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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/40

10:00 a.m., March 13, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	N. Toé, Temporary
C. H. Dallara	M. Lundsager, Temporary
	H. G. Schneider
B. de Maulde	X. Blandin
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	Jaafar A.
	L. Leonard
	G. D. Hodgson, Temporary
A. Kafka	H. A. Arias
H. Lundstrom	H. Fugmann
	A. Abdallah
F. L. Nebbia	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
	A. S. Jayawardena
N. Wicks	T. A. Clark
	L. Tornetta, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

G. T. Park, Latin American Region, IBRD. African Department: F. d'A. Collings, T. Muzondo, R. T. Stillson, J. C. Williams. Asian Department: R. M. Broadway, G. Szapary. European Department: S. Mitra. Exchange and Trade Relations Department: M. Guitián, Deputy Director; G. Begashaw, J. T. Boorman, P. J. Quirk. External Relations Depatment: A. F. Mohammed, Director; H. O. Hartmann, G. P. Newman, H. P. Puentes. IMF Institute: O. B. Makalou. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, Ph. Lachman, A. O. Liuksila, S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; B. A. Karamali. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, D. H. Brown, J. C. Corr, D. Gupta, B. E. Keuppens, T. B. C. Leddy, G. Wittich. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, R. A. Elson, J. Ferrán, M. R. Figuerola, G. Jauregui, T. F. Lehwing, S. Umana. Bureau of Statistics: W. Dannemann, Director; J. B. Gupta, D. K. McAlister, J. B. McLenaghan, K. W. O'Connor. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, D. Hammann, G. E. L. Nguyen, P. Péterfalvy, G. W. K. Pickering, T. Sirivedhin, E. M. Taha, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, I. Angeloni, W.-R. Bengs, J. Bulloch, M. B. Chatah, J. de la Herrán, A. K. Diaby, G. Ercel, V. Govindarajan, N. Haque, Z. b. Ismail, A. K. Juusela, H. Kobayashi, R. Msadek, K. Murakami, E. Olsen, W. K. Parmena, M. Rasyid, D. J. Robinson, J. E. Rodríguez, C. A. Salinas, A. A. Scholten, E. L. Walker, B. D. White.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Henrik Fugmann, Alternate Executive Director, to the Executive Board.

2. COSTA RICA - STAND-BY ARRANGEMENT

The Executive Directors considered a request by Costa Rica for a 13-month stand-by arrangement in an amount equivalent to SDR 54 million (EBS/85/31, 2/5/85).

Mr. Ortiz made the following statement:

Since the end of the last decade, the Costa Rican economy suffered a series of external shocks which precipitated a severe economic crisis during 1980-82. The terms of trade turned sharply against Costa Rica after the second oil shock of 1979, as energy prices and interest rates rose steeply while the price of coffee and other commodities exported by the country fell in real terms. These adverse developments, together with the decline in world economic activity, also affected other countries in the region, resulting in an important real reduction in the trade volume of the Central American Common Market, as well as in difficulties in maintaining a system of trade payments of the area. It is also important to note that the economic difficulties were compounded by the political problems affecting the region; the ensuing deterioration of confidence discouraged private investment provoking at the same time sizable capital outflows.

The economic crisis was reflected in a sharp contraction of economic activity, a surge of inflationary pressures, and growing fiscal and current account deficits. During 1980-82, GDP declined by 10 percent and real minimum wages fell an estimated 20 percent. In per capita terms, the contraction of output and consumption were cumulative in 19 percent and 27 percent, respectively. The rate of inflation which had traditionally remained at moderate levels in Costa Rica climbed to 37 percent in 1981 and 90 percent in 1982, while the current account deficit reached an unprecedented 16 percent of GDP in 1981. In turn, the external and internal imbalances produced an enormous increase of the external public debt which jumped from 66 percent of GDP in 1980 to 119.4 percent in 1983.

In 1982, the new Administration implemented a series of policy actions aimed at correcting the country's economic imbalances, and in December of that year, a one-year stand-by arrangement was approved by the Fund. The program's main objective was to establish the conditions for restoring a viable balance of payments position that would enable the country to eliminate payments arrears, thus setting the basis for the

beginning of negotiations for a rescheduling of Costa Rica's external debt. The correction of the external payments situation and the domestic fiscal imbalances were deemed necessary for the return of confidence and the resumption of economic growth. A number of fiscal, monetary, and exchange rate measures were applied and, as mentioned in EBS/85/31, the results obtained from the application of the program were better than expected in all major aspects. The balance of payments registered a surplus, while the target was to reach equilibrium, and almost all payments arrears were eliminated; the overall deficit of the public sector was reduced by more than 1 percentage point of GDP to 3.2 percent of GDP, further than targeted; and the rate of inflation by December 1983 had been reduced to 11 percent in comparison with the program target of 40 percent.

The process of adjustment of the Costa Rican economy continued through 1984. The overall deficit of the nonfinancial public sector was reduced further to 2.5 percent of GDP. The deficit originated entirely in the Central Government, since preliminary data indicate that the rest of the public sector attained a small surplus. The deficit reduction was achieved mostly through the tax measures introduced in mid-1984, which accounted for a decline in the deficit of approximately 2 percentage points of GDP, and through budget cuts approved by the Legislative Assembly. The finances of the state enterprises were strengthened by means of a steep adjustment in the prices of public utilities--such as electricity, telephone, and water rates. In addition, the Legislative Assembly authorized the selling of some of the major government enterprises operating under the Costa Rican Development Corporation (CODESA).

Preliminary estimates indicate that the GDP grew by about 6.6 percent in 1984, marking the first increase in per capita terms since 1979. The higher than expected economic growth resulted from important increases in agricultural production, the highest in the last five years; construction activity; and industrial output. The increased utilization of idle capacity allowed for an increase in employment of approximately 4 percent without provoking excessive inflationary pressures, although the 17 percent increase in the Consumer Price Index was higher than the rate registered in the previous year. On the other hand, the increase in the Wholesale Price Index which contains a greater proportion of tradable goods was contained to 10.4 percent.

The monetary authorities followed an active exchange rate policy compensating the country's inflation differential with that of its major trading partners. In 1984, the colón was depreciated by about 10 percent. The higher level of world economic activity and the exchange rate policy followed by the authorities contributed to increase Costa Rica's exports to levels substantially above those attained in previous years. In

1984, the country's exports increased 11 percent, compared with a virtual stagnation in 1983 and a substantial decline in 1982. In spite of the large increase of imports, the satisfactory export performance resulted in a trade deficit only slightly higher than the one registered in 1983, while the current account deficit in relation to GDP was approximately of the same magnitude. The deterioration of the overall balance of payments and the accumulation of external arrears during that year originated entirely in the capital accounts, as net capital inflows were substantially lower than expected. As explained by the staff, part of the problem was that Costa Rica failed to obtain debt relief from bilateral creditors. This relief, and other expected flows, were contingent upon reaching an agreement with the Fund. However, some difficulties arose in the coordination of the main participants in the financial arrangement for Costa Rica, since some of the cross-conditional clauses that were being established contained a degree of simultaneity, thus causing some delays in the implementation of the financial package. Nonetheless, it should be emphasized that the authorities continued their adjustment efforts in consultation with the Fund.

The economic program for 1985 contemplates the continuation of the adjustment efforts initiated in 1982. The program's main objectives are a further strengthening of the finances of the public sector and of the balance of payments. The authorities feel that fiscal equilibrium should be pursued over the medium term so that a viable balance of payments position can be obtained and the size of the debt is reduced with respect to GDP. At the same time, important structural measures are also being implemented in connection with a structural adjustment loan (SAL) from the World Bank. As mentioned in Attachment II of the document, the focus of the SAL program is the establishment of a basis for sustained economic growth over the medium term. This implies institutional reforms both in the public and financial sectors as well as a redefinition of priorities for public investments. The program seeks substantial reforms at a microeconomic level aimed at eliminating market distortions and improving overall economic efficiency.

In the fiscal area, the principal objective is to limit the overall deficit of the nonfinancial public sector to 1 1/2 percent of GDP in 1985. As in the previous year, it is expected that the deficit will be generated exclusively by the Central Government, since the rest of the public sector is to remain approximately in equilibrium. The deficit reduction will be achieved through a combination of revenue-raising measures and expenditure reductions. The policy targets for 1985 imply that tax revenue will have been rising by approximately 5 percentage points of GDP between 1983 and 1985. On the expenditure side, the Government intends to maintain the freeze on government employment and to encourage the transfer of labor resources to

the private sector, facilitating this transfer through retraining programs. Additionally, the authorities have indicated their intention to raise the relative weight of investment in relation to current expenditures. The rising increases in current expenditures (about 4 percentage points of GDP between 1982 and 1984) resulted largely from higher wages and salaries of public employees which had fallen sharply in real terms, and from transfers to least-favored social groups. The authorities are convinced that this expenditure policy has been a key factor in maintaining the relatively stable social environment that Costa Rica has enjoyed throughout the difficult period of adjustment.

The strengthening of the financial position by the public sector also includes the state-owned enterprises. As mentioned above, the Legislative Assembly has authorized the selling of most of CODESA's subsidiaries. The divestment will be supported with funds from the Agency for International Development (AID) of the U.S. Government. These funds will be utilized to reduce the liabilities of the heavily indebted state enterprises with the banking system, facilitating the sale of the corporations for which authorization was granted, and reducing the financial burden of the Central Bank. The authorities have also decided to continue lowering the financial losses arising from basic-grain subsidies by raising the effective interest rate charged on loans to the National Production Council (CNP). The Government also plans to continue its policy of maintaining the prices of goods and services produced by the state enterprises constant in real terms through periodic tariff and price revisions.

The continued correction of the public finances has substantially lowered the financial requirements of the public sector, leaving an increasing proportion of financial resources to the private sector. For 1985, the deficit of the nonfinancial public sector will be entirely financed with foreign long-term borrowing obtained mostly on concessional terms; thus, there will be no increase in the net credit of the banking system to the public sector. The authorities are aware of the problem represented by the large losses of the Central Bank. As explained by the staff, these losses have arisen for the most part through the assumption of the commercial foreign debt of the public sector, whose counterpart are mostly credits denominated in domestic currency to state enterprises. In addition to the capitalization of CODESA's subsidiaries, the authorities have taken steps to prevent the future generation of such losses and to reduce the real size of the amount currently outstanding. To that effect, it has been established that all future transfers of foreign credit contracted by the Central Bank to the commercial banking system will carry an interest spread of sufficient magnitude to cover the Central Bank for potential foreign exchange losses. In addition, the Central Bank is now participating in a fund for the payment of foreign exchange losses; this fund was established in 1984 with resources derived from commissions charged to credit users.

