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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/175

10:00 a.m., December 6, 1985

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

Executive Directors

C. H. Dallara

J. de Groote
B. de Maulde

G. Grosche
J. E. Ismael
A. Kafka

M. Massé
E. I. M. Mtei
F. L. Nebbia
Y. A. Nimatallah
P. Pérez
J. J. Polak

G. Salehkhov
A. K. Sengupta
S. Zecchini

Alternate Executive Directors

Mawakani Samba
M. K. Bush
E. L. Walker, Temporary
H. G. Schneider
S. de Forges
T. Alhaimus
M. Sugita

Jaafar A.

M. Foot
H. Fugmann
L. Leonard

A. V. Romuáldez
O. Kabbaj

N. Coumbis
Jiang H.

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

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Also Present

Asian Department: S. Kohsaka, W. G. L. Evers. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; Ph. Lachman, A. O. Liuksila, S. A. Silard. Middle Eastern Department: D. Hammann. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Berthet, M. P. Blackwell, J. E. Blalock, D. H. Brown, J. C. Corr, D. Gupta, B. E. Keuppens, G. Wittich. Western Hemisphere Department: S. T. Beza, Associate Director. Office of the Managing Director: R. Noë, Internal Auditor; C. P. McCoy. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, L. P. Ebrill, M. B. Chatah, S. Ganjarerndee, J. Hospedales, G. Nguyen, P. Péterfalvy, G. W. K. Pickering, M. Z. M. Qureshi, A. Steinberg, E. M. Taha, A. Vasudevan, K. Yao. Assistants to Executive Directors: H. Alaoui-Abdallaoui, A. Bertuch-Samuels, J. de la Herrán, G. Ercel, S. Geadah, V. Govindarajan, G. D. Hodgson, L. Hubloue, O. Isleifsson, Z. b. Ismail, S. King, H. Kobayashi, S. Kolb, K. Murakami, A. Mustafa, W. K. Parmena, M. Rasyid, J. E. Rodríguez, C. A. Salinas, M. Sarenac, L. Tornetta, A. J. Tregilgas, H. van der Burg.

1. OVERDUE FINANCIAL OBLIGATIONS - SPECIAL CHARGES

The Executive Directors considered a staff paper on special charges to recover costs and losses arising from members' overdue financial obligations to the Fund (EBS/85/242, 10/29/85).

Mr. Polak stated that he supported the introduction of special charges, primarily to cover the cost to the Fund of overdue charges, but also to encourage more timely payment. However, the introduction of special charges was unlikely to have a significant impact on the incidence of overdue financial obligations. He was opposed to the introduction of penal charges and supported only the introduction of special charges that would cover the direct financial costs of overdue obligations to the Fund. Those losses arose because the Fund did not charge interest on unpaid charges. Table 1 of the staff report indicated that the only significant loss to the Fund related to unpaid charges to the General Department, as unpaid charges to the SDR Department did accrue interest. There was no loss to the Fund as a result of delayed repurchases of borrowed resources. According to the staff calculations, even the loss arising from late repurchases of ordinary resources was minimal--the margin between the rate of interest on the SDR and the rate of charge.

If the logical, although unacceptable, conclusions of the staff paper were adopted and the rates of charge were raised above the SDR interest rate, countries with overdue payments to the Fund would have to be refunded some money as the Fund would be more than covering its losses, Mr. Polak continued. He was therefore generally in favor of Option A presented by the staff under which the rates of special charge would differ by category of obligation. Option B, based on the application of a more uniform special charge to overdue obligations, was inappropriate. He was opposed to any system that was based on some kind of averaging of the financial costs associated with different categories of overdue obligations. In particular, he was concerned about including both the resources available under the Trust Fund and the ordinary and borrowed resources of the Fund in any calculation to determine special charges. The Trust Fund and the Fund were two different financial institutions, and it would be wrong to average the losses of those two bodies, which would imply a transfer of money between the Trust Fund and the Fund.

It was questionable whether the Fund should apply a charge for any losses incurred by late repayment or late interest payment to the Trust Fund, Mr. Polak noted. The resources in the Trust Fund belonged in perpetuity to the low-income countries, which could borrow those resources at a nominal rate of interest. At present, Trust Fund money was being repaid and temporarily invested, pending disbursement. It was therefore possible that some loss was incurred by the Fund as a result of late repayment of Trust Fund resources. He saw little reason why that small loss arising from late repayment to the Trust Fund should be borne by the

countries with overdue obligations to that facility, as they would inevitably pay a cost by receiving new disbursements late. What were the views of the countries that were the beneficiaries of the Trust Fund on that matter?

He was in fundamental agreement with the staff proposals regarding the operations of the system as laid out in paragraphs (a)-(g) on pages 5-8 of the staff paper, Mr. Polak indicated. He saw some merit in the staff's suggestion that the member should be allowed ten business days after the due date in which to make the repayments. The system of special charges, if approved at the present meeting, should go into effect on January 1, 1986. He was opposed to charging a member an amount that would cover administrative costs for the reasons indicated by the staff. Finally, he was opposed to "pyramiding" of charges, whereby special charges would be levied on overdue special charges.

Mr. Mtei stressed that the only real way to ensure timely repayments to the Fund was to restore financial stability and growth in the debtor countries. The countries that had recently become overdue to the Fund had delayed settling their financial obligations only because they genuinely lacked the necessary foreign exchange. The Fund, in collaboration with the countries concerned, should analyze the reasons for the foreign exchange shortage and should assist the countries in overcoming their problems. In considering the system of special charges, it should be remembered that the overdue obligations were due from sovereign governments and that so long as those governments did not repudiate the claims by the Fund, the debts would ultimately be collected. It was really a question of how the overdue obligations should be treated in Fund accounts.

He was unconvinced that the introduction of penalty or special charges would solve the problem of overdue financial obligations to the Fund, Mr. Mtei stated. Such charges could not make a member repay its arrears promptly. The staff's proposal for a system of special charges gave no consideration to the causes of overdue obligations. He fully agreed with the staff that it was difficult to predict the effectiveness of special charges in helping to secure the settlement of financial obligations to the Fund. There was no merit in the Fund embarking on a course of action that would almost certainly have negative results.

