EBD/85/228

August 30, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: Report of the Deputies of the Group of Twenty-Four on the Functioning and Improvement of the International Monetary System - Transmittal to the Interim Committee

Attached for the information of Executive Directors is a Report by the Deputies of the Group of Twenty-Four on "The Functioning and Improvement of the International Monetary System," together with a letter from the Chairman of the Group of Twenty-Four transmitting the Report to the Chairman of the Interim Committee with the request that it be made available to Interim Committee members.

In accordance with the direction of the Chairman of the Interim Committee, the letter and the Report are being circulated to members of the Interim Committee.

Att: (2)

Other Distribution:
Department Heads

INTERGOVERNMENTAL GROUP OF TWENTY-FOUR
ON INTERNATIONAL MONETARY AFFAIRS

August 22, 1985

Dear Mr. Chairman:

On behalf of the Intergovernmental Group of Twenty-Four on International Monetary Affairs, I am pleased to transmit a report entitled "The Functioning and Improvement of the International Monetary System", approved by the Group at a meeting of the Deputies on August 19 - 21, 1985. It would be appreciated if you could make the report available to the members of the Interim Committee for preliminary consideration by the Committee at its meeting in Seoul, on October 6, 1985.

Sincerely yours,

Juan V. Sourrouille
Chairman, Intergovernmental
Group of Twenty-Four

The Honorable
H. O. Ruding
Chairman, Interim Committee of the
Board of Governors on the
International Monetary System
Casuariestraat 32
The Hague
The Netherlands

INTERGOVERNMENTAL GROUP OF TWENTY-FOUR ON

INTERNATIONAL MONETARY AFFAIRS

THE FUNCTIONING AND IMPROVEMENT OF THE INTERNATIONAL MONETARY SYSTEM

Report of the Deputies of the Group of 24

WASHINGTON, D.C.

AUGUST 21, 1985

INTERGOVERNMENTAL GROUP OF TWENTY-FOUR
ON INTERNATIONAL MONETARY AFFAIRS

August 23, 1985

To the Ministers of the Group of Twenty-Four:

At a meeting on August 19-21, 1985, the Deputies of the Intergovernmental Group of Twenty-Four on International Monetary Affairs, acting in accordance with previously agreed procedures, approved, on behalf of Ministers, a Report on "The Functioning and Improvement of the International Monetary System," based on the August 1 report of the Working Group established in May 1985 to study this matter.

I take pleasure in circulating to you the final Report, which has also been sent to the Chairman of the Interim Committee, with a request that the Report be given consideration by that Committee in Seoul on October 6, 1985.

With my best regards,

/s/ Juan V. Sourrouille
Juan V. Sourrouille
Chairman of the Ministers,
Group of Twenty-Four
and
Minister of Economy of Argentina

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Chapter I

Summary of Recommendations

1. This Report has made a number of recommendations in the major areas of concern for the international monetary system which are summarized in paragraphs below.

The Functioning of the Present Exchange Rate System

2. The experience with the present exchange rate system has not been satisfactory. Exchange rates of major currencies were characterized by a high degree of short-term volatility as well as persistent misalignment which brought about uncertainty regarding future exchange rates, discouraged investment and trade, and resulted in misallocation of resources.

3. Volatility and misalignment of exchange rates have especially hurt the developing countries. They severely affected trade and raised reserve needs of these countries.

4. Exchange rate stability should be an important objective of policy, instead of being a residual of other policy actions of individual countries, as is the case at present. It is necessary to devise an exchange rate system to overcome the recognized rigidities of the par value system and the destabilizing uncertainties of floating rates.

5. The principle behind the concept of 'target zones' for exchange rates of major industrial countries, commitment to which would promote greater international policy consistency, is in line with the approach of the 1984 G-24 Revised Program. Adoption of target zones for the exchange rates of major currencies could help achieve the objective of exchange rate stability and sustainable levels of payments balances. The proposal needs to be further studied and pursued in order to gain general acceptance. In the meantime, a mechanism has to be devised to enforce policy coordination among the major industrial countries.

6. Policy coordination among major industrial countries would imply complementary use of monetary, fiscal and other policy instruments consistent with exchange rate stability and growth without inflation. Intervention may have to be used as a supplementary device for stabilizing exchange rates.

7. A framework for policy coordination already exists under the IMF Articles. In addition to that, a mechanism to trigger consultations among the concerned countries and the Fund is necessary whenever the indicators available suggest excessive short-term movements or misalignments of major currencies. In determining misalignment, the focal point of concern should not be just the attainment of balance in international payments but achieving the objectives of expansion and balanced growth of international trade with high levels of employment and real income and a durable payments equilibrium. The Fund should concentrate more than in the past on issues of a systemic character, and all coordination of policies should take account of the needs of developing countries.