The Costa Rican authorities are committed to continue applying a flexible exchange rate policy in the context of a unified foreign exchange system. In the course of 1985, the colón has been depreciated approximately 2 percent, covering inflation differentials and stimulating the economy's foreign sector. The authorities consider indispensable to achieve a balance of payments surplus in view of the need to cover interest arrears and to reconstitute the level of international reserves which, at the moment, is still negative. Export promotion is a priority in 1985. Apart from an active exchange rate policy, nontraditional exports have benefited from a reduction of taxes and greater credit facilities. Although it is too early to judge the effectiveness of these policies, the results obtained in 1984 are encouraging. On the other hand, the Costa Rican Government is promoting structural reform within the Central American Common Market aimed at reducing both tariff dispersion and the level of protection. It is hoped that these measures will result in increasing competitiveness of domestic firms, enhancing the possibilities of export diversification.

One problem that has seriously affected the reserve position of the monetary authorities has been the deterioration of the trade payments system in the region. Costa Rica has large outstanding balances in its favor with other members of the Central American Clearing House which have not been collected due to the economic difficulties facing these countries. In recent months, however, the authorities have reached satisfactory agreements for the medium-term liquidation of these arrears in favor of Costa Rica. Finally, it should be stressed that the authorities are well aware of the medium-term implications of the high level of external indebtedness. Foreign credit with less than five years' maturity will be avoided while efforts are being made to reschedule obligations with commercial banks maturing in 1985 and 1986. Additionally, the authorities hope to negotiate with the Paris Club in April the bilateral obligations corresponding to 1984 and 1985.

Mr. Arias noted that the Costa Rican authorities had followed most of the policy advice given by Directors at their discussion of the 1984 Article IV consultation with Costa Rica (EBM/84/119, 9/1/84). The adjustment program currently being considered by the Executive Board was comprehensive and focused appropriately. Since 1984 the authorities had shown more determination to strengthen central government administration. Substantial tax revenue measures had been implemented, including customs tariff adjustment in several state enterprises, and a tighter expenditure restraint policy was being pursued. Wage adjustments, however, if not contained, could threaten the objective of reducing the overall deficit of the nonfinancial public sector to 1.5 percent of GDP in 1985. The authorities' intention to reduce revenue earmarking and compulsory spending permanently was important and would help to improve the public finances,

although such changes were often difficult, if not impossible, to implement. In order to improve the central government revenues and reduce its obligations to the Central Bank, the authorities must channel efforts toward selling the subsidiaries of the National Development Corporation (CODESA). The inclusion in the staff paper of a table showing the consolidated operations of the state enterprises would have been useful. Could the staff indicate the overall deficit and the prospects for improvement of those enterprises?

The authorities were aware of the importance of monitoring the total growth of credit to the banking system and of maintaining positive real interest rates to ensure appropriate financial resource allocation by the Central Bank and to strengthen the external profile of the economy, Mr. Arias commented. He was optimistic that the adjustment program would enable the authorities to settle their existing arrears as programmed, despite their previous difficulties. The maintenance of a flexible exchange rate policy could bring about not only an effective reduction in the current account deficit but also a recovery in the level of international reserves.

The authorities faced a difficult external debt situation in the medium term, Mr. Arias noted. He welcomed the World Bank's involvement in Costa Rica in the form of a structural adjustment loan (SAL) which would improve economic development in the medium term. The focus of the SAL program on the promotion and diversification of exports through numerous tariff and trade reforms was encouraging.

Mr. Jensen remarked that recent economic developments in Costa Rica indicated the varied nature of the negative domestic and external factors that had adversely affected a number of developing countries. He welcomed the authorities' strong commitment to adjustment in the medium term, which should restore a more balanced economic growth.

Since mid-1982, the authorities had boldly implemented adjustment policies with positive results, Mr. Jensen observed. The objectives of the 1983 one-year stand-by arrangement had been largely achieved; the reduction in the overall public sector deficit had been greater than planned, the rate of inflation had decelerated at a faster pace than had been projected in the program, and the improvement in the overall balance of payments had been more pronounced than expected. Furthermore, the exchange rate had been unified and most restrictions on payments and transfers for current international transactions had been eliminated. External arrears, which had amounted to about $1 billion--more than 12 months of Costa Rica's total exports--prior to the 1983 stand-by arrangement had been virtually eliminated by the end of 1983. Those results were all the more remarkable as Costa Rica had experienced a weak export performance and a stronger than projected rise in imports during the year.

The authorities had remained committed to adjustment and stabilization over the past 15 months, in spite of a short-lived policy relaxation during mid-1984 that had been related more to changes in economic management than

to political will, Mr. Jensen noted. Costa Rica could have, and probably should have, had a formal multilateral financial package in place during 1984. The temporary slippages in fiscal and monetary policies, coupled with delays in obtaining additional external assistance, had made inoperable the stabilization program prepared by the authorities in March 1984. They had taken additional adjustment measures in the monetary and fiscal fields to tackle the emerging problems. In an informal sense, the authorities had successfully implemented a series of measures similar in nature and in purpose to the prior actions often required of members. Their action was most commendable given the potential political consequences of adjustment without financial support.

The economic program to be supported by the stand-by arrangement was strong, with continued emphasis on improving the public sector finances, reducing the current account of the balance of payments significantly, and increasing the foreign reserves of the Central Bank, Mr. Jensen noted. The rate of inflation was expected to be reduced to 11 percent and real growth to increase to 3 percent of GDP in 1985. Unlike many other countries in similar circumstances that had abandoned the pursuit of sound economic policies, Costa Rica had been implementing adjustment policies in the absence of a formal external financial arrangement, apart from a short-term arrangement with foreign commercial banks reached in mid-June and disbursements of additional U.S. bilateral assistance.

He was concerned about the emphasis on revenue measures in the economic program, Mr. Jensen remarked. Under the proposed adjustment program, the fiscal burden would increase to 31 percent of GDP in 1985, from only about 17 percent three years earlier, while expenditures would continue to rise, albeit at a slower pace. Did the shift toward revenue-raising measures away from expenditure restraint reflect a more permanent change in policy? The authorities' monetary management and interest rate policies were commendable, particularly their efforts to maintain real positive rates of interest.

Costa Rica could be a test case of the success of the interlocking of rescheduling arrangements and the provision of medium-term financial support from the Fund during the remainder of the decade, Mr. Jensen remarked. The Executive Board's approval of Costa Rica's request for a stand-by arrangement would unlock a substantial amount of additional external financing. A $80 million structural adjustment loan from the World Bank in support of economic growth through improved resource allocation, the introduction of institutional reforms, and the elimination of structural rigidities would become available. An additional $75 million would be made available by foreign commercial banks, and rescheduling arrangements would relieve Costa Rica's debt service burden somewhat. Furthermore, $190 million would be provided by the U.S. Agency for International Development. Those inflows, together with the resources available under the proposed stand-by arrangement, would bring the financial package to about $400 million in 1985.

He hoped that the SAL from the World Bank, to be considered by the World Bank Executive Board by April 1985, would be the first in a sequence, Mr. Jensen commented. The commercial banks were expected to oversubscribe their financial assistance to Costa Rica through the remainder of the decade. He congratulated the Managing Director and the staff on reaffirming the Fund's vital catalytic role in the financial markets. He strongly supported the proposed decision.

Mr. Hodgson remarked that the stand-by arrangement being considered by the Executive Board was an important step toward strengthening Costa Rica's external position over the medium term. His chair could support the proposed decision. Nevertheless, there was little room for slippage in the adjustment effort if Costa Rica was to maintain its credibility with the international financial community and thereby obtain the debt relief and new credits that would be required. Some important gains had already been made, notably in reducing the fiscal deficit, restoring economic growth, and reducing the rate of inflation sharply to about 10 percent. Economic policy in Costa Rica had, however, been applied inconsistently over the past few years. Exchange rate policy and the growth of bank credit had not been dealt with in an evenhanded manner in 1984. That erratic pattern would have to be avoided if economic performance was to improve.

The major constraint facing the authorities was the debt burden, with total outstanding debt currently exceeding 125 percent of GDP and the debt service ratio before rescheduling in excess of 50 percent, Mr. Hodgson noted. The evolution of the balance of payments as presented in the staff medium-term scenario, was sobering; by 1990 the current account deficit was projected to decline only to 4.5 percent of GDP, while net reserves would increase by only about $40 million--equivalent to three weeks of imports--from the 1985 level. Furthermore, the assumptions underlying the medium-term projection seemed to be on the optimistic side. Past performance suggested that exports were unlikely to grow at an annual rate of 11 percent between 1986 and 1990, implying that the projected trade surplus might not be realized. Additionally, there was no guarantee that interest rates would decline as assumed.

Given those considerations, the Costa Rican authorities had little choice but to maintain firm control over domestic demand in order to strengthen the country's external position, Mr. Hodgson considered. Adjustment on the supply side was also required, and he was pleased to learn that the World Bank was expected to approve the first in a series of SALs aimed at supporting price reform, reducing subsidies, changing tariffs, and increasing competition in the financial sector. Close Fund-Bank cooperation was essential to ensure a strong and lasting recovery in Costa Rica.

He welcomed the steps being taken to reduce the public sector deficit still further in 1985, although he was concerned that the recurring losses of the Central Bank had tended to modify the otherwise impressive adjustment in the fiscal balance, Mr. Hodgson commented. The tax measures

introduced in 1984 should lead to substantial revenue increases. The quarterly limits for total expenditure were appropriate and should be adhered to strictly. While he welcomed the shift in expenditure toward capital outlays, he hoped that more could be done to reverse the growing trend of expenditures as a share of GDP. The system of linking public sector wage increases to a basic basket of essential goods and services was novel, and its effectiveness would be carefully monitored. The increased tariffs for some parastatals and the sale of a number of CODESA's subsidiaries were also positive steps, although he agreed with the staff that additional measures were needed to divest CODESA of its major enterprise holdings.

The adjustment program was aimed appropriately at shifting the distribution of new credit in favor of the private sector, Mr. Hodgson observed. Real interest rates, however, remained high. Could the staff indicate if real interest rates of 7 percent and above were necessary for the program to be operational?

He welcomed the authorities' commitment to maintaining a flexible exchange rate policy and implementing the tariff reforms proposed under the SAL from the World Bank, Mr. Hodgson stated. The medium-term outlook assumed that exports would grow at a rate that would be heroic by historical standards. Could the staff comment on the adequacy of measures contained in the program to encourage a strong and diversified export growth?