It was clear from staff reports for Article IV consultations that many low-income economies had experienced devastating, exogenous factors, including deteriorating terms of trade, drought, an adverse international environment, and declining external financial flows, Mr. Mtei noted. In some countries, the authorities were also pursuing inappropriate domestic policies. The combination of those negative factors had forced a number of countries to delay repayment not only to the Fund but also to other creditors. In circumstances of severe economic hardship, no penalty, whether in the form of special charges, a declaration of ineligibility, or a threat of expulsion from the Fund, would enable the member to make timely repurchases. A system of special charges had a great deal of

merit if it were intended to tighten conditionality but no justification if it were intended to solve the problem of overdue obligations to the Fund.

Member countries were striving to maintain respectability and credibility in such institutions as the Fund, Mr. Mtei remarked. None of the countries in his constituency cherished the unenviable position of being overdue in their obligations to the Fund. Executive Directors had heard from a Minister of Finance how his authorities had been forced to divert the only resources available for food imports to repay part of their overdue obligations to the Fund, action that certainly indicated a high degree of commitment.

The key to solving the problem of overdue obligations, Mr. Mtei reiterated, was to secure sustained growth in the countries concerned. The Fund should focus its attention on helping member countries to design adjustment programs that would facilitate an early return to financial stability and growth by addressing the structural problems in their economies. His chair was opposed to the introduction of special charges, which would only complicate members' financial problems and reduce the likelihood of the eventual settlement of the arrears.

Mr. Grosche stated that he supported the introduction of special charges on overdue repurchases and overdue charges, a system that would help to alleviate the burden on those members that remained current in their obligations to the Fund and that were, at present, bearing the costs arising from overdue obligations. He preferred Option B of the two options presented by the staff for calculating special charges, as it would avoid the imposition of unduly high charges on overdue Trust Fund obligations and would be relatively simple to administer since the rate of special charges would remain fixed for a substantial period. Furthermore, it would provide stronger financial incentive for the settlement of overdue repurchases than Option A. However, he would be prepared to go along with Option A should it be favored by the majority of Directors.

Special charges should be viewed in the context of the negative implications of the buildup of arrears for the Fund's income position, Mr. Grosche considered. A system of special charges to recover losses arising from members' overdue obligations would help to keep down the costs for other members, as reflected in the rate of charge. It would be useful if the staff could provide further information on the possibility of including administrative costs in the calculation of special charges at the next review of special charges. The operational procedures for the imposition of special charges outlined by the staff were appropriate.

Special charges should provide stronger incentive for the prompt settlement of members' overdue obligations to the Fund and could help to avoid the emergence of arrears at the outset, Mr. Grosche maintained. In that context, overdue obligations in the SDR Department, although still relatively small, should be included in the calculation of special charges.

Finally, it should be made clear that the introduction of special charges in no way implied that arrears would henceforth be regarded as more acceptable.

Mr. Pérez stated that he was concerned about the rapid deterioration of the problem of overdue obligations and about the costs to the Fund as a result of those arrears. He was in favor of finding a solution to the problem of overdue obligations. However, the establishment of a system of special charges, although a useful device to cover the direct financial costs to the Fund of overdue obligations, did not represent an incentive for countries to repay their overdue obligations rapidly. On the contrary, such a system would increase the difficulties facing those countries. The Executive Board must act cautiously as special charges, rather than lessening the financial costs of arrears to the Fund, could discourage countries with overdue obligations from becoming current to the Fund. In sum, he was opposed to the introduction of a system of special or penalty charges. However, in the event that such a system were approved, the Fund should indicate clearly to members that the decision to adopt a system of special charges responded strictly to financial considerations and should in no way be interpreted as punitive action.

Some combination of Option A and Option B, which both had disadvantages and advantages, should be sought, Mr. Pérez considered. On the one hand, Option A included a rate of charge to be applied to Trust Fund repayments that was so high that it disregarded the concessional nature of those resources. On the other hand, while Option B included a rate of charge for overdue obligations to the Trust Fund that was concessional, it did so by redistributing the burden among only the very low-income countries, which were experiencing the worst economic and financial difficulties. Another option should be considered under which the formula for special charges would be based on Option A, but which preserved the concessional nature of Trust Fund resources. He suggested the adoption of a formula establishing special charges for Trust Fund repayments at about one half of the level proposed under Option A, perhaps about 3.5 percent.

On the operational procedures suggested in the staff report, he agreed that administrative costs of overdue obligations to the Fund should not be included in the rate of special charges, as it would be difficult to measure those costs accurately, Mr. Pérez commented. Countries with overdue obligations should have ten business days within which to become current before special charges were applied to those obligations. The system of special charges should be introduced eight weeks, rather than one month as the staff proposed, after Executive Board approval of the system. A review of the system would be appropriate given the uncertainties surrounding the effectiveness of special charges. He agreed with Mr. Polak that pyramiding of charges was not desirable. Finally, special charges should be applied to all overdue obligations outstanding on the date of the introduction of the system and to all overdue obligations arising after that date.

Mr. de Maulde observed that repayments of previous Trust Fund loans would be used, pending a forthcoming decision by the Board, to make further loans to the low-income countries. In the meantime, Trust Fund reflows would be invested and, in the future, money accruing from repurchases would also be invested pending redisbursement. If Trust Fund resources were treated separately from other Fund resources, the loss to the low-income countries arising from late repayment of Trust Fund obligations was the loss of income that would have accrued if those resources had been invested. If that were the case, the special charge applied to late repayment of Trust Fund resources should be based on that loss of income. Could the staff confirm his understanding of that point?

The Deputy Treasurer remarked that it was true that the investment income on the resources in the Special Disbursement Account (SDA) would accrue to that account and that it was likely that that increase would be available to finance further loans following the Executive Board's decision on the use of resources in that account. However, the funds in the account were not devoted in perpetuity to any particular use; the funds available under the SDA might, for example, eventually revert to the General Resources Account, and they should be considered as part of the Fund's overall resources.

Mr. de Groote stressed that it was the concessional nature of the resources rather than the difference between the different categories of resources that was important.