8. Exchange rates of individual developing countries do not have any systemic impact on international alignment of exchange rates. Assessment of the appropriateness of a developing country's exchange rate is not comparable with considerations that are applicable to the exchange rate of a major industrial country.

Surveillance

9. The surveillance function of the IMF is crucial for an orderly international monetary and financial system. It has so far been largely ineffective on major industrial countries, resulting in asymmetry in the international adjustment process, the burden of which has fallen disproportionately on developing countries. The main objectives of Fund surveillance should be to bring about symmetric international adjustment and facilitate expansion and balanced growth of international trade, high economic growth and orderly financial conditions. To achieve these objectives, Fund surveillance should effectively influence the policies of industrial countries in a manner that would be supportive of growth, particularly of developing countries.

10. Multilateral surveillance and bilateral (Article IV) consultations should form two separate stages of the surveillance process. The first stage would involve multilateral negotiations about a mutually consistent set of objectives and policies among the major industrial countries. These multilateral negotiations should be conducted on a regular basis within the framework of the IMF. The World Economic Outlook exercise should provide the background for multilateral consultations, spelling out the international repercussions of national policies of major industrial countries. The second stage would involve a comparison between the actual outcomes and the targets of policy, setting off discussions of appropriate measures when the two deviate. The Fund should follow up with reports on recommended policies and performance indicators and deviations from them. These reports should be discussed by the Fund Board.

11. For improving effectiveness of surveillance over industrial countries, it is necessary to continuously monitor key developments pertaining to these countries and exercise pressure on them during both multilateral surveillance and Article IV consultations.

12. Bilateral consultations with major industrial countries should evaluate their policies against this multilateral framework of international adjustment. If the Board is not convinced of a country's explanations for the deviations from the recommended policies, it could request the Managing Director of the Fund to discuss the matter further with the country concerned and to report back to the Board the outcome of these discussions for appropriate action.

13. For major industrial countries, Article IV Consultations should concentrate on a thorough assessment of their national policies and their international impact. For developing countries, recommendations of policies should be made with a view to promoting adjustment consistent with economic development, bringing out the underlying needs of finance and the part that exogenous factors play on the adjustment efforts of these countries.

14. In prescribing exchange rate policies for developing countries, it is essential to consider that changes in resource allocations are time-consuming and would need adequate financing. In

many developing countries, controls to limit capital outflows may become necessary for the stability of exchange and interest rates. Flexibility in regard to use of multiple currency practices is also necessary in certain cases.

15. In view of the underlying confidentiality of the exchange of information and discussion between the members and the Fund, no publicity should be given to the conclusions of the consultations in any form.

16. The Fund should continue to play its role in easing the debt burden of developing countries through arrangements for use of Fund resources and also in a catalytic manner for facilitating the flow of resources from banks and other creditors. Deputies expressed concern over the implications of IMF involvement in "enhanced surveillance." It is viewed by the Deputies as yet another evidence of creditor unwillingness to restore normal access to external financing despite significant adjustment efforts. The catalytic role of the IMF should, in principle, be exercised without "enhanced surveillance." However, in cases where it proves necessary "enhanced surveillance" should be considered exceptional and undertaken only at the request of a member country. It is justified only if it secures financing from non-Fund sources in the context of a multi-year debt rescheduling. It is important that in "enhanced surveillance," priority is given to policies aimed at promoting self-sustained growth. However, the Fund's continued analysis and policy advice under "enhanced surveillance" arrangements should be clearly differentiated from the programs under Fund arrangements. The main objective of "enhanced surveillance" should be the early normalization of market relations between the member country and the international financial system. To this end, the period under which the country is under "enhanced surveillance" should be limited to the debt consolidation period or the grace period.

Management of International Liquidity and the SDR

17. The record of creation and management of international liquidity in the past decade has been unsatisfactory. During this period the supply of international liquidity was uneven and grossly inadequate, especially for developing countries. The recent contraction

in commercial bank lending shows its unreliability as a source of liquidity.

18. Even if certain improvements in the functioning of capital markets such as deregulation are brought about, they may not result in increased availability of credit to developing countries. The recent improvement in the balance of payments of many of these countries has not reversed the decline in commercial lending to them, despite strenuous adjustment efforts.

19. If reserves are to be built to acquire "creditworthiness", many developing countries will be required to generate current account surpluses for the next several years, at a time when many of them are facing a severe problem of reverse flows of real resources. For low-income countries, the official assistance fell in real terms in recent years, and they face a severe shortage of liquidity. As a result, many of these countries have accumulated payment arrears. They have to approach the Fund for support but often have to face reduced access limits and tightened conditionality without the provision of adequate liquidity.