Mr. Goos remarked that it was disappointing to note that, despite the generally satisfactory implementation of the previous stand-by arrangement, Costa Rica's external position had not yet been turned around. In fact, the current account had deteriorated in the past two years and external arrears had accumulated in 1984. Given the continued precarious debt situation of Costa Rica and the difficult medium-term balance of payments outlook, those developments were worrying, particularly as they had been due to inappropriate domestic policies including slippages in the implementation of adjustment measures at least in the first half of 1984. Continuous forceful adjustment was essential if a viable overall economic position was to be achieved. He did not wish, however, to detract from the progress achieved in the recent past; the reduction in the public sector deficit and the slowing of inflation had been impressive. Nevertheless, much more remained to be done.

The adjustment program for which the authorities had requested Fund assistance had been appropriately designed as part of a comprehensive approach to tackle the structural deficiencies in the economy within the framework of a SAL from the World Bank, Mr. Goos observed. The limited and short-lived improvement in the external account, as a result of recent adjustment measures, and the weak response of the current account to the improvement of the fiscal position suggested the existence of severe structural problems that would have to be resolved in order to improve the efficiency of fiscal and monetary policy.

While it was appropriate to emphasize the need for fiscal and monetary restraint accompanied by exchange rate flexibility in the proposed adjustment program, he was somewhat disappointed about the degree of adjustment envisaged given the objectives of the adjustment program and the precarious external situation, Mr. Goos stated. The projected sizable decline in the combined public sector deficit for the third consecutive year was commendable, but at slightly less than 6 percent of GDP in 1985 it would still remain at an excessive and clearly unsustainable level.

Two features of fiscal adjustment gave cause for concern and suggested that there might be considerable scope for reducing the fiscal deficit further, Mr. Goos remarked. First, the projected improvement in fiscal performance in 1985 seemed to rest largely on measures taken in the previous year; there was apparently no intention to take sizable additional corrective steps during the program period. Second, the fiscal effort was concentrated exclusively on the revenue side, even allowing for a considerable expansion of real expenditure. While some acceleration of investment outlays might be justified in order to strengthen the productive capacity of the economy, a more restrictive stance on current expenditure would be appropriate.

He had similar difficulties concerning the approach of monetary policy under the program, Mr. Goos indicated. Although he commended the authorities for the strong deceleration of monetary growth in recent years and their commitment to maintaining positive real interest rates, he was not convinced that an expansion of total bank credit by 18 percent was a restrictive policy stance, particularly as nominal GDP was projected to increase by only 13 percent.

A flexible exchange rate policy was crucial to the success of the stabilization effort, particularly to structural reform, but the authorities' commitment to pursuing such a policy had been qualified by a number of considerations relating to developments in the balance of payments, relative price performance, and net international reserves, Mr. Goos noted. He failed to understand exactly what the authorities had in mind in that area and would have preferred a more clear-cut commitment on their part to maintaining an appropriate real effective exchange rate.

His comments, which might sound unduly critical, were prompted by his authorities' concerns about the precarious balance of payments outlook, which indicated a continued need for exceptional financing until the end of the decade, Mr. Goos commented. Given the responsiveness of the international financial community to the country's difficult debt situation, the Costa Rican authorities must make every effort to bring their economy back to a sustainable position. Decisive and forceful adjustment efforts would be required. The authorities should aim to achieve fiscal equilibrium as soon as possible, rather than in the medium term as Mr. Ortiz had indicated. He wondered whether the objective of increasing the rate of real GDP growth to about 5 percent might be too ambitious as it might restrict the amount of resources that would be available to meet external obligations in the coming years. In any event, he urged the

authorities to consider the program targets in the monetary and fiscal areas and the balance of payments projections as the minimum objectives. With those reservations, he could go along with the proposed decision. He was pleased to note that the Costa Rican legislative body had finalized the rescheduling agreement with the Paris Club, thereby opening the way for another rescheduling arrangement in the current year. He understood that there were, however, still some issues pending in the bilateral execution of the previous Paris Club agreement. He hoped that those issues would soon be resolved.

Mr. Clark noted that since the financial crisis of 1980-82 the Costa Rican authorities had made considerable progress in reducing the imbalances in the economy. Since 1982 the nonfinancial public sector deficit had been reduced sharply, reflecting an increase in public savings of about 10 percent of GDP; the rate of inflation had fallen rapidly; and real GDP growth had resumed. Nevertheless, the external situation continued to be difficult. The debt service burden remained extremely high and, although the trade deficit had been reduced considerably in 1982, it had widened since then. Given the low level of liquid reserves, it was perhaps not surprising--although it was regrettable--that external arrears had increased. The staff's medium-term projections indicated that debt rescheduling would probably be required every year until at least the end of the decade. While he recognized that the Fund was likely to have a medium-term role in Costa Rica, Fund financial assistance would have to be modest in view of the high level of credits already outstanding and Costa Rica's extremely difficult debt position.

The authorities would clearly have to make every effort to improve the supply side of the economy and, in particular, to encourage exports, Mr. Clark stated. The series of SALs envisaged by the World Bank would play a crucial part in the development effort. Appendix II of EBS/85/31 summarizing policy actions envisaged under the first structural adjustment loan was useful.

The continuing large losses of the Central Bank, amounting to about 20 percent of GDP--more than 50 percent of the total public sector deficit--between 1982 and 1985, posed major problems, Mr. Clark considered. Furthermore, the unclassified assets of the Central Bank reflecting accumulated losses, represented almost one half of the Central Bank's net domestic assets. The program objective to reduce those losses by only 0.5 percent of GDP in 1985 seemed rather modest. Could the staff or Mr. Ortiz provide more information about the Central Bank's position in the medium term and, in particular, about the projected path for the public sector deficit, including the losses of the Central Bank.

He welcomed the authorities' intention to eliminate external arrears by the end of 1985, Mr. Clark stated. The projected increase in net external reserves should help to prevent any re-emergence of external arrears. The balance of payments position, however, remained vulnerable to external shocks, notably to changes in interest rates and in prices for coffee and bananas. It would have been helpful if the staff had included

a sensitivity analysis of its balance of payments projections. Could the staff indicate the likely effect of changes in those variables on the balance of payments position in the medium term?

He had been surprised to read on page 8 of the staff paper that the performance criterion restricting Costa Rica's right to make a final purchase under the arrangement required only that the rescheduling agreements currently under negotiation or proposed for 1985 be completed by January 30, 1986, Mr. Clark went on. Would Costa Rica be able to draw SDR 44 million of the total amount available of SDR 54 million without concluding the rescheduling agreements, thereby maintaining a substantial amount of arrears?

In sum, he could support the proposed adjustment program but was concerned that it was not sufficiently ambitious, especially given the extremely high level of external debt and the substantial nonconcessional component of the financing arrangements, Mr. Clark stated. He wondered particularly whether the fiscal aspects of the program, which involved only a decelerating increase in the ratio of government spending to GDP, should not be tighter.

Ms. Lundsager noted that following the successful completion of the 1983 stand-by arrangement, Costa Rican economic performance had lost some of its momentum in early 1984. The actions taken at midyear to correct the downward economic trend would be consolidated and reinforced under the proposed arrangement. The stated aims of the program were appropriate in the short term, although she agreed with other Directors that stronger measures would be necessary in the medium term. Improved relations with external creditors and a reduction in the internal and external disequilibria would help the authorities to close the financing gaps projected for the next several years. The World Bank structural adjustment loan to Costa Rica would complement the policy measures proposed under the stand-by arrangement, and she welcomed the mutually supportive approach by the Fund and the Bank.

The reduction in the fiscal deficit programmed for 1985 appeared appropriate in the short term, but she felt that stronger efforts would soon be needed, Ms. Lundsager remarked. The pace of adjustment over the past few years had been impressive; the public sector deficit had fallen from 9 percent of GDP in 1982 to a projected 1.5 percent of GDP in 1985. Nevertheless, she did have some reservations about the emphasis on taxes, which were expected to increase from 26 percent of GDP in 1983 to 31 percent of GDP in 1985. Costa Rica also relied to some extent on export taxes, which were becoming burdensome to exporters, in particular, of traditional goods. The problem might not be just one of discouraging production, but might lead to disinvestment in some export sectors of the economy. Reduction of those taxes should therefore be of high priority.

She recognized that the authorities were making an effort to control expenditure, with substantial increases expected only in the capital budget, Ms. Lundsager remarked. Wage expenditures were being contained

by a freeze on employment combined with small nominal wage increases. Current expenditures as a percentage of GDP were, however, still climbing and would reach 24 percent of GDP in 1985, compared with 20 percent of GDP in 1982. She hoped that the upward trend could soon be reversed. She wondered whether the authorities' plan to increase taxes and expenditure under the adjustment program was consistent with the objective of the structural adjustment loan of reducing the role of the Government in the economy, a goal she strongly endorsed. She was pleased that the public sector deficit would be financed entirely by long-term concessional assistance.

The operating deficit of the public enterprises was expected to be reduced in 1985, following tariff increases, Ms. Lundsager noted. The more rational system of pricing, developed with the assistance of the World Bank, would promote more efficient production and use of publicly provided products. Furthermore, the streamlining of CODESA, with several divestitures planned, was especially welcome.

The proposed reduction in the fiscal deficit of the nonfinancing public sector would virtually eliminate the need for domestic banking system credit to the public sector, Ms. Lundsager observed. The operating deficit of the Central Bank, however, remained larger than the overall deficit of the nonfinancial public sector owing to the debt service obligations assumed by the Central Bank in 1983. From the description on page 13 of EBS/85/31, it appeared that the Central Bank would be recovering the local currency cost of servicing the foreign commercial debt and would thus be reducing its deficit. On the other hand, the public entities appeared to be in arrears to the Central Bank, which still continued to carry a large deficit. She would be interested in hearing more about the arrangement whereby the Central Bank had assumed all foreign commercial debt of the public sector, particularly about the exchange rate used to convert the external obligations into local currency. How would the 1984 arrears to be included in the 1985 rescheduling agreement be treated domestically? She welcomed the maintenance of positive real interest rates and the authorities' commitment to provide adequate credit to the private sector and to earmark for private sector use the counterpart funds generated by foreign assistance.

The authorities intended to follow a flexible exchange rate policy, with adjustments determined not only by relative price changes but also by developments in the balance of payments, Ms. Lundsager observed. A real depreciation might be required to bring the current account deficit down from its currently high level. She would be interested in hearing more about the events that might trigger changes in the real effective exchange rate. The projected reduction in the external current account deficit, from 12 percent of GPD in 1983/84 to 9 percent of GDP in 1985, excluding grants, was welcome, but it remained high. While concessional financial assistance was supporting that deficit at present, the authorities should pursue appropriate policies to reduce the deficit further so that less reliance would have to be placed on one single source of external financing. She supported the limit on external borrowing on

concessional terms as Costa Rica's high level of external arrears, which would be eliminated under the program, indicated the country's limited ability to service nonconcessional debt. Furthermore, the medium-term outlook was not promising, with debt service ratios, after the projected reschedulings, of about 40 percent in 1986-87. Those projections might argue for even stronger adjustment measures, especially on the supply side to promote exports. Specifically, the real exchange rate should be adjusted sooner rather than later.