Mr. Foot indicated that his authorities favored the introduction of a system of special charges aimed at recovering the direct costs of overdue obligations, which had grown considerably in the recent past. Special charges should, at present, recover only the direct financial losses arising from overdue obligations, but associated administrative costs should be monitored and the possibility of their incorporation into the system considered at a later stage. It would be useful if the staff could indicate how practicable it would be to monitor those costs. The system of special charges was unlikely to reduce the arrears to the Fund substantially, but it would reduce the incentive for members to use the Fund as a source of cheap finance. It might therefore benefit modestly the Fund's financial position and protect the interests of those borrowers that remained current in their obligations. He was opposed to a system of penalty charges at present, although penal elements might need to be incorporated in the future. He favored a scheme that could be introduced rapidly, was simple to understand and administer, and could be applied uniformly to all members. Furthermore, the system should be one that could be relatively easily changed if necessary.

He supported the operational features of the system as outlined on pages 5-8 of the staff report, Mr. Foot stated. However, neither of the options presented by the staff for the calculation of special charges was perfect. Option A achieved a uniform effective overall rate of charge but did not include a special charge for borrowed resources and included

a high rate of special charge for Trust Fund resources. In contrast, Option B had advantages in terms of its uniformity and simplicity. Furthermore, it retained a degree of concessionality in the rate of charge applied to overdue payments to the Trust Fund. However, that option had an arbitrary element as it was based on an estimate of the financial costs of arrears to the Fund at a particular point in the year. Moreover, it imposed only a modest overall effective rate on the late payment of charges.

He was prepared to go along with either option, although he had a marginal preference for Option B as it was easier to understand and apply, Mr. Foot commented. A detailed review of the system of special charges should be held in about 18 months, as it would be difficult to determine the success of the scheme in terms of its impact on the various categories of arrears in a shorter period. However, the Executive Board would have an opportunity to discuss the scheme at the time of its consideration of the six-monthly report on overdue obligations.

Mr. Massé recalled that at the Executive Board discussion on the Fund's income position (EBM/85/89 and EBM/85/90, 6/5/85), his chair had not been convinced that the system of special charges was warranted but had indicated its willingness to reassess the issue in light of developments in the coming months. Unfortunately, the total amount and length of overdue obligations to the Fund had increased considerably since then. In addition, a growing number of countries had become overdue in their obligations to the Fund, even if only for a short period. Those serious developments had convinced him that the introduction of special charges would be useful to encourage members to meet their obligations to the Fund in a timely manner.

Special charges would not solve the problem of arrears, Mr. Massé agreed. For some members, the repurchase obligations were so large and their balance of payments problems so acute that special charges would simply create an added burden, making the need for donor assistance all the more pressing, particularly in those cases where external factors had been the primary cause of late repayments. For that reason, he would have favored, in principle, a provision for exemption in any system of special charges. However, in practice, it would be difficult to establish grounds on which exceptions might be made. If suitable modalities could be found for such a provision, the matter would merit further consideration.

Of the 117 countries making payments to the Fund in 1985, 25 had been overdue by 10 working days or more in making their payments, Mr. Massé noted. Special charges might encourage the majority of those countries to meet their obligations on time. At present, it was logical for a country facing a short term liquidity squeeze to pay commercial creditors, which demanded interest on payments past due, rather than the Fund, which levied no charge. The introduction of a system of special charges would end that discrimination against the Fund.

The system of special charges should recover the direct operational costs of arrears as its overall purpose was to encourage timely repayment, Mr. Massé remarked. He supported an integrated system that would cover all obligations to the Fund. It was very important that resources such as the Trust Fund be promptly repaid so that Trust Fund reflows could be recycled to those in need of concessional assistance. He would be willing to consider the separate treatment of Trust Fund resources from the viewpoint of special charges, as proposed by a previous speaker, if the modalities could be worked out and if there were no negative consequences for the Fund.

He agreed with the staff proposal that a delay of ten business days before imposing charges on overdue obligations was warranted to allow time for the staff to consult with the authorities and to clear any technical difficulties that might have led to the emergence of arrears, Mr. Massé indicated. However, it would be inappropriate to impose special charges retroactively to overdue obligations that had accumulated under a different set of financial rules. All overdue obligations outstanding at the time of the introduction of a system of special charges should be subject to special charges. There should be delays of about one month before the system was introduced once the Executive Board had decided on the need for such a scheme so that all members could be notified of the change. No special rule was needed to guide the order in which obligations were repaid. There should be no pyramiding of charges, and special charges should be treated in the same manner as other charges in the Fund's income statement. The system of special charges should be reviewed to determine the success of the procedure at the time of the Executive Board's review of the Fund's income position. However, a short paper on special charges could be considered between those two reviews at the time of Board consideration of the six-monthly report on overdue obligations.

Mr. Ismael observed that the issue of special charges to deal with the problem of overdue obligations had been the focus of many Board discussions since the beginning of 1985. In spite of divergent views on the effect of special charges, the Executive Board had decided to consider some of the technical aspects of a system of special charges.

The staff had presented alternative options for the structure of special charges, Mr. Ismael noted. Option A rested on the principle that different rates of special charge should be applied to different types of obligations according to the costs of those obligations to the Fund. Option B was more simple in that it applied a uniform rate of special charge to all categories of obligations, while still recovering the costs to the Fund of overdue obligations. He recognized the staff's concern about simplifying the administrative procedures of such a system, but noted that under Option B the rate of special charge (Table 2, column 2) was uniform, while in Option A, the effective rate of charge was uniform, with the exception of the rate of charge on the repurchase of borrowed resources. If the cost of overdue obligations were the same for all categories of resources, a member would be indifferent in its choice of discharging such obligations. If the determining factor in repaying

overdue obligations was based on the effective rate of charge, a member would, under Option B, settle its obligations in the following order: borrowed resources, ordinary resources, net SDR charges, and so on. Under Option A, a member was likely to settle overdue repurchases of borrowed resources first, with no preference for repaying the other categories of overdue obligations, which had the same effective rate of charge. The three most important categories of outstanding obligations were ordinary resources, charges, and borrowed resources. As Option B placed the least weight on overdue obligations on charges, Option A seemed to be most appropriate, unless, of course, as he believed, the system of charges did not serve as an effective incentive for payment.