20. The conditions of supply of international liquidity and its distribution are more important than the world aggregate reserve holdings. The scope for international liquidity policy is now limited by the willingness of major countries to consider the international impact of their policies. In addition to surveillance over exchange rate and other macroeconomic policies of major industrial countries, the Fund should be enabled to influence the liquidity of the world economy through adequate SDR creation and its more efficient distribution.

21. There is at present a long-term global need for a substantial allocation of SDRs in relation to expected growth of world trade, financial transactions and output. An allocation at this time would relieve the stringency in the reserve position of a large number of developing countries; promote economic recovery and would not be inflationary; improve balance between conditional and unconditional liquidity; reduce dependence on costly borrowed resources and help orderly adjustment. For this purpose, an annual allocation of no less than SDR 15 billion as recommended by the 1984 G-24 Revised Program is warranted.

22. To make the SDR the principal reserve asset, as required under the Articles, SDRs should be issued on a regular annual basis with a view to ensuring that their proportion in reserves rises progressively.

23. Since the unsatisfied liquidity needs of developing countries are more than those of industrial countries, distribution of supply of liquidity in favor of developing countries would benefit all countries without creating any additional inflationary pressures. It will be desirable to link the allocation of SDRs to the development needs of developing countries.

Role of the Fund

24. The purposes of the International Monetary Fund were set out in Article I of the Articles of Agreement. During the past forty years, the Fund has certainly played an important role, but it was not very successful in fulfilling the aspirations of a large number of developing countries which form a substantial part of the Fund membership.

25. The Fund has a role to play both in financing transitory payments problems and in financing and promoting adjustment of persistent imbalances.

26. Transitory payments problems are met by international reserves, borrowing from capital markets or drawing on Fund resources. The Compensatory Financing Facility (CFF) was created to provide low conditionality finance to meet transitory payments deficits produced by events outside the control of the borrowing country. The effectiveness of this facility has been in the recent past very much diluted. The tighter conditionality attached to the CFF and the reduction of access limits are retrograde steps and should be reversed immediately. The CFF should be extended to cover not only export shortfalls but also deterioration in terms of trade that is quantifiable. CFF drawings should be related to calculated shortfalls rather than to quotas, and should be provided automatically. The repayment period of the CFF should be extended as recessions have tended to become deeper and the cycles longer in the recent past, giving rise to prolonged stress on the balance of payments of most developing countries.

27. In view of the large variability in interest rates, a new facility to provide financing for interest rate increases needs to be introduced. This facility could also be a part of a facility which may cover defict resulting from any exogenous factor that is reversible.

28. In contrast to transitory imbalances, persistent payment deficits require both large-scale finance and adjustment. The Fund is enjoined to promote adjustment with due regard to the requirements of growth and prosperity. Therefore, adjustment measures should not lead to contraction in activities and reduction of growth and development in the deficit countries.

29. Policies to correct persistent imbalances should be devised according to the nature of the underlying disequilibrium. Persistent disequilibria in developing countries are often structural in nature requiring measures to raise the economy's productive capacity and expand the supply of goods and services.

30. Reorientation of conditionality criteria from demand deflation to growth-oriented structural adjustment requires lengthened program periods and increased levels of financing. Instead of underplaying the EFF as in the past two years, it should be used extensively.

31. It is recognized that the balance of payments problems of most low-income countries are structural in nature, caused mainly by persistent deterioration in their terms of trade, disproportionately large debt service burden, decline in the flow of ODA, and very limited capability to attract external resources from non-official sources. These problems have been seriously compounded by devastating droughts of unprecedented proportions that have hit many African countries. Of late, many low-income countries have experienced net outflows of resources, including to the multilateral financial institutions. In view of the particularly difficult structural problems of these countries, it is essential that the Fund provide substantially larger and longer-term financing in support of their structural adjustment programs than has been done so far.

32. Some Fund programs have broken down in recent years because of excessively rigid performance criteria, which were not

revised in the light of unforeseen developments beyond the control of the borrowing country. There is a need for greater flexibility in the application of such criteria. It is necessary that repayment obligations to the Fund are settled on time. However, where the balance of payments situation, made adverse by exogenous factors, makes it practically impossible for a country to repay according to a fixed schedule, mechanical application of sanctions would not be appropriate. To help such countries become current in their obligations to the Fund, new mechanisms should be evolved, in collaboration with the World Bank and regional development institutions to provide longer-term assistance for orderly adjustment of these countries.