The broad scope of structural adjustment was covered by the SAL from the World Bank, Ms. Lundsager commented. Normally, she might have preferred to see several of the structural measures, such as the dismantling of price controls and subsidies, included in the stand-by arrangement. In Costa Rica, however, the financing provided by the World Bank was essential to enable adherence to the stand-by arrangement and she believed that the authorities were, therefore, fully committed to both programs. The lead taken by the Costa Rican authorities within the Central American Common Market on tariff reform was commendable.

On Costa Rica's overall financing package, the combination of substantial bilateral assistance, the SAL, and the new commercial bank financing had permitted Costa Rica to finance its 1985 balance of payments deficit, Ms. Lundsager observed. The debt problem would remain significant in spite of the financial package, as evidenced by the projected need for exceptional financing in the medium term. Furthermore, access to Fund credit might be limited in the future, although the Fund might continue to play a catalytic role. Further adjustment would definitely be required in the future.

She welcomed the information presented in Supplement 1 of EBS/85/31, which would help to avoid any misunderstandings that might arise over the Executive Board's temporary approval of exchange restrictions, Ms. Lundsager remarked. The references to Article VIII, Section 2(b) and to Decision No. 446-4 raised questions that had not been clearly addressed. She would, however, reserve her comments on those issues for another occasion. In conclusion, she could support the proposed decision as amended in the Supplement.

Mr. Fujino noted that Costa Rica's economic performance had improved under the previous stand-by arrangement. Although continued efforts to promote the adjustment process through fiscal and monetary restraint had been made, they had not been sufficient to reverse the deterioration. He welcomed the intensification of the adjustment efforts in 1985 and was encouraged to learn from Mr. Ortiz that almost all payments arrears had been eliminated. He could go along with the proposed decision.

On a procedural matter, although the staff paper had been issued on February 5, 1985, the Executive Board had known only on March 11 that a meeting would be held on March 13 to discuss Costa Rica's request for a stand-by arrangement. In the meantime, the Executive Directors were very slightly informed of the developments related to Costa Rica. He himself

had received some information from the authorities but did not have a complete picture of the situation. In future, he would appreciate having more advance information on the latest developments so that he would not be surprised by a sudden announcement on the date of a Board meeting.

The staff representative from the Western Hemisphere Department stated that the staff shared the concerns expressed by a number of Directors about the balance of fiscal policy between expenditure restraint and revenue-raising measures. The staff had stressed to the authorities the need to improve control over expenditure. The problem was related partly to the structure and management of the public sector entities outside the Central Administration. The Fund had provided technical assistance in that area, and the Government was working with the World Bank to strengthen the Budgetary Authority in the Ministry of Finance, a newly created institution that would exercise gradually greater control and coordination over the public sector entities. A commission on fiscal reform was examining the institutional arrangements affecting legislation bearing on the earmarking of revenues and compulsory spending. Some improvement in that area should be expected in the future.

Although the public sector deficit had been reduced substantially, the overall size of the public sector, as measured by expenditure as a percentage of GDP, remained high, the staff representative indicated. The authorities were making efforts to reduce its size by freezing public sector employment in 1984 in response to the Fund's recommendations and by reducing the number of public sector employees through a policy of attrition and the introduction of retirement schemes. Furthermore, the dismantling of complex legislative arrangements, which predetermined fiscal operations, should reduce the size of the public sector over time. Additionally, the authorities planned to divest CODESA of some of its subsidiaries that had been largely inefficient and a burden on the state. The Price Stabilization Board, a marketing agency that had incurred significant losses in recent years, would also be reformed. The Government had committed itself to reducing the deficit of that marketing agency by 50 percent through adjustments in relative prices, policy changes regarding the budget, and, particularly, a change in the arrangements by which rice production had been encouraged in the country.

The arrears of the public enterprises that had been assumed by the Central Bank as part of the rescheduling agreement with foreign commercial banks in 1983 would be converted at the current exchange rate, the staff representative stated. The arrears incurred by the public sector enterprises in 1984 were mainly to the Paris Club or to bilateral creditors, and were expected to be rescheduled.

The staff agreed with the authorities that positive real interest rates were essential and should be maintained, the staff representative remarked. The demand for credit was high at present in spite of the high interest rates. Additionally, interest rates, together with the exchange rates, affected the balance of payments position; the substantial turnaround in the private capital account in 1983 had reflected not only a

change in inflationary expectations, but also a sharp increase in domestic interest rates in real terms. Positive real interest rates would be important to protect the private capital account and to encourage further increases in savings.

The staff had stressed to the authorities the importance of reducing the losses of the Central Bank, an issue that had not been addressed clearly in the past, the staff representative commented. The large external current account deficit reflected the size of the Central Bank losses to some extent, and the staff had begun developing a methodology for calculating those losses and formulating measures that would solve the problem. In October 1984, the authorities had begun to reform the structure of interest rates; the lending rates of the Central Bank had been increased in general, while subsidized interest rates, particularly those of the State Marketing Agency, had been raised. The losses of the Central Bank had arisen because of the small proportion of its earning assets and the large amount of liabilities on which the Central Bank had to pay high interest rates abroad. The structure of the earning assets would have to be changed over time as the interest rates paid by the public sector to the Central Bank were below the cost of the funds to the Central Bank.

In future discussions with the authorities, the staff would stress the need for them to monitor changes in the interest rate structure and to emphasize fiscal adjustment, the staff representative stated. Over time, the nonfinancial public sector would have to generate an overall surplus simply to offset, in an accounting sense, the losses of the Central Bank. In that way, the staff hoped that the external current account could be reduced by one half over the medium term, a target that had been established with the Costa Rican authorities.

The staff agreed with Directors on the need for an aggressive exchange rate policy and had advised the authorities to take action in three areas, the staff representative commented. It had suggested last year that the exchange rate should be adjusted by 6.5 percent in terms of the U.S. dollar in view of the appreciation of the colón in the first ten months of 1984. The authorities also had agreed to adjust the colón frequently during 1985 to achieve a real depreciation of at least 2.5 percent over the year. In the event of any slippages in the fiscal and monetary objectives under the program as reflected in the monthly targets for net international reserves, the Central Bank would accelerate the depreciation of the colón beyond 2.5 percent in real terms. Thus far in 1985, the exchange rate had been adjusted three times, bringing the cumulative rate of depreciation in the year to about 2.3 percent, or about 15 percent on a compounded basis. Assuming that the inflation differential between Costa Rica and its trading partners remained at about 8 percent and that the appreciation of the dollar remained at about 3-4 percent, the depreciation of the colón thus far in 1985 would imply a real depreciation of 2.5-5 percent in real terms for the year. In any event, the staff would monitor exchange rate developments closely.

The staff was of the view that a 50 percent reduction in the external current account deficit in the medium term would be sustainable given the availability of concessional resources and foreign aid, particularly if conditions in Central America allowed for a gradual recovery of private foreign investment in the area, the staff representative remarked. The medium-term scenario had been prepared with the aim of achieving an overall surplus each year through the end of the decade, implying that net official international reserves would increase by about $80 million a year. The gross liquid reserves of the Central Bank would thereby be increased and its short-term liabilities would be reduced.

The authorities would have to shift away from a trade policy that emphasized import substitution toward one that encouraged exports if the medium-term objectives for exports were to be achieved, the staff representative indicated. Tariff reform was a key feature of the structural adjustment loan with the World Bank, and some initial steps had already been taken by the Central American Common Market to change the common external tariff of Central America. A real effective exchange rate depreciation was essential to complement the changes under way in the trade system.

When the staff paper had been issued, the staff had expected that it would have been able to confirm at the Executive Board discussion of Costa Rica that the Paris Club had indicated its willingness to consider Costa Rica's request for future rescheduling, the staff representative from the Western Hemisphere Department stated. The members of the Paris Club had, in the previous week, expressed concern about the bilateral agreements that had not been finalized as a result of the previous rescheduling arrangement with Costa Rica. Those uncertainties, however, were likely to be resolved by the time that the Paris Club took up Costa Rica's request for rescheduling, tentatively set for April 22, 1985. On a related point, the performance criterion on rescheduling arrangements had been included in an effort to avoid the kind of delay in bringing the bilateral agreements of the Paris Club rescheduling to completion that had been experienced in 1983. If the rescheduling arrangements were not completed on a timely basis, the stand-by arrangement would in effect be suspended as it would be difficult to complete the midterm program review by the target date of August 31, and Costa Rica would be unlikely to meet the arrears target.

The Deputy Director of the Exchange and Trade Relations Department, commenting on the short notice that had been provided regarding the date of the present meeting, remarked that in cases where the negotiations on the financing package involved numerous parties and had been protracted, it was important to act promptly once a consensus among those parties was reached. Another consideration had been the need to wait until the Paris Club had indicated its willingness to meet with the authorities to consider a rescheduling arrangement before presenting Costa Rica's request to the Board.

Mr. Ortiz commented that the Costa Rican authorities had in 1984 continued with the adjustment efforts initiated in 1983 under the previous stand-by arrangement. Strong adherence to the 1983 program had undoubtedly helped to improve the financial situation of the country and to restore a degree of confidence in the country's prospects and its economic management. According to preliminary data, private investment in 1984 had increased by more than 20 percent, resulting in improved output in manufacturing and construction.

A number of Directors had referred to the lopsided fiscal adjustment effort, Mr. Ortiz recalled. The sharp revenue increases reflected the correction of prices and tariffs of goods and services of the state enterprises, which had declined rapidly in recent years, resulting in rising demands for those services and higher deficits for the state enterprises. Those revenue measures were necessary to correct relative prices, and further revenue increases would not be so sharp. The authorities had felt that the revenue increases were necessary to share more equitably the burden of adjustment and they were intending to subsidize some essential goods.

The relatively high current account deficit projected for the medium term reflected Costa Rica's large debt burden, Mr. Ortiz noted. The speed with which Costa Rica could regain viability depended on the availability of external finance and the country's ability to generate enough resources to meet domestic demand and to improve its export performance. A high rate of economic growth was a necessary precondition to easing the debt burden. The authorities shared Directors' views on the need for structural reform on the supply side, and they considered the World Bank particularly important in that respect.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Costa Rica has requested a stand-by arrangement for the period March 13, 1985-April 12, 1986, for an amount equivalent to SDR 54 million.