He agreed with all but three of the operational features of the system of special charges proposed by the staff, Mr. Ismael remarked. However he was concerned about the statement that "the existence of a generally applicable system of special charges would not preclude a decision by the Executive Board to apply further charges to overdue repurchases on an ad hoc basis, outside and in addition to the general system of special charges, in particular circumstances," (page 5, EBS/85/242). He could support the system of special charges only if it was based on the principle of cost recovery and was applied uniformly to all members. He would appreciate some clarification of the operational implications of the staff's statement. Was it advocating a case-by-case approach within the principle of uniform treatment? The Executive Board should prevent the introduction of any element of arbitrariness. He had no difficulty allowing a short delay of ten days before a member became liable for special charges. However, that guideline should be applied flexibly to take into account extraordinary circumstances beyond the control of the authorities that might lead to obligations that were overdue by more than the ten-day grace period. The staff advocated treating special charges in the same way as other charges for the purpose of accounting for the Fund's income. The merit of the proposal lay in the uniform application of the accounting principle. However, to the extent that the special charges were not paid--in other words, they were overdue--the amount to be regarded as deferred income would also increase by the amount of the overdue special charges. The current income of the Fund would thereby be reduced relative to the income target, and the rate of charge would have to be increased, putting an extra burden on other members. In order to avoid such difficulties, special charges should be treated as an off-book item in the Fund's statement.

A 70 percent majority was required to adopt a system of special charges that covered the various categories of obligations with the exception of charges, as indicated in Article V, Section 8(d), Mr. Ismael pointed out. He was concerned about the relevance of Article XII, Section 2(g) to the imposition of special charges on overdue charges and about the staff's statement on page 4 of the staff report regarding the Fund's implied powers. It was unclear whether Article XII, Section 2(g),

had been intended to cover financial matters. Therefore, the decision on the imposition of special charges on overdue charges should be covered by Article V, Section 8.

He was largely in agreement with Mr. Polak that overdue Trust Fund reflows and interest should be isolated from other Fund resources under the system of special charges, Mr. Ismael indicated. Finally, he was in favor of Option A but was opposed to the imposition of special charges on overdue payments to the Trust Fund.

The Deputy Treasurer, responding to a question from Mr. Nimatallah, stated that he understood Mr. Ismael's concern to be that because uncollected special charges would be placed in deferred income, the Fund's income target would not be met and, consequently, there would have to be an increase in the rate of charge. However, the staff had not proposed including any projections of special charges in the estimates of the Fund's income. Therefore, although special charges that remained unpaid would be placed to deferred income, nonpayment of those charges would have no impact on income in relation to the income target and therefore no effect on the rate of charge. Nevertheless, if the special charges were paid, there would be a beneficial impact on the Fund's income. The staff had tried to formulate the proposal in a way that would avoid the problem about which Mr. Ismael had expressed concern.

Mr. Nimatallah inquired whether, if a member managed to formulate an adjustment program and if a friendly creditor country agreed to repay the member's arrears to the Fund, special charges would also have to be repaid before the Fund could support the adjustment program?

The Deputy Treasurer remarked that the special charge would be an obligation to the Fund that would have to be settled before a member could use Fund resources.

The Director of the Legal Department, responding to a further question by Mr. Nimatallah, commented that penalty charges, if imposed at a future date, would also be treated in the same way as special charges. In other words, a member would have to become current in all its obligations, including the penalty charges, in order to have access to the Fund's resources. However, the Executive Board could take a decision specifying that the member could have access to the Fund's resources before clearing any particular obligation, such as penalty charges.

Mr. Massé indicated that his authorities had been aware of the problem raised by Mr. Nimatallah and it was for that reason that they favored provision for an exemption in any system of special charges in certain circumstances.

Mr. Polak stated that as special charges would amount to only a small proportion of total overdue obligations, he was certain that a country that was willing to help a member become current to the Fund would be

willing to cover the costs of special charges. However, it would be inappropriate to include a provision in the system of special charges to waive those charges.

Mr. Foot indicated his agreement with Mr. Polak.

Mr. Nimatallah stated that he was concerned more about the possibility of waiving penalty charges, should they be introduced at a later stage.

Mr. de Groote commented that he agreed with Mr. Ismael that the different effective rates of charge gave debtor members an incentive to give higher priority to repaying some categories of obligations than others. Under both Option A and Option B, the highest effective rate of charge was appropriately on borrowed resources, which represented the greatest burden to the Fund. The effective rates of charge for all other types of obligations under Option A were the same. Under Option B, a member with overdue obligations was encouraged, based on the effective rate of charge, to give priority to repayment of borrowed resources, followed by ordinary resources, net SDR charges, Trust Fund repayments and, finally, charges and Trust Fund interest. Such a ranking of priorities was logical as it encouraged the debtor member to discharge its obligations in an order that was most beneficial to the Fund.

Mr. Polak stressed that the purpose of introducing special charges was to cover the financial costs incurred by the Fund as a result of overdue obligations. Those financial costs arose largely from nonpayment of charges. Therefore, the effective rate of charge should provide an incentive for repayment of charges. On that basis, Option A was more appropriate.

The Deputy Treasurer stated that the staff, in designing the two options for the structure of special charges, had not done so with the objective of establishing differential incentives for payment of different types of obligations. Option A applied special charges to each overdue obligation based on the cost associated with that specific obligation. Option B applied a more uniform special charge to overdue obligations. Different effective rates of charge in Option B derived from the original rates of charge that applied to each type of obligation plus the addition of a flat rate of special charge.

Responding to a question from Mr. de Groote, the Deputy Treasurer recalled that at EBM/85/90 (6/5/85) Executive Directors had broadly endorsed the staff suggestion that the SDR rate of interest would constitute a reasonable and appropriate basis for the determination of special charges on overdue obligations in the General Department under a system intended to recover operational costs to the Fund. Therefore, costs would be recovered in respect of overdue charges at the SDR rate of interest, representing the income loss to the Fund. The special charge on overdue repurchases of ordinary resources would be determined by

deducting the rate of charge that continued to accrue on those overdue repurchases from the SDR rate of interest. Under Option A, the rates of special charge applied to different types of obligations might be different, although the effective rate of charge--the special charge plus the rate of charge--would be the same for all obligations except for overdue repurchases of borrowed resources. Under Option B, the effective rate of charge represented the normal rate of charge for each type of obligation plus a flat rate of special charge of 2.83 percent.