33. In recent years, the burden of increase in costs of Fund activities has fallen disproportionately on developing countries. Increasing rates of charge and the declining grant element impaired the process of adjustment, especially in low-income countries. To alleviate this, facilities and mechanisms should be established in the Fund such as an Interest Subsidy Account on a stable basis. The Trust Fund should be revived to make concessional loans to eligible countries.

34. Quotas must remain the primary source of finance for the Fund. The Eighth Review of Quotas has fallen far short of the current requirements, which underlines the need to advance the Ninth Review. It would be desirable to relate quotas to a measure of the size of the world economy. In the absence of such a link, the interval of quota reviews should be reduced to three years. Until the size of quotas is increased adequately the option of borrowing by the Fund from any other official source should be kept open.

35. Enlarged Access Policy should be continued until the size of quotas bears an appropriate relationship to the size of the world economy. The present limits of access are too meager and should be enhanced to be useful for orderly adjustment in developing countries.

36. Any coordination between the Fund and the World Bank should not lead to cross conditionality, but should help further their mutual objective of providing resources to developing countries. While closer contacts between the Management and staff of both institutions and sharing of relevant information could be useful, steps to seek

uniformity of advice should not become a means of exerting a concerted pressure on the borrowing countries.

37. The role of developing countries in the decision-making process in the international financial institutions needs to be substantially increased. The system of weighted voting has led to a situation where, after the Eight Quota Review, developing countries as a group have no more than 38 percent of total votes. While the principle of weighted voting may be unavoidable in financial institutions, a better balance in the voting pattern is needed for a more equitable and effective functioning of these institutions. The share of developing countries in the total votes in the multilateral financial institutions should be increased to 50 percent. For this purpose, consideration might be given to, inter alia, an increase in basic votes. The present geographical representation of developing country regions in the Boards of the Bank and the Fund should be preserved.

The Debt Problem and Transfer of Resources

38. The debtor countries have been undertaking strenuous adjustment efforts in response to the external environment and the consequential adjustment process is having serious social and political consequences. The debt crisis is a result of excessive lending by commercial banks, abrupt policy changes, and, in some cases, an unbalanced policy mix by industrial countries and other factors leading to historically high interest rates, excessive borrowing with inadequate policies by many debtor countries, and the failure of Fund programs in the case of many low-income countries. Thus, finding realistic formulae and viable mechanisms for the solution of the crisis would require cooperative actions of debtor and creditor countries, commercial banks and multilateral financial institutions. It is important to reiterate the view of the G-24 Ministers, as expressed in their April 1985 communique: "Also required is a co-responsibility of debtors and creditors, symmetry of adjustment and cooperative efforts aimed at a durable solution to the debt problem in a global framework."

39. The debt situation requires imaginative solutions involving debt restructuring and relief in order to bring the debt

burden within the effective ability of the debtor countries to pay. There is an urgent need to move towards a "positive" type of adjustment, consistent with sustained growth of output in the medium and the long run. To support the efforts by developing countries to prevent the capital flight from the debtor countries, developed countries should, through their regulatory agencies, discourage capital outflows from those developing countries which are facing acute capital flight problems. Multi-year restructuring of debts has prevented the bunching of maturities in the near future and has been a helpful development. Co-responsibility of debtors and creditors also requires that interest rates should more closely reflect the real cost of funds for the creditors.

40. The lesson learnt from the recent experience with the debt crisis is that heavy reliance on medium- and short-term borrowing for development financing is bound to give rise to liquidity problems even if such financing were to be directed to sound and viable projects. Therefore, there is an imperative need to expand sufficiently the resource base of international institutions.

41. In recognition of the interdependence of money, finance and trade in the global economy, it is important to emphasize the close relationship between an expanding world trade and the solution of balance of payments problems including the indebtedness of developing countries. Developed countries should therefore roll back protectionist measures, refrain from introducing new restrictions, and improve access for exports of developing countries to their markets.

42. Adequate flows of long-term resources are of paramount importance to the orderly and speedy adjustment of developing countries. The official flows in recent years have not even made up for the losses incurred by the developing countries on account of adverse movements of terms of trade and high interest rates. The quality and composition of aid also deteriorated.