2. The Fund approves the stand-by arrangement attached to EBS/85/31, Supplement 1, and waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7928-(85/40), adopted
March 13, 1985

Exchange System

Costa Rica maintains restrictions on payments and transfers for current international transactions that result from payments arrears and the process of rescheduling, as described in EBS/85/31

and EBS/85/31, Supplement 1. In light of the implementation by Costa Rica of policies for balance of payments adjustment, which are supported by a stand-by arrangement (EBS/85/31, Supplement 1), and in view of the considerations referred to in EBS/85/31, Supplement 1, the Fund grants approval for the retention of these restrictions, other than the restriction described in footnote 1 on p. 19 of EBS/85/31, until the conclusion of the 1985 Article IV consultation, or August 31, 1985, whichever is earlier.

Decision No. 7929-(85/40), adopted
March 13, 1985

3. OVERDUE FINANCIAL OBLIGATIONS TO THE FUND - EFFECT OF OVERDUE PAYMENTS ON FUND INCOME AND RESERVES, REPORTING BY THE FUND OF OVERDUE OBLIGATIONS, AND PUBLICITY UPON A DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the reporting of overdue financial obligations by the Fund and on the effects of overdue payments on the Fund's income and reserves (EBS/85/32, 2/5/85; and Cor. 1, 2/28/85), in the form of supplementary notes to the six-monthly report on overdue financial obligations to the Fund (EBS/84/211, 10/11/84) and to a paper on the effect on income and the treatment in financial statements of overdue obligations to the Fund (EBS/84/231, 11/14/84), which had been discussed at EBM/84/166 and EBM/84/167 (11/19/84). They also had before them a staff paper on the question of publicity in cases where a member was declared ineligible to use the general resources of the Fund (SM/85/12, 1/9/85).

The Chairman made the following statement:

On March 13, 1985, Executive Directors will consider three issues arising from the Fund's experience with overdue financial obligations. The first concerns the effects of overdue obligations on the Fund's income and reserves and steps to strengthen the Fund's financial position in light of overdue payments. The second concerns the reporting by the Fund, in its annual reports, financial statements and regular statistical publications, of information on overdue obligations to the Fund. The third is the question whether, beyond such factual and statistical reporting as may be appropriate, the Fund should engage in "active publicity" by issuing a press release upon or soon after a declaration of a member's ineligibility to use the Fund's general resources.

All of these issues have already been the subject of considerable discussion in the Board. Supplementary information on the first two topics, requested by the Board at its meeting on December 17, 1984, is provided in EBS/85/32, dated February 5, 1985. As also requested by the Board at the December 17 meeting, the staff has prepared a short separate paper (SM/85/12, 1/9/85) on the question of publicity upon a declaration of ineligibility.

The issues, while related in that they all derive from the problem of overdue obligations to the Fund, are separable, and I would suggest that a separate treatment of them in the discussion on March 13 would serve the interests of clarity. In an effort to facilitate the Board's further consideration of these issues, the following paragraphs outline some main points Directors may wish to bear in mind, in particular on the effect of overdue payments on the Fund's income and reserves.

1. Effect of overdue payments on Fund income and reserves

In the Board's earlier discussion of this subject, it was generally appreciated that the incidence and growth of overdue payments have negative effects on the Fund's financial position and standing and that, while these effects may be difficult to assess with precision, it would be prudent that action in some form be taken to strengthen the Fund's financial position in the presence of sizable overdue payments. Two general approaches have attracted the most attention: steps to increase the rate of accretion of the Fund's reserves, either guided by formulas relating the reserve increase to relevant variables, or decided on an ad hoc basis; and the nonaccrual of charges due from members having protracted arrears, together with some accretion of reserves in light of overdue repurchase obligations. Executive Directors will recall that a number of variants on the former course had been suggested for consideration by the staff in EBS/84/231 (11/14/84), and further information requested by Directors, relating primarily to possible guiding formulas, is provided in EBS/85/32. The possibility of not accruing overdue charges in certain circumstances was also suggested by some Directors during the course of the meeting on December 17. In response to further questions, this possibility is also discussed in further detail in the supplementary notes in EBS/85/32.

In examining the alternative approaches, several points common to them may be noted. (a) The issue at hand is to decide on steps that would better secure the financial position of the Fund in circumstances of overdue payments. A further step which also might be thought to encourage members directly to discharge their overdue obligations would be to impose special charges on such obligations. This will be discussed in a paper to be issued separately. (b) Whatever course is chosen, a strengthening of the Fund's finances implies raising charges somewhat above levels that would otherwise prevail--that is, of raising charges or of moderating reductions that might otherwise have taken place. (c) It does not seem possible, however, to predict with certainty the quantitative effect of any of the techniques on charges or on their variability, and the effects of any of the techniques may well be overwhelmed by other factors determining the Fund's income. (d) Many Directors have shown some reservations toward

exclusively automatic formulas, whether they would operate to increase the Fund's reserves or to deduct certain amounts from the Fund's accrued income.

In this light, Directors may now wish to come to a decision on a technique that would lie between automaticity and reliance on fully ad hoc decisions. The following two options may provide a helpful basis for deciding on an approach in this middle range.

(a) An agreed increase of the reserve target by some minimum amount, which would continue so long as overdue obligations having a duration of six months or more are outstanding. It would be understood that further increases could be decided if there were further deterioration in the situation on overdue obligations, and the results of the various formulas could be taken into account in considering such decisions. A minimum increase of the targeted reserve growth from 3 percent to on the order of, say, 6 percent--which would raise the income target by about SDR 30 million--would be broadly consistent with the results of several of the formulas illustrated and would seem to be indicated in present circumstances.

(b) A presumption that unpaid charges would be placed in nonaccrual status after a certain period of nonpayment of charges by a member, such action to be taken on a lapse of time basis, but such action to be deferred if in management's judgment payment is imminent or other strong reasons justify deferral. If this course were favored, it would be for consideration that a period of nonpayment of charges of six months be selected as the presumptive "trigger" for decisions on nonaccrual. A somewhat smaller increase of the reserve target, in light of overdue repurchases, would be consistent with this option.

I believe we should try to resolve this issue on the basis of these options which, of course, partly overlap. The staff will prepare specific amendments to Rule I-6(4) in light of the Board's decision, for adoption by the Board at an early date.

2. Reporting by the Fund on overdue obligations

The Executive Board will consider a number of questions relating to the reporting by the Fund in published documents on the matter of overdue obligations. The question of such reporting arises in connection with the Fund's Annual Report, the quarterly financial statements, Balance of Payments Statistics and International Financial Statistics.

With respect to the Annual Report, the staff has proposed that decisions by the Executive Board on complaints with respect to members' overdue obligations be reported in the Annual Report. This is, of course, the most comprehensive vehicle for the

communication to the public of important decisions and activities by the Fund, and publication of this kind would be in line with past practice. I have sensed little, if any, objection to the staff's proposals in this respect.

The issue in relation to the other three publications is essentially that of the identification of members in arrears to the Fund. With respect to the financial statements, the general view in earlier discussions was that reporting in aggregated form would be appropriate and consistent with the Fund's standards. Before deciding the further issue of identifying the names and amounts involved for individual members, however, Directors wished to have supplementary information on the practices of other institutions. That information has been supplied in EBS/85/32. While its relevance to the Fund's practices may not be conclusive, it does not point to individualized reporting. If such individualized reporting is not favored by the Board, the Board might wish to consider whether to delete references currently made to individual members in the notes to the financial statements.

It is suggested that the matter of identification of members in arrears to the Fund in Balance of Payments Statistics be guided by the decision on this issue with respect to the financial statements. It is proposed not to modify the presentations of Fund Accounts and Monetary Accounts in IFS so as to identify members' overdue obligations to the Fund.

3. Publicity upon a declaration of ineligibility

SM/85/12 presents some relevant history and discusses considerations bearing on the issue whether the Fund should engage in what Directors have called "active publicity" in relation to declarations of ineligibility, by issuing a press release upon or shortly after such declarations. In my judgment, the Board's decision should be guided primarily by whether such active publicity is judged likely to be of positive benefit to the Fund in dealing with the problem of overdue obligations. Another consideration is whether in the absence of such releases there would be a significant risk of premature and partial disclosure which the Fund should feel compelled to avoid. Partly related to both of these considerations is the question whether, if issuance of press releases is favored, it would be desirable to provide for some delay following a declaration of ineligibility. In any event, Directors will wish to weigh these different considerations in the light of the overall relationship between the Fund and member countries.

The Treasurer informed Directors that obligations that were overdue by more than two weeks had amounted to SDR 219 million on March 8, 1985, of which SDR 124 million represented overdue repurchases and SDR 70 million overdue charges. Of that total, SDR 190 million was owed by countries that had been overdue for six months or more in at least one of the categories of overdue obligations. SDR 55 million was related to charges, of which a part had been overdue by more than six months.

The Fund's income would have been SDR 6.7 million lower at the midyear review and would be SDR 53.6 million lower at present if all charges accruing from those members that were overdue for six months or more were not included in the Fund's income, the Treasurer indicated. In other words, there had been a sharp increase in the amount of overdue charges.

The staff representative from the Treasurer's Department, responding to a question from the Chairman, stated that the total obligations overdue by six months or more was SDR 190 million, of which SDR 114 million reflected overdue repurchases and SDR 54 million reflected overdue charges. There were also small amounts overdue to the Trust Fund.

Mr. Dallara remarked that his authorities were extremely concerned about the rapid increase in overdue obligations to the Fund and about the implications of that problem on the financial integrity of the institution. The Executive Board had devoted a substantial amount of time to the question of overdue payments of individual countries, and the staff had provided technical assistance to those members with overdue obligations to help them formulate policies designed to correct the economic imbalances. There was an urgent need for further action to strengthen the financial position of the Fund and to demonstrate to the international financial community that the Fund was determined to preserve its financial integrity. The need for action was also underscored by the decline in the Fund's reserves as a percentage of the variables presented in Table 4, Attachment III of EBS/85/32: Fund credit to members with arrears over six months as a percentage of reserves has grown from 1.2 percent in 1983 to 68.2 percent in January 1985, and arrears to the Fund have grown from 3.6 percent of reserves in 1983 to 14.8 percent in January 1985. More generally, total reserves as a percentage of outstanding purchases had declined from 6.2 percent in 1982 to 3 percent in January 1985 and as a percentage of outstanding Fund borrowings had declined from 13.8 percent to 7.2 percent in the same period. Those statistics indicated the need for the Fund to adjust its income to reflect the buildup of arrears. Any delay in taking such action could raise questions about the quality of member country claims on the Fund and could potentially jeopardize public support for the Fund. The growth of arrears also raised questions about Fund conditionality, program design, and the related question of prolonged use of Fund resources and access. Any unwillingness to act decisively on the problem of arrears at the present meeting would make more urgent the need to address those issues directly.