Mr. Zecchini observed that the purpose of the proposed system of special charges was to recover the costs arising from overdue obligations which had been rising rapidly. Their actual and potential negative effects on the Fund's income and liquidity position had increased, affecting the revolving nature of the Fund's resources and undermining the cooperative nature of the institution. Furthermore, as pointed out by the staff in a previous discussion, most countries in arrears to the Fund did not give the highest priority to repaying their obligations to the Fund. Therefore, those countries should not be treated leniently. He supported the goal of recovering the costs to the Fund arising from arrears, as the burden of such costs should not be borne by the membership as a whole, particularly, by those countries that honored their financial obligations to the Fund.

The staff paper did not deal with the possibility of imposing special charges that would increase over time and would, therefore, encourage countries to repay their obligations promptly, Mr. Zecchini noted. He recognized that in most cases such charges could worsen the problem of overdue obligations as they would add to the financial burden of countries already experiencing difficulties. For that reason, they should not be applied in normal circumstances. However, the possibility of imposing such charges could play a useful role in some cases, and that option should be left open for consideration on a case-by-case basis. If such an approach was supported by Executive Directors, the summing up could be drafted to indicate clearly to members that the Executive Board could consider imposing penalty charges that increased over time.

He supported the staff proposals regarding the operations of the system of special charges presented, Mr. Zecchini indicated. The staff should not, at present, try to calculate the administrative costs to the Fund of overdue obligations. Periodic review of special charges could be associated with the six-monthly reports on overdue obligations.

While neither of the two options presented by the staff were optimal from the viewpoint of calculating the opportunity cost, Option B had several advantages, Mr. Zecchini considered. Under that option, special charges could be applied to repurchases from borrowed and nonborrowed resources. Furthermore, that option would not increase the charges on Trust Fund loans excessively. It was easily understood and simple to administer, and it appropriately differentiated between the effective rates of charge for different types of obligation. In that respect, he supported the view expressed by Mr. de Groote. Those advantages more

than offset a possible shortcoming of that option arising from the discrepancy between the method of imputing costs to the various accounts and the system of allocating the proceeds of the charges to the same accounts. For example, the staff in its paper identifies the costs associated with the General Resources Account and the Special Disbursement Account as equal to SDR 8.9 million and SDR 2.6 million, respectively, while the amounts allocated to those accounts would be SDR 10.5 million and SDR 1 million, respectively.

The system of special charges should be applied flexibly, Mr. Zecchini commented. In particular circumstances, when a country with arrears to the Fund could prove that it attached the highest priority to the repayment of the Fund and had actively cooperated with the Fund in taking appropriate measures to become current, the Fund could remit part of the special charges that had already been levied.

Mr. Nimatallah remarked that the proposals in the staff paper on a system of special charges to recover the direct operational costs associated with overdue obligations represented a small step in the right direction toward encouraging members to settle their financial obligations to the Fund on time and recovering some of the costs that were currently borne by other members without overdue obligations. He supported the system of special charges to recover direct operational costs but urged the Executive Board to take a step further and adopt a system of penalty charges in the near future. Penalty charges should be applied in stages. An initial charge should be levied immediately when a country fell into arrears, with an increase in the rate of charge at the time of Executive Board consideration of the case. Such a system of penalty charges would represent another procedure to apply before declaring a member ineligible, would give members in arrears greater incentive to settle Fund obligations first, and would increase the Fund's income and thereby reduce the burden of higher charges on other members. Special penalty charges should be applied uniformly before a declaration of ineligibility, but should not be applied uniformly after declarations of ineligibility. He agreed with a suggestion put forward by the staff on a previous occasion that an ad hoc special charge could be imposed on countries that showed no sign of cooperating with the Fund on settling its arrears.

He had an open mind regarding the two options presented for the structure of special charges, Mr. Nimatallah stated. He agreed with most of the staff's proposals regarding the operations of the system. However, special charges should perhaps be paid monthly rather than quarterly, as circumstances could change rapidly. In addition, the system should be reviewed annually from the outset to avoid attaching particular significance to the proposed review on April 30, 1986. The interim reports on the system of special charges should be combined with the three-monthly, rather than the six-monthly, reports on overdue financial obligations to the Fund.

Mr. Sengupta commented that although there was logic in the principle of special charges for the reasons presented by Mr. Polak, his authorities had doubts about the effectiveness of such a system as a means of encouraging members facing balance of payments difficulties and large overdue obligations to become current to the Fund. Any system of special charges would be unacceptable. He concurred with the view expressed by the G-24 on the subject in its report on the international monetary system. The problem of overdue obligations should be resolved through new mechanisms and productive approaches. Any imposition of special charges would add to the payments burden of countries in arrears, which already faced serious structural problems and were subject to exogenous shocks.

Mr. de Groote stated that his view of the system of special charges for overdue obligations had not changed since the previous Board discussion on the issue. He favored a system of special charges that aimed at recovering the direct costs to the Fund of overdue obligations. The system should be applied uniformly to all members as soon as obligations became overdue. It should be free of technical and administrative complications and should not include any penalty elements.

Option B best reflected the intentions of the Executive Board and met most closely the technical and administrative requirements of such a system, Mr. de Groote considered. He therefore favored Option B, in part as it allowed for much lower rates of special charges to be applied to overdue obligations to the Trust Fund than Option A and provided an incentive for the settlement of overdue obligations.

It would be useful if the staff, in a future report on the subject, presented the amount and nature of the administrative costs incurred by the Fund in connection with overdue obligations, Mr. de Groote stated. However, administrative costs should not be covered by special charges. It would be ironic and even cruel to force member countries in difficult straits to bear the costs of Fund missions, the purpose of which was to help those countries through their difficulties. Would the effects of Option A and Option B be identical if a larger number of countries fell into arrears? Option B had a wider coverage than Option A as it applied special charges not only to overdue charges but also, indirectly, to overdue repurchases. Would all losses to the Fund be recovered if the special charges were levied only on those categories of arrears that entailed a cost?

Mr. Dallara indicated that he supported a system of special charges designed to recover the costs to the Fund arising from overdue obligations. While the effects of such a system were uncertain, the imposition of special charges could serve in some cases as a useful incentive for timely payment and would help to alleviate the burden of overdue obligations on members that remained current to the Fund. However, the imposition of a system of special charges would increase the external financial obligations of countries experiencing serious and protracted payments problems.