43. IDA has played an important role in promoting development and increasing productivity, thus helping to raise the standard of living and to alleviate poverty in the low-income countries. There has been a steep decline in IDA resources in the Seventh Replenishment, and

additional commitments are necessary. During the mid-term review to be conducted shortly by the IDA, additional resources should be made available to restore the IDA VII Replenishment to US$12 billion. It is essential that funding for IDA VIII should be substantially larger than that for IDA VI, and efforts should be made to restore the historical rates of growth in IDA. The Special Assistance Facility established for Sub-Saharan Africa is inadequate and it will be necessary to substantially increase the level and quality of funding in this respect. Developed countries should redouble their efforts to reach the internationally agreed target of 0.7 percent of GNP as Official Development Assistance as quickly as possible and at any rate not later than the end of this decade. Each developed country should make binding commitments for annual growth rate of assistance. In respect of low-income countries, the Resolution of the Trade and Development Board 165 (S-IX) should be implemented expeditiously and fully.

44. The role of the World Bank should continue to be one of commitment to development, growth and poverty alleviation. The recent reduction in the lending program of the IBRD is regrettable and it is essential to adopt lending policies to enable it to provide effective support. It is also necessary to increase the General Capital of the World Bank urgently to resume significant increases in flows to developing countries. In this context it is disturbing to note that there is a possibility of negative net transfers from the World Bank and this should be reversed effectively. Bank's lending policies including those of structural adjustment should conform to the national policy requirements of the borrowing countries. There should not be undue emphasis on so-called policy-based lending or on linking the quantum of Bank assistance to increasing conditionality.

Follow-up Action

45. The recommendations of the Deputies of the G-24 embodied in this Report, together with those of the G-10, should receive consideration by the Interim Committee in October 1985. But, as the assessment of the situation in the world economy by developing countries differs from that by industrial countries, with different policy implications, a suitable institutional mechanism should be evolved for

an in-depth and joint examination of the two Reports. A representative committee of Ministers from developing and industrial countries, which could perhaps take the form of a joint subcommittee of both the Interim and Development Committees, should be formed for this purpose. It should conduct its business on the basis of consensus.

Chapter II

Introduction

46. The Ministers of the G-24 adopted, in September 1984, the Revised Program of Action Towards Reform of the International Monetary and Financial System (hereafter referred to as 1984 G-24 Revised Program), which examined the various shortcomings of the international monetary and financial system and made several recommendations to improve its functioning.

47. The continued malfunctioning of the international monetary and financial system has also led to repeated calls from the non-aligned countries, the Group of 77, and several important industrial countries for the examination, in a broad-based international forum, of the defects of the existing system. They underlined the need for action for improvement and reform of the system.

48. The Interim Committee, at its meeting on April 17-19, 1985, noted that improvements of the international monetary system were currently under study and agreed to review this matter at its next meeting in Seoul. The Ministers representing the Group of Ten have recently forwarded a Report of their Deputies on the Functioning of the International Monetary System for the consideration of the Interim Committee. That Report covers mainly four areas, namely, the exchange rate system, surveillance, international liquidity and the role of the Fund.

49. In May 1985, the Chairman of the G-24 appointed a Working Group to examine these and some other related issues in the light of recent developments. The report of the Working Group was examined by the Deputies of the G-24 and it forms the basis of this Report.

50. The Deputies wish to emphasize that the 1984 G-24 Revised Program, annexed hereto, sets out the basic position of the Group on various issues of the international monetary and financial system. This Report is essentially an elaboration of the Revised Program on the areas covered in the G-10 Report and also the problems of debt and transfer of

resources, as no meaningful improvement of the international monetary system is possible without their solution.

51. The recommendations of the Deputies of the G-24 embodied in this Report, together with those of the G-10, should receive consideration by the Interim Committee in October 1985. But, as the assessment of the situation in the world economy by developing countries differs from that by industrial countries, with different policy implications, a suitable institutional mechanism should be evolved for an in-depth and joint examination of the two Reports. A representative committee of Ministers from developing and industrial countries, which could perhaps take the form of a joint subcommittee of both the Interim and Development Committees, should be formed for this purpose. It should conduct its business on the basis of consensus.

52. The G-24 Deputies considered that an effective reform of the international monetary and financial system requires a convening of an international conference. The joint examination of the recommendations of these Reports by the proposed representative committee of Ministers will be an effective step in preparing for such a conference.

Chapter III

An Overview of the International Economic Situation

53. The low growth rates and severe recessionary conditions in the international economy that prevailed in the early 1980s continue to have debilitating effects on many developing countries. The recovery in industrial countries, which showed its first signs in 1983 and peaked in 1984, has been fragile, partial and unbalanced. Unemployment has remained high. And there has been intensification of current account imbalances of a number of industrial countries. Disparities in their fiscal stance, too, have continued. There has also been a deceleration in the growth of trade in recent months. In 1985 so far, the rate of expansion in these countries has slowed down considerably and the growth rate in the current year will perhaps be one-half of the 4.9 percent rate recorded in 1984. The medium-term scenarios until the end of the decade, as set out in the World Economic Outlook for 1985, envisage that the average rate of growth in industrial countries will be slightly over 3 percent.