It was important for the Fund to follow standard accounting practices by placing charges on the use of Fund resources for members that were overdue in meeting financial obligations for six months or more to a deferred income account, Mr. Dallara remarked. When the overdue charges were repaid, of course, nonaccrued charges would be revised and the Fund's income statement would be changed to reflect the payment. Nonaccrual accounting for charges would present a more accurate picture of the Fund's financial position than the current accounting method and would provide a more accurate base for setting income targets and the rate of charge. He did not share the view of some Directors that nonaccrual accounting for charges amounted to a judgment of ultimate uncollectibility.

His authorities had taken a number of considerations into account when viewing the need for a reserve buildup, including the question of the income shortfall deriving directly from the late payment of charges, the level of overdue charges and repurchases, and the inadequacy of the 3 percent reserve target, Mr. Dallara commented. There were merits to using a formula to determine the needed increase in reserves--for example, Formulas II-V on page 30 of EBS/85/32. On the basis of Formula I, an increase in reserves of SDR 34.2 million was called for, representing an additional 3 percentage point increase in the reserve target. Formula III suggested the need for a 9 percent reserve target, or 6 percentage points above the current reserve target. Formulas II and IV pointed to the need for substantially higher increases in reserves.

The urgent need for action was demonstrated by looking at the amount, in addition to net income target, that would have been necessary under Formula III in October 1984 and January 1985, Mr. Dallara observed. In that brief period of less than three months, the addition to net income target required to counteract the accumulation of overdue payments had increased from SDR 33.9 million to SDR 76.7 million. If the Executive Board delayed taking action, the option would be narrowed and the Fund's financial position would be made more difficult. He recognized that a number of Directors had been concerned about the deficiencies of the various formulas. Indeed, there was a certain inflexibility in a reserve target system based on formulas. He was therefore willing to support a more general overall increase in the reserve target using the formulas presented in the staff paper as indicative of the range of change that was needed. He suggested that an increase in the net income target from 3 percent of reserves to 8 percent of reserves was fully justified. Option (b) of the Chairman's statement was close to the position that he could support. In contrast to the Chairman's suggestion, however, he was in favor of automatically placing unpaid charges in nonaccrual status after six months and in increasing the reserve target to 8 percent.

He was in favor of reporting overdue obligations on both an aggregate and country-specific basis in the Annual Report and quarterly financial statements, Mr. Dallara stated. An explanation of the Fund's general policy on arrears should be presented in order to put the data in perspective. Some information on overdue obligations should be included in the Balance of Payments Statistics and International Financial Statistics.

Reporting on overdue obligations in the quarterly financial statements was the most appropriate way to present an accurate and realistic picture of the Fund's financial position to the financial community, Mr. Dallara continued. There were differences between the Fund and other financial institutions which did not publish the names of individual debtors that were in arrears to them. In the light of the Fund's unique responsibility as a catalyst for additional finance and the importance that was attached by the international community to the Fund's judgment as indicated by the approval of stand-by and extended arrangements, he did not find the information provided in the staff paper on the practices of other institutions to be relevant to judgments on how the Fund should deal with the problem. Members of the international financial community would be better able to assess the Fund's financial position if they knew which countries were in arrears to the Fund. They could then judge the likelihood of repayment by those countries. Aggregate publication of overdue payments might cast doubts over those debtors that were not in arrears to the Fund and might adversely affect the Fund's ability to mobilize the additional financing that was necessary for many of the adjustment programs.

Publication of country-specific data in the quarterly financial statements, including the statement in the Annual Report, would most adequately meet those needs, Mr. Dallara commented. He would envision a short table showing the amount of arrears on charges and on repurchases separately for each country. A footnote for each member with one or more obligations overdue for six months or more might be included, with an indication of the duration of the longest overdue payment.

A short note putting arrears into perspective could be placed in the quarterly financial statement. As a follow up, a longer explanatory section could be placed in the Annual Report to describe the Fund's general policies on arrears. Both would provide the financial community with more understanding of arrears, Mr. Dallara remarked. Inclusion of that information in the Annual Report, only, would not be appropriate since there would not be an opportunity to set the record straight on members whose arrears were reported in one Annual Report but were eliminated before the next.

The staff had pointed out the difficulties of reporting overdue payments only in the Annual Report, and he therefore thought that the quarterly financial statements should also include such information, Mr. Dallara stated. He recognized the presentation problems associated with reporting of overdue payments in the Balance of Payments Statistics and IFS.

He fully supported automatic issuance of a press release upon a Board decision on declaration of ineligibility which represented an important change in the legal relationship between the Fund and a member, Mr. Dallara indicated. Such a press release should indicate the size, duration, and nature of the overdue obligation, as well as reviewing briefly the events leading to the declaration of ineligibility and describing the Fund's general policy and the legal implications of such action. No explicit

recommendation regarding policy steps that the member should take in order to address its underlying payments problems or resolve its arrears should be included. Active publicity would help to protect the financial integrity of the Fund and would also represent an incentive for members to resolve their arrears problems hastily. An ad hoc approach to publication of declarations of ineligibility would be inconsistent with the principle of uniform treatment of members. The press release should be issued immediately following a Board decision on ineligibility, given the possibility of a leak to the press.

Mr. Wicks stated that he favored placing unpaid charges in nonaccrual status after a period of time for a variety of reasons. It would be indefensible for the Fund, which was at the heart of the international financial system, to include uncollected charges as income actually earned. If the nonaccrual system of accounting were not adopted, unpaid charges would exceed the Fund's net income in financial year 1985. The Fund, despite its unique character, should not adopt a less rigorous accounting method than that of the commercial banks and the World Bank. He did not go along with the argument that the commercial banks and the World Bank had to satisfy the tough standards of bond holders and the financial markets, while the Fund did not. Furthermore, it would be difficult to explain to the financial community that the Fund had decided to take account of overdue payments by adjusting reserves on the basis of a complicated formula rather than by changing to a nonaccrual method of accounting for overdue charges. By shifting to that method of accounting, the Fund was not accepting that those charges would never be paid, but was recognizing that the charges had not been paid during the accounting period in question and that some uncertainty existed about when payment would be made.

He understood the concerns of some Directors about the effect of nonaccrual accounting on the rate of charge, particularly about the possibility of excessive fluctuations in the rate of charge, Mr. Wicks stated. It would be at the discretion of the Executive Board to decide on the rate of charge, based on the circumstances existing at a particular time. The rate of charge could be adjusted downward when members became current in their payments to the Fund. The change to nonaccrual accounting would become more difficult the longer the Executive Board delayed taking a decision because of the cumulative effects on the Fund's accounts of unpaid charges. For various reasons, he favored a move to nonaccrual accounting. He agreed with option (b) presented by the Chairman, although he would appreciate some clarification from the staff of the accounting method suggested in that paragraph.

The Fund's reserve target should be increased in response to the present financial circumstances of the Fund, Mr. Wicks indicated. Total overdue payments were equivalent to about 20 percent of reserves, with overdue repurchases representing about 13 percent of reserves. Over the past five years, the Fund's reserves had fallen from 9 percent to 3 percent of outstanding use of Fund credit. He noted that Mr. Dallara had suggested in increase in the reserve target to between 6 percent and 8 percent.

In view of its pivotal financial role, the Fund had an obligation to publish accurate information about overdue obligations, Mr. Wicks considered. He favored the issuance of a press release upon declarations of ineligibility. Furthermore, aggregate information on overdue payments should be reported by the Fund in published documents. When payments were overdue by more than a certain period, for example, and the Fund ceased to accrue them as income, individual countries should be identified in those reports. The practice of commercial banks regarding reporting of overdue obligations was irrelevant to a judgment on reporting by the Fund. If the Fund did not provide such information, the press and financial institutions would attempt to discover through unofficial sources which countries were in arrears to the Fund, which could lead to the publication of erroneous information. Finally, he was in favor of including information on overdue payments in the Fund's statistical publications, although the tables should not deliberately be redesigned to highlight the existence of arrears.

Mr. Schneider remarked that the problem of protracted overdue obligations to the Fund was a difficult and novel one. In view of the increasing incidence of overdue payments, it seemed advisable to approach that problem in a medium-term perspective under the assumption that overdue payments would increase in the next few years. Moreover, in deciding on an appropriate course of action, the Executive Board should pay due regard to the interests of the parties involved.

On the one hand, the Fund's financial position and its standing vis-à-vis the creditor countries should be protected, Mr. Schneider commented. It should not be forgotten that the claims of those member countries on the Fund were part of their official foreign reserves that were regarded as liquid claims. On the other hand, action should not be taken that would alienate the debtor countries from the Fund and that would be contrary to the cooperative nature of the institution.

It could be argued that an ad hoc approach to accounting for overdue payments would be appropriate given the Fund's limited experience with overdue obligations and the many uncertainties involved in assessing future developments, Mr. Schneider noted. An ad hoc approach could, however, result in erratic changes in reserves or charges, depending on the frequency and magnitude of overdue obligations and would also involve frequent Board discussions. Consequently, a predetermined, but flexible, approach would be more appropriate. Option (b) outlined by the Chairman, although placing a heavy burden on management in exercising its judgment on what action ought to be taken, would maintain a reasonable degree of flexibility, while increasing the reserve target moderately to take account of existing overdue obligations.

He agreed with other Directors that decisions on complaints regarding overdue obligations should be reported fully in the Fund's Annual Report, Mr. Schneider stated. He would prefer that information on members in arrears to the Fund was included only in aggregate in other Fund publications. He recognized, however, that individual reporting in the Annual

Report would not indicate when a member became current between two publications of two Annual Reports. He was open to suggestions with respect to a prompt updating of the status of a member with overdue obligations that had been identified in the Annual Report.

The question of issuing a press release upon declarations of ineligibility was sensitive, Mr. Schneider observed. By issuing a press release, the Fund would be explicitly blaming a sovereign state of wrongdoing, regardless of whether the situation leading to the overdue payments had developed as a result of endogenous or exogenous factors, or a combination of both. Such a public identification of a member could be counterproductive and might alienate the member concerned. Furthermore, the Fund should avoid giving the impression that a member might eventually be asked to withdraw from the Fund. The cooperative nature of the Fund should not be forgotten. Active publicity could also have damaging effects on the Fund if the number of members declared ineligible to use Fund resources increased. He was therefore opposed to active publicity.

Mr. Jayawardena expressed his concern about the growing problem of overdue obligations. He agreed that nonpayment of obligations by a member to the Fund disrupted the international cooperative character of the institution and the principle of uniform treatment of members. Every effort should be made to identify the reasons for overdue payments and to find practical solutions to the problem. He hoped that the emergence of overdue payments was a temporary problem arising from the difficult problems faced by borrowing countries in recent years. There was a need for an in-depth study of the origins of the problem, the difficulties faced by member countries in meeting their payments obligations to the Fund, and future developments regarding settlement of overdue payments. The Executive Board should avoid proposing hasty remedies that hinted of punitive action, which might prove counterproductive. It should resolve the problem with understanding, while maintaining the revolving character of the Fund's resources and the financial integrity of the Fund.