Special charges should be set at a level that would recover the operational costs to the Fund of overdue obligations, Mr. Dallara remarked. It would perhaps be inappropriate to recover the administrative costs which, in any event, were difficult to calculate. The system of special charges should be applied uniformly to all members. Special charges should apply to late payments if they were not settled within ten business days after the due date.

He agreed with the staff that special charges should apply both to overdue obligations outstanding at the date of the introduction of the system and to new overdue obligations, Mr. Dallara said. In view of the rapid change in the arrears situation, Mr. Nimatallah's suggestion that special charges should be payable monthly, rather than quarterly, seemed appropriate. However, he would be interested in hearing the staff's view on that matter. Periodic reviews of the system's special charges were called for, although a review in Spring 1986 might be too soon to be useful.

As to the structure of special charges, he was willing to support either of the two options, although he had a slight preference for Option B, Mr. Dallara indicated. He was unconvinced that penalty charges would be effective, although they did merit further consideration. Penalty charges should perhaps be applied if a member indicated to the Fund that it did not intend to meet its financial obligations to the Fund in a timely manner.

Mr. de Maulde observed that the purpose of the proposed system of special charges was to recover the financial costs arising from arrears to the Fund, which represented a burden to all members. The staff proposal was moderate, as it did not take into account any nonfinancial costs, including the administrative costs, of overdue obligations. Furthermore, it did not include a penalty charge contrary to the practice of other lenders, private or public, in the case of payment delays. He therefore supported the staff proposal.

Of the two options presented by the staff, he preferred Option A for a variety of reasons, Mr. de Maulde indicated. It was simple, resulting in a uniform effective rate of charge for each category of overdue obligation. Furthermore, it did not depend on an estimate of the annual financial costs associated with overdue obligations: it ensured that the Fund recovered the costs exactly, without the possibility of any overcollecting or undercollecting in the event of a sharp increase or decrease in the volume of arrears. In addition, Option A was more in line with the principle of equal treatment of members. Option A demonstrated clearly the cost to the international community of the nonpayment of the more concessional resources. Overdue obligations to the Trust Fund resulted in a loss of income that prejudiced those members that remained current to the Fund and that were eligible for Trust Fund resources. Those losses should clearly be compensated by the delinquent party.

He would have no problem if some Directors wanted to implement a system of special charges for a trial period, which would be followed by a review, providing the Executive Board with an opportunity to adapt and improve the system, Mr. de Maulde commented. Special charges should apply to late payments from the day they became overdue if settlement was not made within one week to ten days after the due date. There should be no provisions for special exemptions, given the aim to recover costs and the relatively moderate amounts involved.

Mr. Sugita remarked that it was disturbing and regrettable that the cost of overdue obligations was borne by those members that remained current to the Fund. A system of special charges that was designed to recover the costs to the Fund arising from delays in payments was appropriate and could serve as an important policy instrument by providing financial incentive for prompt repayment. With regard to the structure of special charges, while Option A was more logical than Option B, he preferred Option B because of its simplicity and because special charges applied to overdue obligations to the Trust Fund were not unduly high. However, he could go along with Option A if the majority of Directors supported that option. He generally supported the operational procedures outlined by the staff. Any modification that might be necessary could be determined at the first review of the system, perhaps as early as April 1986.

Mr. Romuáldez observed that there were two basic arguments in favor of a system of special charges: it would help to offset the financial losses incurred by the Fund as a result of overdue obligations, and it would remove the burden arising from overdue obligations from those members that managed to meet their obligations on time, often at considerable costs. Directors who were opposed to a system of special charges pointed out that such a system would not encourage members to discharge their obligations and might make their situation even more difficult. Furthermore, they considered that special charges were not in line with the cooperative nature of the Fund.

He favored the introduction of a system of special charges, which should be designed to recover only the direct operational costs to the Fund arising from arrears, Mr. Romuáldez remarked. Option A appeared to be more in line with the principle of equal treatment of members. In particular, the rates of special charge under that option would reflect the financial advantage arising from the different categories of overdue payments. For example, those members using Fund credit in the form of overdue charges would lose the advantage they had over other members that remained current to the Fund. The advantages of Option B over Option A--simplicity, greater stability in the rate of special charge, some incentive for members to repay first their overdue obligations to the Fund's borrowed resources, and a concessional rate of special charge on arrears to the Trust Fund--were insufficient to outweigh the advantage of Option A in terms of equity considerations. In fact, a concessional rate of charge for overdue Trust Fund obligations was perhaps a negative feature of Option B. Why should members that had not met their Trust Fund obligations

benefit more than those that had remained current and those that had access only to the Fund's more expensive resources? It seemed unfair that members with overdue Trust Fund obligations should benefit at the expense of members that would be eligible for access to Trust Fund reflows. As to simplicity, an effective rate of charge on overdue obligations that was equivalent to the SDR rate of interest was not too difficult to understand. He therefore favored Option A, unless the administrative complications of that option were inordinate.

He agreed with the operations of the system outlined by the staff, Mr. Romuáldez stated. However, it should be emphasized to members that although a member would be allowed a short delay of ten business days after a repurchase became overdue before becoming liable for special charges, special charges would be imposed from the day the obligation became overdue.

Mr. Mawakani considered that the issue before the Executive Board was whether a member's overdue obligations stemmed more from considerations relating to reserve management by the authorities or from difficult payments problems. The answer to that question would determine whether special charges would be an effective means of encouraging members to settle their overdue obligations and become current with the Fund. It was evident from data on the overdue obligations and foreign exchange reserves of six members--Guyana, Liberia, Sudan, Zambia, Kampuchea, and Vietnam--whose overdue obligations accounted for about 85 percent of total overdue obligations, that a special charge was likely to exacerbate the already weak financial situation of those countries rather than provide incentives for prompt repayment. Consequently, he was opposed to any system of special charges.

Mr. Nimatallah explained that those Directors in favor of a system of special charges recognized that most members with overdue obligations could not repay the Fund immediately. The system was intended to encourage countries to adopt adjustment programs that would improve their economic situation and improve their access to resources.