54. Per capita real incomes of many developing countries continue to be lower than in the 1970s. Most of them have large current account deficits, and large debts to be serviced. Their capacity to repay by generating export surpluses is limited not only by their own low growth performance but also by declines in the terms of trade, an increase in protectionism and the low growth in industrial countries. Prices of oil, primary commodities and manufactures of developing countries have either declined or been falling. The index for non-oil commodity prices in June 1985 is about 30 percent below the 1980 average and is lower than the bottom level recorded in 1982. High real interest rates have increased the debt service burden further. Interest rates ruled high during a good part of the 1980s. There has, however, been a welcome decline in interest rates in recent months, but with the spreads for 'country risks' and with falling export prices, the real interest rate payable on bank loans by debtor countries would be unsustainable in

the long run as it may exceed the likely rate of growth in real income and real value of exports.

55. Official assistance and Fund financial support have both declined. Commercial bank lending to developing countries has been virtually withdrawn since the middle of 1982. The value of 'spontaneous' syndicated credits raised by developing countries at US$10.9 billion in 1984 was lower than $14.2 billion in 1983. In the first five months of 1985, no more than $2.9 billion was raised, indicating a continuation of the downward trend.

56. The net effect of these developments is that there has been a substantial outflow of resources from many developing economies. If this situation continues, the stability of the international financial system would be seriously impaired, unless the international community takes immediate steps to correct it in a manner that promotes adjustment and growth in developing countries. In the case of low-income countries, viability in external account and future development could be brought about only by substantial concessional financing.

57. Correction of the present malady requires a concerted action on the part of the policy makers in the industrial countries and in the major international institutions. The functioning of the exchange rate system should be improved to reflect fundamental underlying economic conditions. To ensure consistent policies among industrial countries aimed at sustained growth and financial and exchange rate stability, Fund surveillance of major industrial countries should be strengthened. The IMF should promote an international monetary system in which payments adjustment fosters international prosperity. Adjustment by strong demand management policies has in the past led to contractionary situations in many developing countries. Further adjustment of this kind in the present circumstances would sap their growth potential, reduce their imports and ultimately bring about a fall in the volume of trade. Adjustment without large-scale financing would not, in the current circumstances, lead to correction of persistent payments imbalances. And inadequate financing with high conditionality would correct neither transitory nor persistent payments imbalances.

58. Developing countries suffer from a shortage of resources for productive investment activities. They have large reserve requirements. Their liquidity needs will have to be met by substantial SDR allocations, which will promote trade expansion without endangering price stability. Their development programs will have to be supported by large international financing. Even their balance of payments adjustment programs should be supported with substantial medium-term financing by the international institutions. But, in order to enable countries to approach these institutions, conditionality in lending should be modified by bringing forward development as a major objective. In turn, to enable these international institutions to play their part, their resources should be strengthened by increasing their quotas/general capital, and access of borrowers to these resources should be enhanced. Absence of adequate financing, in fact, could take the world economy back to the recessionary conditions.

Chapter IV

The Functioning of the Present Exchange Rate System

59. Floating exchange rates were adopted by major industrial countries in the early Seventies as the par value system established at Bretton Woods could not cope with the stresses generated by divergent national macroeconomic policies in an environment of increasing capital mobility. It had been anticipated at that time that market forces, aided by stabilizing capital flows, would keep exchange rates close to the levels required to achieve current account equilibrium and free other macroeconomic instruments to deal with domestic economic priorities. It was also hoped that floating exchange rates would assist the adjustment process and growth of world trade and output.

The Experience with Floating Rates

60. The experience with floating exchange rates has not been up to the original expectations. Both in terms of short-term volatility and long-term misalignment, exchange rate variability has increased since the abandonment of the Bretton Woods system. The increase in volatility, referring to short-term fluctuations, since the adoption of floating rates is well documented. Exchange rate volatility has not declined as markets became used to dealing with the flexible exchange rate system, as was anticipated when floating was first adopted.

61. Wide fluctuations in exchange rates have tended to bring about greater uncertainty about future exchange rates. Evidence from forward markets indicates that most exchange rate fluctuations are unanticipated. Volatility has contributed to expansion of financial transactions and greater capital movements not directly related to trade flows. It has discouraged investment and trade by adding to financial risks for investors and traders.