He agreed with the Chairman that it would be prudent, given the sizable overdue payments, to take action to strengthen the Fund's financial position, Mr. Jayawardena remarked. The Chairman had proposed various approaches, including measures to increase the Fund's reserve target on the basis of formulas or on an ad hoc basis. His authorities based their position on the question of a reserve target increase on the principle, outlined at previous meetings, that the cost of the Fund's operations of the accrual of reserves should be shared equitably by all members in relation to their voting power. On earlier occasions, his chair had expressed its concern that the burden arising from the increase in the Fund's expenses and reserve accumulation was falling disproportionately on the borrowing members.

More specifically, the contributions to the Fund by nonborrowing members were in the form of foregone income on their unremunerated positions in the Fund as well as through the loss of a portion of interest on their remunerated positions, as the rate of remuneration was currently

less than 100 percent of the SDR interest rate, Mr. Jayawardena stated. The unremunerated positions were more or less fixed in absolute amounts because the Second Amendment of the Articles of Agreement clearly provided that new increases in quotas would result in increases only in remunerated positions. The loss of income from unremunerated positions could be approximated by applying a rate of interest that was equal to the SDR interest rate. Income would be lost from the remunerated positions only as long as there was a difference between the rate of remuneration and the SDR interest rate. It would be possible to assess whether the foregone income of creditor members, as a proportion of administrative expenses and reserve accumulation, was in line with the voting strength of those members. If their contributions, in terms of foregone income, were less than the proportion of voting power, the borrowing countries were obviously paying for the Fund's expenses and reserve accumulation at a greater rate than that of the nonborrowing members.

Moreover, Mr. Jayawardena went on, his authorities perceived that the contributions from nonborrowing member countries would decrease in the future for two reasons. First, the unremunerated positions would decline in relative terms when new quotas were approved. Second, the contributions in the form of foregone income from the remunerated positions of nonborrowing members would decline to zero as the rate of remuneration was increased to the SDR interest rate. Hence, he was concerned that the nonborrowing members would be contributing gradually less toward the operations of the Fund, a development that was contrary to the principle of international cooperation and of uniform treatment of members.

Any decision on reserve accumulation should be subject to a careful evaluation of the problem he had just outlined, Mr. Jayawardena remarked. His office had taken up that question bilaterally with the staff and had agreed that the problem was difficult to quantify. Some approximation was necessary, however, to preserve the basic international cooperative character of the Fund and to ensure uniform treatment of members. Furthermore, it was difficult to apportion the contributions made by each country against specific items of expenditure, whether to administrative expenses or to payments for remuneration. Such a detailed exercise was not necessary, however, to establish broad orders of magnitude and by whom the additional burden of expense was borne. He hoped that the staff could examine that issue and propose a solution to the problem, which could not be ignored. Given the current practice of determining charges on a residual basis, the proposal to place in a deferred income account charges on the use of Fund resources for members that were overdue in meeting financial obligations for six months or more would result in an increase in charges for a handful of borrowing countries.

The question of burden sharing was so basic to any determination of expenditure, rate of remuneration, charges, and reserve accretion, that only a detailed staff examination of the issue would provide the Board with an appropriate base on which to determine the extent to which the reserves of the Fund should be increased to provide for overdue payments, Mr. Jayawardena noted. He urged the Executive Board to defer taking

decisions on the accounting method and on the reserve target until more information was presented on relative burden sharing between borrowing and nonborrowing member countries. Rigid formulas for reserve accumulation might not be helpful, particularly if the problem of overdue payments was only temporary in nature. Flexibility was essential, and decisions on reserve accumulation should be made on an ad hoc basis, such as on the occasion of the forthcoming discussion of the Fund's income position.

As to reporting by the Fund of overdue obligations, the staff's survey of the practices of various financial institutions indicated that it was not standard practice to identify individual borrowers that were in arrears to those institutions, Mr. Jayawardena pointed out. Identification of members with overdue payments in any of the Fund's publications would represent a breach of the confidentiality of relations between the Fund and its members. He was therefore opposed to reporting of individual countries with overdue payments in any Fund publications, including the quarterly financial statements, Balance of Payments Statistics, and IFS.

The previous practice of reporting on overdue obligations without identifying members in the Annual Report should be followed, Mr. Jayawardena considered. The Fund had a duty to inform its members of overdue payments to the Fund, as was done in the normal course of events. However, despite the Fund's catalytic role, it was not obliged to inform the general public of overdue payments by its members.

His authorities were opposed to the issuance of a press release upon declarations of ineligibility, either immediately or after a time lag, Mr. Jayawardena stated. Furthermore, a declaration of ineligibility should be used only sparingly. The staff had presented four arguments in favor of active publicity and four arguments opposed to such publicity, but had come to the abrupt conclusion that active publicity was desirable. He agreed with the Chairman that "the Board's decision should be guided primarily by whether such active publicity is judged likely to be of positive benefit to the Fund in dealing with the problem of overdue obligations." He had serious doubts on the value of active publicity as a deterrent. A declaration of ineligibility itself was a serious decision relating to a member, and the issuance of a press release would only be further aggravation. He urged the Executive Board and the Chairman to make further efforts to find a positive solution to the problem of overdue obligations that was consistent with the cooperative character of the Fund.

Mr. Kafka said he agreed that it was no surprise that the incidence of overdue obligations was increasing at a time when the world was emerging in an uncertain fashion from the worst depression since the 1930s. Nevertheless, the Fund should take action to protect its financial integrity. He favored adopting a nonaccrual method of accounting for charges along the lines suggested by the Chairman in option (b). Some increase in the reserve target would also be necessary in view of the existence of overdue payments. Option (b) would be acceptable, however, only if there were no individualized reporting of overdue charges. The Chairman's statement did not indicate explicitly whether the increase in the reserve target

necessitated by the change in accounting method would be met partly through a reduction in the rate of remuneration, although his reference to Rule I-6(4) suggested that he did not contemplate such action. Yet Mr. Jayawardena had presented a good case for distributing the burden arising from the overdue payments on both the innocent borrowers and the innocent lenders. He was not proposing a change in the formula by which the rate of remuneration was moved gradually toward the SDR rate.

No useful purpose would be served by individual reporting in the Annual Report of members with overdue payments to the Fund, Mr. Kafka considered. The suggestion that globalized reporting could cast suspicion on members that were not overdue in their payments to the Fund was unrealistic. Member governments were fully informed by their Executive Directors about the incidence of overdue obligations, and the Fund had no obligation to provide any information to private lenders. There should be no individualized reporting of overdue obligations in other Fund publications, and such individual references should be deleted in those publications where they currently appeared.

As the Fund's members considered the mere incidence of overdue obligations to be opprobrious, the threat of issuing a press release upon declarations of ineligibility would add no additional incentive for members with overdue obligations to repay, Mr. Kafka remarked. Active publicity would merely serve to embitter relations between the Fund and those members. The Fund must do no more than take the practical steps necessary to safeguard its position. Leaks to the press and the publication of erroneous information regarding overdue payments would inevitably occur, and any member affected could correct such misinformation through its own actions. The External Relations Department could help, when solicited, by issuing a denial regarding erroneous declarations of ineligibility.

Mr. Grosche stated that he saw no major difference, with respect to the possible consequences on the rate of charge, between the two options proposed by the Chairman. He favored the adoption of a nonaccrual method of accounting for charges from members with overdue obligations. The financial integrity of the Fund should be preserved given its responsibilities vis-à-vis the international financial community. Under generally accepted accounting principles he would expect the Fund to exclude from net income charges payable by members that were overdue in meeting financial obligations for six months or more. He had doubts about the suggestion that such action could be deferred if, in management's judgment, payment was imminent or if other strong reasons justified deferral, a practice that would be at variance with strict accounting principles. He agreed that a smaller increase in the reserve target would be acceptable if the Executive Board agreed to nonaccrual accounting for charges from members with overdue obligations.

In view of the Fund's pivotal role in the international monetary system and its special responsibilities within the international financial community, members' overdue payments to the Fund should be reported on an individual basis, Mr. Grosche remarked. The practice of other

financial institutions should not be a guideline for the Fund, which had a different and unique role to play. Individual countries with overdue obligations and the amounts should be reported in the Fund's financial statements, Annual Report, and IFS.

There were a number of convincing arguments in favor of the issuance of a press release upon declarations of ineligibility, Mr. Grosche considered. The Fund had a responsibility to inform its members of important decision. In addition, active publicity would provide an additional incentive for member countries to settle their overdue obligations in a timely manner. Furthermore, the risk of incorrect disclosures of declarations of ineligibility by unauthorized, non-Fund sources would be reduced. Therefore, he would favor the issuance of a press release immediately upon declaration of ineligibility, since a delay in publication would only increase the risk of a premature or partial disclosure. The Executive Board would declare a member ineligible to use Fund resources only after considering the member's circumstances in great depth, and, having taken such an important step, the Board should make it public.

Finally, on an administrative point, it would be useful if the staff could produce a paper listing payments overdue by more than four weeks by country and by type of payment every quarter, Mr. Grosche stated. Such information would help the Executive Board to keep track of the accumulation of arrears.

Mr. de Maulde agreed with the Chairman on the importance of protecting the Fund's financial position in the light of the increasing incidence of overdue payments. He agreed, in principle, that charges on the use of Fund resources from members that were overdue in meeting financial obligations for six months should not be included in accrued income. However, before the Board took a decision on that issue, a staff paper on the effects on the rate of charge of nonaccrual accounting for charges should be prepared. Should the Board decide to adopt that method of accounting, there would be no need at present to raise arbitrarily the reserve target.

He was in favor of reporting in the Fund's Annual Report on decisions taken by the Executive Board on complaints regarding members' overdue obligations, Mr. de Maulde indicated. Overdue obligations should be reported, in aggregate, in the quarterly financial statements, Balance of Payments Statistics, and IFS. He was reluctant to support the identification of countries and the amounts involved, which would be contrary to the practices of other financial organizations, although he recognized that the aggregate information might cause speculation about which countries were overdue in their payments.

He saw no need for issuance of a press release upon declarations of ineligibility, Mr. de Maulde stated. His country had first-hand experience of the subject. The financial community would generally be aware of any Executive Board decisions declaring a member ineligible to use Fund resources. The issuance of a press release would excite the media and the general public and would be contrary to the Fund's interests and damaging to its image.

The Director of the Legal Department, responding to a question from Mr. Salehkhou, stated that a decision to change the net income target and the rate of charge would require a qualified majority of 70 percent of the Executive Board's total voting power.