Mr. Mtei remarked that if Directors recognized that members with overdue obligations could not repay the Fund, it was illogical to introduce a system of special charges that would increase the burden on those countries. The Fund should help those countries to design a program that would help them overcome the problems they faced.

The Chairman pointed out that the countries Mr. Mawakani had mentioned could not become current with the Fund because they had let their economic situation deteriorate. A number of other countries that had experienced similar economic and financial situations had not become overdue in their obligations to the Fund as they had pursued more appropriate economic policies. Even though some countries had overdue obligations that were larger than their level of reserves, those countries could still take action that would improve their economic position.

The Fund was working with the authorities in a number of countries with overdue obligations to formulate adjustment programs and identify sources of financing.

Mr. Fugmann remarked that his authorities were concerned that the introduction of a system of special charges for overdue obligations might be seen as legitimizing the existence of arrears to the Fund. The Fund's priority must be to reduce overdue obligations rather than to reduce their negative effects. With that reservation, they were prepared to consider the introduction of a system of special charges. Arrears to the Fund had grown sharply and their effect on the Fund's income position had become noticeable. The amounts overdue for longer periods had also continued to increase, and there were no discernible signs of a substantial improvement in the situation. The costs and losses arising from members' overdue obligations, which were currently being borne by the membership at large, should, in the future, be borne by those members that had incurred the overdue obligations.

Both Option A and Option B were designed to recover the operational costs to the Fund arising from overdue obligations, Mr. Fugmann observed. However, it was doubtful whether either option would provide the desired incentive for discharging overdue obligations. In addition to recovering costs, the system should provide incentives for repaying some categories of obligations before others. Option A did not appropriately differentiate between the incentives for settling different categories of obligations, for example, between repurchases and charges, and between ordinary and borrowed resources and Trust Fund resources. In that respect, Option B was preferable, if not ideal. It had the additional advantage of being easy to understand. However, the difficulty in estimating the costs and losses arising from overdue obligations under Option B was a disadvantage because of the various uncertainties that entered the calculations. That difficulty could be overcome by reducing the emphasis on precise calculations of the special charge and introducing a reasonable "reference rate," which could be reviewed periodically.

Thus, on balance, he favored Option B, although he did not have strong feelings on the matter, Mr. Fugmann indicated. He was particularly sensitive to the argument of equity. He supported the operational features of the system outlined by the staff. Frequent reviews of the scheme was called for, as the situation regarding overdue obligations, which could change quickly, was important to the overall functioning of the Fund. Moreover, the various effects of the system would be difficult to predict. Finally, the introduction of a system of special charges did not preclude a decision by the Executive Board to apply additional charges on an ad hoc basis in particular circumstances.

Mr. Nebbia recalled that each time the system of special charges to recover costs arising from members' overdue obligations to the Fund had been considered by the Executive Board, the Board had decided to consider the issue further as part of the Fund's policy for dealing with the problem of overdue obligations. Most of the countries in arrears to the Fund

had experienced an extremely severe deterioration in their external positions and, consequently, in their ability to become current with the Fund without imposing even greater hardship on the economy and the society. Almost 85 percent of the total amount of arrears to the Fund was accounted for by a small number of members whose economic imbalances had been extremely serious even before they had become users of Fund resources. The imposition of special charges would only add an additional burden to their already precarious external condition. Furthermore, it might convey a wrong signal to the financial community and would not solve those countries' problems or encourage them to become current with the Fund.

It could be argued that special charges could help to contain the problem of overdue obligations as members would not wish to incur the extra costs involved in late repayment, Mr. Nebbia noted. That argument underscored the need for remedial action to deal with overdue obligations and the need to safeguard the Fund's financial position from any deliberate postponement of repayments by a member, in which case, special charges would represent a well deserved penalty. However, that argument failed to recognize that members with overdue obligations were not unwilling to become current to the Fund and that the period between consideration of a formal complaint and a subsequent declaration of ineligibility had been shortened, thereby limiting the grace period which could enable members to become current to the Fund before a formal complaint was issued.

Although he recognized the merits of a system of special charges in terms of recovering the costs and losses arising from members' overdue obligations to the Fund and in terms of limiting late repurchases, such a scheme was not an effective part of the Fund's strategy to deal with the problem of overdue payments.

Mr. Kafka stated that he was doubtful whether the introduction of a system of special charges would help to solve the problem of overdue obligations. The Fund's policy with respect to overdue obligations had so far been unsuccessful, and he urged the Executive Board to review that policy as a matter of priority. In the present circumstances, he could not support the imposition of special charges.

Mr. Jiang remarked that the overdue financial obligations to the Fund, amounting to SDR 0.4 billion at end-August 1985, had been a cause for concern, particularly as the costs involved, while still small, were rising rapidly. However, he had serious reservations about the effectiveness of a system of special charges as a way to provide an incentive for member countries to become current with the Fund. Most, if not all, members with overdue obligations were facing acute balance of payments difficulties. In most cases, member countries wanted to respect their obligations to the Fund but simply could not. The imposition of special charges would only aggravate their difficult situation.

Although there was a need to recover the financial costs to the Fund arising from overdue obligations, the Executive Board should bear in mind that the Fund was a cooperative international financial institution that should continue to play a central role in alleviating the debt burden of the developing countries, Mr. Jiang commented. The introduction of a system of special charges could be seen as a movement away from that central role toward the role of a commercial bank. He urged the staff to examine alternative ways of recovering the costs to the Fund without imposing a system of special charges and to make a case-by-case study of those member countries with overdue obligations to determine the extent to which arrears were attributable to external factors and to determine whether a growth-oriented adjustment program could be implemented. If, after all other options had been explored, there was no alternative but to adopt a system of special charges, he would reluctantly go along with the majority view. In that event, special charges should be applied on an ad hoc, case-by-case basis as had been suggested by Mr. Zecchini.

On the options for calculation of special charges, Mr. Jiang went on, a special charge of 6.85 percent on Trust Fund arrears under Option A was too high given the concessional nature of those resources. The uniform rates of special charge under Option B led to effective rates of charge on repurchases that were well above the SDR interest rate and even above the market interest rate.