62. Misalignment, referring to a persistent deviation of the exchange rate from the equilibrium level, has been severe and, according to some studies, it has also become larger in the recent period than under the Bretton Woods system. Much of the medium-term movement in real exchange rates in recent years reflects not the changing pattern of

competitiveness but rather the result of differences in fiscal and monetary policies, in which industrial countries have chosen macroeconomic policies independently, without serious consideration of their impact on the world economy. Misalignment inevitably produces either idle resources or wasteful shift of resources back and forth between tradables and non-tradables. It becomes a potent source of pressures for protectionism.

63. Exchange rate variability has, as the 1984 G-24 Revised Program had put it, "especially hurt the developing countries." Exporters and importers in these countries are exposed to high exchange risks in the absence of well-developed financial markets, especially forward cover arrangements. The destabilizing uncertainties of floating rates have increased the reserve and capital needs of developing countries from the levels which would otherwise exist.

64. The functioning of the present floating rate system has thus not been able to provide, as Article IV, Section 1 of the Articles of Agreement of the IMF, puts it, "a framework that facilitates the exchange of goods, services, and capital among countries," which sustains sound economic growth and helps develop orderly underlying conditions necessary for financial and economic stability.

Proposals for Improving Exchange Rate Stability

65. The 1984 G-24 Revised Program stated that an exchange rate system should be devised to overcome the recogized rigidities of a par value system and the destabilizing uncertainties of floating rates. Besides, the improved functioning of the exchange rate system requires the recognition by major countries that both the floating rate and the fixed rate systems need rules of the game relating to domestic macroeconomic policies. The Revised Program categorically stated that "this implies greater effort on the part of the developed countries to achieve a substantial degree of discipline and coordination in the conduct of their national policies." Exchange rate stability should be an important objective of policy instead of being a residual of other policy actions of individual countries, as is the case at present.

66. The principle behind the concept of 'target zones' for exchange rates of major countries, commitment to which would promote greater international policy consistency, is in line with the approach of the 1984 G-24 Revised Program. Adoption of target zones for the exchange rates of major currencies could help achieve the objective of exchange rate stability and a sustainable pattern of payments balances. The proposal needs to be further studied and pursued to gain general acceptance. In the meantime, a mechanism has to be devised to enforce policy coordination among the developed, especially the key currency, countries. Although the role of the developing countries in influencing such an exchange rate system is necessarily limited--and therefore the related mechanism of coordination and surveillance will be essentially concerned with the developed countries--it is important, as the 1984 G-24 Revised Program states, "that this coordination should take account of the needs of developing countries."

67. Policy coordination in this context implies that monetary policy for exchange rate stability should complement the use of fiscal policy to counter inflationary and deflationary pressures as well as the use of other policy instruments. Intervention, for instance, could be used on a meaningful scale, without confining it to 'leaning against the wind,' towards the end of exchange rate stability, as a complementary measure to other policies, and sometimes in coordination with other countries.

68. A framework for such a policy coordination already exists under Article IV of the IMF, according to which "each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates" (Section 1) and "the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies" (Section 3(b)). Over and above the regular multilateral consultations, a mechanism or procedure that would trigger consultations among the concerned countries and between them and the Fund is necessary whenever the indicators available suggest that excessive short-term movements of one or more major currencies are taking place, or that any major

currency is already, or is in the process of, becoming seriously misaligned.

69. Since the concept of misalignment is central in this process of surveillance, it should be clearly spelt out in operational terms. Although the term misalignment was not used in 1970, the IMF's report on the "Role of Exchange Rates in the Adjustment of International Payments" of that year provided an authoritative definition of the concept of fundamental disequilibrium, which was the Bretton Woods term for the same thing:

> "A basic feature of the concept of fundamental disequilibrum is that although its ultimate focus is on the balance of payments it is related to a general condition of the member's economy and does not require that an imbalance must have developed in the balance of payments. This, in turn, reflects the underlying philosophy of the Bretton Woods system that while attainment of balance in international payments must be a focal point of concern for the international financial community, it is not to be regarded as an objective in isolation from other objectives of the international monetary system. These objectives include the expansion and balanced growth of international trade on the basis of a liberal and nondiscriminatory regime of trade and payments, to contribute to the promotion of high levels of employment and real income and to the development of the productive resources of all the Fund's members as primary objectives of economic policy. In this conception, attainment of payments balance through the use of measures destructive of national or international prosperity would clearly not comprise a durable payments equilibrium."

70. The alignment or misalignment of an exchange rate thus has to be judged in the light of a country's overall economic performance and its impact on the international economy and not merely its balance of payments performance. For example, in many developing countries with relatively undiversified economies, protection of infant industries, judiciously applied, may be an indispensable element in the process of diversification and development, as recognized by GATT. On the other hand, for countries with diversified economies and relatively high mobility of factors of production, substantial or increasing restrictions on trade could well be a major symptom of exchange rate misalignment.