Mr. Tornetta observed that payments that were overdue by six months or more had increased dramatically with respect to reserves, while total reserves had decreased as a percentage of quotas, outstanding purchases, and borrowing. Corrective action was therefore necessary to strengthen the Fund's financial position. He was opposed to a mechanical approach to increasing the reserve target on the basis of one of the formulas, which might lead to erratic changes in the reserve target, but he could support the suggestion to change the rate of increase of reserves from 3 percent to a maximum of 6 percent. The reserve target should be reviewed periodically and adjusted in light of changes in the amount of overdue obligations and their ratio to reserves. As overdue obligations were likely to fluctuate, the reserve target should be reviewed every six months on the occasion of the midyear review of the Fund's income position.

His authorities had mixed feelings regarding the question of nonaccrual accounting for charges, Mr. Tornetta indicated. Nonaccrual accounting might be an appropriate course of action in some cases, as overdue charges were large compared with the net income target and some overdue obligations were unlikely to be repaid in the short term. He had doubts, however, about the relatively large and sudden changes in the rate of charge that would be necessary to achieve the net income target if a nonaccrual accounting method were adopted. The required flexibility could be introduced if nonaccrual accounting for charges was deferred when management considered that payments by a member was imminent. Decisions on placing unpaid charges in nonaccrual status should be taken by the Executive Board, either on a lapse of time basis or at Board meetings. He could support a change to nonaccrual accounting for charges if such flexibility were introduced. With respect to the lapse of time after which the nonaccrual status could be applied, even though a six-month period might be appropriate, he could also favor longer periods.

The decision on reporting of overdue payments in Fund publications should be guided by two objectives, Mr. Tornetta stated. On the basis of generally accepted accounting principles, the Fund should disclose information on overdue payments if it were considered significant for the transparency of the figures reported in the relevant publications. For that purpose it was unnecessary to disclose the amounts due by individual member countries. In addition, the reporting of overdue obligations of individual member countries should be seen as an instrument of the Executive Board to deal with and reduce the amount of overdue payments to the Fund. For that reason, he believed that the best results could be obtained if no reporting on the arrears of individual members were made in the early states of the procedures keeping this instrument for the most serious cases. In taking a decision on reporting by the Fund, the Executive Board should bear in mind the responsibilities of the Fund, as a public international financial organization, to its member countries.

The Fund should avoid premature reporting that might harm member countries and affect their relations with the Fund. Other financial institutions, including the World Bank, central banks, and commercial banks, did not usually provide information that would permit the identification of borrowers in arrears.

Thus, he was in favor of reporting on financial obligations that were overdue for six months or more in aggregate but without identifying the members involved, in the Fund's Annual Report and quarterly financial statements, Mr. Tornetta indicated. The same principle should be applied to the Balance of Payments Statistics, for which he supported option (b) on page 8 of EBS/85/32. As for reporting in IFS, he supported option 2 of Attachment II to EBS/85/32. Reporting of overdue obligations in the manner that he had suggested would disclose information that could be considered as material to evaluating the Fund's income and financial position.

Reporting on the arrears of individual countries was a serious matter that he would favor only when a member was declared ineligible to use the Fund's general resources, Mr. Tornetta stated. That would also be consistent with the principle of applying progressive sanctions to members with overdue obligations. If the Fund reported on the overdue financial obligations of individual member countries before a declaration of ineligibility, the impact of issuing a press release upon a declaration of ineligibility would be reduced. He therefore considered it inappropriate to report on the decisions of the Board on complaints with respect to overdue financial obligations. Additionally, the staff's survey indicated that it was common practice in the financial community to deal with overdue financial obligations with confidentiality. Furthermore, reporting of decisions on complaints in the Annual Report alone might be contrary to the principle of uniform treatment of members as, depending when the case comes up, some decisions would be disclosed after a short period of time and others after a much longer period of time.

While it was important to treat information on members' overdue payments confidentially, it was also crucial to avoid concealing information from the international financial community in cases of substantial or long-standing arrears, Mr. Tornetta remarked. He was therefore in favor of reporting in the Annual Report on any Board decision declaring a member ineligible to use the Fund's general resources. Such action might encourage a country to fulfill its obligations. Reporting in the Annual Report would not be timely, however, and might not have the desired effects on repayments. Furthermore, it did not guarantee equal treatment to all members, as some decisions would be reported sooner than others. He therefore favored the issuance of a press release upon an Executive Board decision on ineligibility, with a delay of about two weeks to give the member country a chance to repay the Fund. As to the content of such a press release, he favored option (b) on page 6 of SM/85/12. He was opposed to publication of the Fund's view on policy actions that the member might take to enable it to repay the Fund. The Fund might, however, invite the country to take corrective action.

The staff had not dealt with the question of active publicity and reporting in Fund publications of a decision declaring a member eligible to use Fund resources following repayment of its overdue obligations, Mr. Tornetta observed. That issue should be examined as it might provide further incentive for members to repay their obligations after they had been declared ineligible to use the Fund's resources. That aspect should be considered also because of its implications in terms of an even-handed treatment of member countries.

Mr. Fugmann stated that member countries should be aware of the adverse effect of overdue obligations on the Fund's income and liquidity position. He favored a solution which would reduce the need for a major increase in the reserve target and, therefore, preferred option (b) in the Chairman's statement which would involve a certain increase in the reserve target in addition to a change in accounting methods.

He agreed that overdue obligations should be reported in aggregate in Fund publications, Mr. Fugmann stated. When considering whether to identify individual members and the amounts of overdue payment, the Executive Board should consider, on the one hand, the Fund's role as a public international financial institution, and, on the other, the need for confidentiality in relations between the Fund and its individual members. A declaration of ineligibility was the point at which a member with overdue obligations to the Fund should be identified individually in Fund publications.

A press release should be issued within one month of the Board decision declaring a member ineligible to use Fund resources, Mr. Fugmann considered. A delay between the Board's decision and the issuance of a press release would provide still a further opportunity for the member to settle its obligations. The press release should contain relevant facts as proposed in formula (b) on page 6 of SM/85/12. He was opposed to including Fund views in such press releases, because Fund discussions with members should not be publicized.

Mr. Nimatallah remarked that overdue obligations were a matter of serious concern to the Executive Board as they weakened both the Fund's financial position and the confidence in the Fund, which could make it difficult for the Fund to acquire additional resources for its members through quota increases, borrowing, or from the commercial banks. Overdue obligations could harm all Fund borrowers not only because they reduced the availability of resources but also because they led to pressure from some members to tighten conditionality and restrict access. Most important, the increase in overdue obligations made it necessary for the Fund to increase its reserves, thereby imposing a burden on members without arrears to the Fund. It was in the interest of all members to cooperate to deal effectively with the problem and to strengthen the Fund's financial position.

There were three ways to improve the Fund's financial position, Mr. Nimatallah considered. Existing procedures for encouraging prompt settlement of arrears should be strengthened. The issuance of a press release once a member was declared ineligible to use the Fund's resources was appropriate in that respect. As countries with arrears to the Fund were not allowed to use Fund resources, a declaration of ineligibility, without issuance of a press release, was not particularly effective. The Fund, owing to its catalytic role, had a responsibility to inform the international financial community of all relevant information concerning its relations with members. Furthermore, the Fund should guard against the risk of such information leaking out, possibly with a harmful distortion of the facts. Such a press release should include information on the amounts overdue, the length of time overdue, and the Fund's general policy on declarations of ineligibility. The press release should also state that the Fund and the member remained in close contact to find ways to settle the overdue obligations, so as to indicate that the Fund and the member were trying to normalize relations. He would prefer the immediate issuance of a press release following a declaration of ineligibility, but could go along with a delay of two weeks, in which case the Executive Board should decide in advance to issue the press release, based on a lapse of time decision, unless the member became current within the two-week period.

Existing procedures could also be strengthened by shortening the three-month period between the emergence of arrears and the circulation of the Managing Director's complaint to the Board, Mr. Nimatallah stated. Potential problems could be highlighted at an early stage and brought to the attention of the authorities by the Managing Director so that appropriate solutions could be worked out before further action became necessary.

The introduction of penalty charges would represent a tightening of existing procedures by giving members in arrears a clear financial incentive to repay promptly, Mr. Nimatallah commented. Penalty charges could also be a useful deterrent in some cases, and he looked forward to a Board discussion of specific staff proposals on that issue at an early date.

Another way to strengthen the Fund's financial position was to increase reserves, which had deteriorated seriously in relation to such variables as Fund quotas, outstanding borrowing, and outstanding purchases, Mr. Nimatallah noted. Moreover, the present 3 percent reserve target had been agreed at a time when overdue obligations had not been a problem. Reserves should be increased to reduce apprehensions about overdue obligations and to improve the Fund's financial position. He could go along with option (b) in the Chairman's statement, as modified by Mr. Dallara. Given the relative decline in the Fund's reserves and the amount of overdue obligations, he favored, at a minimum, a doubling of the reserve target to 6 percent. The Executive Board should, in the near future, re-examine the adequacy of the Fund's reserves and the ways of enhancing them.

Credible and realistic reporting of its activities would also strengthen the Fund's financial position, Mr. Nimatallah considered. He agreed with the staff that Executive Board decisions on complaints with respect to overdue obligations should be reported in the Annual Report. Furthermore, overdue obligations should be reported in the notes to the Fund's financial statements to give an accurate picture of the institution's financial position. He had an open mind whether those notes should refer to individual countries or should simply contain aggregate information.

The Executive Board agreed to continue its discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/39 (3/11/85) and EBM/85/40 (3/13/85).

4. PEOPLE'S REPUBLIC OF CHINA - TECHNICAL ASSISTANCE

In response to a request from the authorities of the People's Bank of China for technical assistance on a range of central banking matters, the Executive Board approves the proposal set forth in EBD/85/67 (3/6/85).

Adopted March 11, 1985

5. EXECUTIVE BOARD COMMITTEES - NOMINATION

The Executive Board approves the election of the Executive Director nominated by the Managing Director to assume the vacant positions on the Committee on Administrative Policies and the Committee on Liaison with the CONTRACTING PARTIES to the GATT as set forth in EBD/85/66 (3/5/85).

Adopted March 11, 1985

6. ADMINISTRATIVE BUDGET FOR FY 1985 - TRANSFER OF APPROPRIATIONS

The Executive Board approves the transfer of appropriations between categories of expense in the Administrative Budget for FY 1985 as set forth in the memorandum attached to EBAP/85/56 (3/7/85).

Adopted March 12, 1985

7. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/85/59 (3/11/85) is approved.

APPROVED: December 20, 1985

JOSEPH W. LANG, JR.
Acting Secretary