Mr. Salehkhoul considered that the problem of overdue obligations could hardly be attributed to members' reluctance to repay the Fund. Overdue obligations were more a reflection of members' payments difficulties in an unfavorable international environment. The punitive element and the implied incentives in a system of special charges overlooked the primary cause of overdue obligations--the virtual depletion of a member's international reserves. As the proposed system would only worsen the difficulties of a member with overdue obligations, he was opposed to the introduction of any such system.

Mr. Alhaimus remarked that he had approached the question of special charges with an open mind, not only because he believed that the Fund should utilize all possible means to control the problem of overdue obligations, but also because it would be useful, in some cases where administrative or technical problems were encountered, to give additional financial incentives to members to avoid payment delays. Nevertheless, in most cases, members with overdue obligations had experienced genuine difficulties in generating sufficient foreign exchange resources to repay the Fund. He was reluctant to increase the burden of those members, making it even more difficult for them to settle their obligations fully. The question whether to introduce a system of special charges should be reassessed at a future date once the effect of other procedures agreed upon by the Board at the previous six-monthly review of overdue obligations became clear.

The Deputy Treasurer, responding to a variety of questions from Directors, remarked that the statement on page 5 of the staff paper that a "system of special charges would not preclude a decision by the Executive Board to apply further charges to overdue repurchases on an ad hoc basis" was meant to indicate that a decision to establish a system of special charges would not limit the Executive Board's ability to apply penalty charges if it so wished. With respect to the possibility of monthly payments, it would be an additional administrative burden if special charges were to be payable each month rather than each financial quarter. Accruing monthly payments might also be seen as giving priority to payment of special charges over repayment of the overdue obligations. Both Option A and Option B could be easily administered if the amounts of overdue obligations increased considerably.

If the Executive Board wished to introduce a system of special charges, the staff would need to prepare a formal decision for the Board's approval, the Deputy Treasurer said. As Directors seemed to agree that members should be given one month's notice of the new procedures following Executive Board approval, it was unlikely that the system could be implemented before February 1986. In that event, it would seem too early to hold a review to evaluate the operation of the system in late Spring at the time of the review of the Fund's income position.

The staff had been aware that the ten-day delay following the due date of an obligation might be seen by members as a kind of grace period, the Deputy Treasurer remarked. That was clearly not the intent. However, the staff had seen the need to consult with members before charges on overdue repurchases were imposed and to take account of a possibility that delays in payment could be due to problems that were entirely beyond the authorities' control. He agreed that care should be taken to ensure that members did not see that ten-day delay as a grace period.

The Director of the Legal Department commented that the legal basis for the application of special charges to overdue repurchase obligations was provided in Article V, Section 8(c). Under that provision, the Fund could apply charges on a uniform or an ad hoc basis in the light of a member's situation. Article XII, Section 2(g) provided the legal basis for the Fund to recover the operational costs and losses associated with unpaid charges.

Responding to a question from Mr. Polak, the Director of the Legal Department stated that under Option B there would be no transfer of resources from the General Department to the Trust Fund. Based on the structure of special charges proposed in Option B, the resources recovered in the form of special charges applied to repurchases would go to the General Department and the special charges applied to overdue Trust Fund obligations would go to the Trust Fund.

The Chairman noted that 8 Directors, representing some 22 percent of the voting power, did not favor the introduction of a system of special charges. However, 14 Directors, representing some 76 percent of the

voting power, favored the establishment of such a system to recover the direct operational costs arising from overdue obligations. The qualified majority of 70 percent of the voting power needed for the introduction of the scheme had therefore been reached. The operational procedures outlined by the staff were generally acceptable to Directors.

The Secretary commented that Directors were divided in their views on the structure of special charges. Seven Directors, representing about 48 percent of the voting power, favored Option B. Five Directors, representing about 20 percent of the voting power, supported Option A. However, most Directors who preferred Option B said that they were flexible and could go along with Option A, while those in favor of Option A were not prepared to go along with Option B.

Mr. Nimatallah inquired whether the staff could prepare a paper in the next few days containing a third option that represented a compromise between Option A and Option B.

Mr. de Maulde suggested that as the system would be reviewed soon after its introduction, the Executive Board should adopt one of the options with the understanding that it would be reviewed in a few months on the basis of experience.

Mr. Pérez reiterated that he was opposed to Option B, and could go along with Option A only if the rate of special charge applied to overdue Trust Fund obligations was concessional, about 3.5 percent.

Mr. Polak inquired whether Directors might be in favor of Option A if no special charge were applied to overdue Trust Fund obligations.

Mr. Zecchini wondered how the average rate of special charge would be affected if no special charge were applied to overdue Trust Fund obligations.

The Chairman observed that if no special charge were applied to overdue Trust Fund obligations, that would assume that there was no operational cost arising from overdue obligations to the Trust Fund. However, nonpayment of Trust Fund resources had a cost in terms of the loss of income deriving from short-term investment of those resources pending their redisbursement.

Mr. Grosche observed that there was a difference between actual costs and opportunity costs and for that reason he was moving in favor of Option A.

Mr. Zecchini stated that the reasons for not imposing a rate of special charge on overdue Trust Fund obligations should be outlined. He saw no reason for attaching a lower opportunity cost and, therefore, a lower rate of special charge for overdue obligations to the Trust Fund. On the contrary, there was a strong argument in favor of applying the

entire opportunity cost to Trust Fund resources in order to increase the benefits for members that were entitled to use Trust Fund resources and that remained current in their obligations.

Mr. Dallara and Mr. Nebbia indicated their agreement with Mr. Zecchini.

The Deputy Treasurer commented that income was forgone on the funds that would have been invested if members had not delayed repayment. That income would have accrued to the Special Disbursement Account, in the General Department.

Responding to a question from Mr. Zecchini, the Deputy Treasurer stated that if the overdue obligations to the Trust Fund were not included under Option B, the uniform rate of special charge applied to overdue obligations in the General Department would be 2.4 percent, rather than the 2.8 percent in Table B of the staff report.

The Director of the Legal Department reconfirmed that the Special Disbursement Account was a separate account and there was no mix of resources between that account and the General Resources Account.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/174 (12/4/85) and EBM/85/175 (12/6/85).

2. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/85/293 (12/3/85) is approved.

APPROVED: July 14, 1986

LEO VAN HOUTVEN
Secretary