilled repurchase expectation would not be transformed into an overdue financial obligation. In particular, a failure to meet a repurchase expectation would not be regarded as a failure to meet an obligation for the purposes of Article XXVI, Section 2. It would be appropriate to treat an unfulfilled repurchase expectation as if it were an overdue financial obligation; after all, the repurchase expectation would arise because a member country had made a purchase that was subsequently found to have been unwarranted.

Mr. Sengupta noted that normally a member country had from three to five years in which to make a repurchase in respect of a purchase of the Fund's general resources. Under the proposals, however, a member would have just 30 days to fulfill a repurchase expectation in respect of a noncomplying purchase. Moreover, the decision obliging the member country

to make a repurchase in just 30 days could be adopted by a simple majority rather than the 85 percent majority that under present practice was required to transform an unfulfilled repurchase expectation into an overdue financial obligation.

The staff representative from the Treasurer's Department responded that the timing of a normal repurchase obligation depended upon the kind of facility under which the purchase was made. At the same time, member countries were on notice that in certain circumstances, the repurchase schedule could be advanced. For example, an early repurchase would be expected by the Fund when a member country's external position was considered sufficiently strong for it to make such a repurchase; in that event, the member would be expected to repurchase in a period of about three months and the period began when the Executive Board decided that the member country was sufficiently strong to make an early repurchase.

Mr. Mtei remarked that a member country normally made a purchase on the assumption that it would have from three to five years in which to make the corresponding repurchase. However, a member with an unfulfilled repurchase expectation would have only 30 days to meet that expectation, even though the authorities might not have agreed that a particular purchase was noncomplying in nature and might wish to make a representation challenging the Fund's finding. The new decisions should provide that the proposed procedures would not be followed unless the member had not challenged the existence of a noncomplying purchase and the expectation to repurchase.

Mr. Suraisry considered that it was important to bear in mind that the procedures for dealing with an overdue financial obligation continued to be followed even when the Fund was no longer permitted to negotiate or approve either a stand-by or extended arrangement for a member country or the use by that country of the Fund's general resources outside an arrangement. In addition, countries with repurchase expectations enjoyed certain safeguards--namely, the time lag between the discovery of misreporting and the decision establishing a repurchase expectation and the option available to management to propose a waiver of a repurchase expectation. Accordingly, a country had ample time between the discovery of a misreporting and the decision establishing a repurchase expectation to correct a noncomplying purchase by making the corresponding repurchase.

The Director of the Legal Department remarked that a member country would be notified as soon as the staff expected that a noncomplying purchase had occurred. The staff would consult the authorities to confirm the facts of the case, including the reasons for the misreporting. The staff then would report its findings to the Managing Director, who, in turn, would bring his own report to the agenda of the Executive Board. If a decision proposed in the Managing Director's report was approved, the country would have 30 days in which to make the expected repurchase. Accordingly, the member would have both the 30-day repurchase period and the period in which the staff and the authorities concerned would be in consultation about a misreporting in which to prepare to handle a misreporting and a possible repurchase expectation.

Mr. Suraisry considered that it was important to underscore the fact that a country would be aware of its misreporting as soon as the staff notified the authorities and well before the Managing Director presented his findings to the Executive Board.

Mr. de Groote said that he wondered whether the proposed decisions would adequately maintain the established distinction between an overdue financial obligation and an unfulfilled repurchase expectation. Did the staff believe that the most important distinction between an unfulfilled repurchase expectation and an overdue financial obligation was that one was subject to the provisions of Article XXVI, Section 2 while the other was not?

The Director of the Legal Department responded that the staff considered that that legal possibility was an important difference between an unfulfilled repurchase expectation and an overdue financial obligation. As the staff had stated, for the purpose of the decisions in SM/85/40, the proposed similarity in treatment between overdue financial obligations and unfulfilled repurchase expectations would apply only in respect of the negotiation or approval of stand-by or extended arrangements, or purchases under or outside such arrangements. For other purposes, unfulfilled repurchase expectations would not be treated as if they were overdue financial obligations. Accordingly, a failure to meet a repurchase expectation would not be regarded as a failure to meet an obligation for the purposes of Article XXVI, Section 2.

Ms. Bush said that she supported Option B, since any overdue payments to the Fund were serious and should be treated in a manner that would protect the Fund's financial position. Option B would maintain a sufficient distinction between an unfulfilled repurchase expectation and an overdue financial obligation. A noncomplying purchase would have to be discussed with the authorities of the country and would have to be considered by the Executive Board before a formal decision establishing a repurchase expectation could be taken. Moreover, after that decision was adopted, the member would have 30 days to make the expected repurchase.

Mr. de Beaufort Wijnholds considered that a country with an unfulfilled repurchase expectation should not be permitted to use Fund resources. However, it would be excessively restrictive to prevent such a country from negotiating a new arrangement with the Fund. He could go along with Option B, provided that it was interpreted broadly, to permit discussion of a possible arrangement.

The Director of the Legal Department recalled that the staff had originally proposed that the Fund would not discuss or approve a purchase or stand-by or extended arrangement with a member that had an unfulfilled repurchase expectation or an overdue financial obligation. Executive Directors had agreed that the reference to "discussion" should be replaced by a reference to "negotiation." Accordingly, while the Fund would not be permitted to negotiate an arrangement with the member, the staff and

the authorities could discuss the country's economic policies with a view to enabling it to improve its position and repay the Fund as soon as possible.

The Executive Board agreed (as part of Option B as set forth in SM/85/40) that, if a member were failing to meet a repurchase expectation pursuant to the guidelines on corrective action with respect to a noncomplying purchase, the Fund would not negotiate or approve either a stand-by or extended arrangement for the member or the use of the Fund's general resources outside an arrangement, as in the case of an overdue financial obligation to the Fund.

The Executive Board also approved the following decisions:

a. Stand-By and Extended Arrangements

1. The following paragraph shall be included, as paragraph 5, in the form of the stand-by arrangement in Attachment A to Decision No. 6838-(81/70), April 29, 1981, as amended, with an appropriate reference to this paragraph to be included in paragraph 1 and the subsequent paragraphs of the form to be renumbered accordingly: "(Member) will not make purchases under this stand-by arrangement during any period of the arrangement in which the member has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase."

2. The following paragraph shall be included, as paragraph 5, in the form of the extended arrangement in Attachment B to Decision No. 6838-(81/70), April 29, 1981, as amended, with an appropriate reference to this paragraph to be included in paragraph 1 and the subsequent paragraphs of the form to be renumbered accordingly: "(Member) will not make purchases under this extended arrangement during any period in which the member has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action with respect to a noncomplying purchase."

3. Other stand-by or extended arrangements granted by the Fund after the date of this decision shall include also the provision in 1 or 2 above.

4. The provision in 1 and 2 above shall be included also in an existing stand-by or an extended arrangement when the Fund and the member reach understandings regarding the circumstances in which further purchases may be made under the arrangement.

5. Decision No. 7678-(84/62), April 20, 1984, shall cease to apply in respect of a stand-by or an extended arrangement that includes the provision in 1 or 2 above.

Decision No. 7908-(85/26), adopted
February 20, 1985

b. Rule G-4(e)

Rule G-4 shall be amended to include the following provision as paragraph (e):

"Instructions for the transfer of currency for any purchase, other than a reserve tranche purchase, shall be rescinded, to the extent that it is feasible, during the period between the issuance of the instructions and the value date for the purchase if, during that period, the member requesting the purchase has any overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action with respect to a noncomplying purchase."

Decision No. 7909-(85/26), adopted
February 20, 1985

APPROVED: November 21, 1985

LEO VAN HOUTVEN
Secretary