71. Exchange rates of developing countries are not of any great significance in relation to the international alignments of exchange rates, and assessment of the appropriateness of a developing country's exchange rate does not generally involve systemic considerations comparable to those applicable to the exchange rate of a major industrial country.

Chapter V

Surveillance

72. In their 1984 Revised Program, the G-24 Ministers had noted that in view of "the high degree of interdependence of the world economy, the success of economic policy followed by one country often depends on actions by others." It is equally true that cooperative macroeconomic policy formulation on the part of the major industrial countries can achieve a superior outcome, for each country, than would be achieved by each acting independently. In the recent past, their uncoordinated attempts to disinflate led to an excessive emphasis being given to monetary restriction relative to other instruments. The result was a halting process of recovery with high real interest rates and low commodity prices having particularly adverse effects on the developing countries.

73. The IMF has a key role in the conduct of international surveillance. However, Fund surveillance has to date been largely ineffective over the major industrial countries whose actions have substantial spillover effects on the world economy. These countries have been able to pursue domestic policies without taking into account their impact on the international economy. In some cases, the subordination of international responsibilities to domestic priorities has been quite explicit, and notwithstanding the urgings of the Fund, the mix of monetary and fiscal policies remains inappropriate.

74. On the other hand, the influence of the Fund has been effectively felt by the users of its resources, mostly developing countries. Even if a formal distinction is made between Article IV consultations and adjustment programs associated with the use of Fund resources, the effect of Fund surveillance on inducing policy changes is much larger on developing countries than on major industrial countries, which have adequate access to external financing and do not require an IMF supported adjustment program.

75. As a result of this basic asymmetry in the Fund's surveillance function, the international adjustment process has been seriously biased. The deficit developing countries have been faced with harsher adjustment, and the world economy with a lower level of activity, than would otherwise be necessary. Any program for strengthening international surveillance has to reduce this asymmetry and devise methods for coordination of policies of major industrial countries for promoting world economic activity and trade expansion in a manner supportive of growth in developing countries.

The Objectives of Surveillance

76. The objectives of surveillance of the Fund to date are limited to surveillance over members' exchange rate policies. Article IV, Section 3 and Executive Board Decision (No. 5392-77/63 of April 29, 1977) spell out that the Fund shall exercise firm surveillance over the exchange rate policies of members, and that a member shall avoid manipulating exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members, that it should intervene in the exchange market if necessary to counter disorderly conditions characterized by disruptive short-term movements in the exchange rates, and that it should take into account in its intervention policies the interests of other members.

77. Surveillance, to be effective, should be explicitly recognized as surveillance of the international adjustment process. "The adjustment process," stated the 1984 G-24 Revised Program, "must be adapted to the present global economic environment and the need for promoting development." The design of such international adjustment process, based on coordinated national economic policies, must aim at sustained growth of output, employment and trade of all countries and ensure adequate real resource transfers to developing countries. This follows from the primary purpose of the International Monetary Fund as enshrined in Article I(ii): "To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy."

The Analytical Basis of Surveillance

78. The process of surveillance for international adjustment should focus on international policy interactions and economic linkages among the major industrial countries which are mainly responsible for the course of the world economy. Multilateral surveillance and bilateral (Article IV) consultations should form two stages of the surveillance process, rather than two parallel operations. The first stage would involve multilateral discussions and negotiations to be conducted on a regular basis within the framework of the IMF about a mutually consistent set of objectives, and a set of policies to collectively achieve these objectives. The aim might be to search for a set of outcomes or "objective indicators" or "targets," that appear to be sustainable in the medium term and desirable to all parties. This should be quite feasible when the multilateral surveillance exercise is limited to a few major industrial countries, such as the key currency countries. The second stage would involve a comparison between the actual outcomes and the recommended targets or indicators, and a discussion of what measures would be appropriate when the two deviate. This stage might most efficiently be conducted on a bilateral basis as part of Article IV consultations.

79. The form in which multilateral surveillance has so far been conducted is through annual World Economic Outlook (WEO) type of exercises. Such exercises could serve a useful purpose if they provide a background for multilateral consultations about the mutually consistent set of objectives and policies as mentioned above. The WEO should clearly spell out the international repercussions and interactions of national policies of the major industrial countries and contain fairly specific proposals of policies for these countries. These analyses should be considered by the Fund Board to recommend a set of policies and the likely outcomes or performance indicators. The Fund should prepare follow-up reports on the implementation of the recommended policies, deviations from them and the actual outcomes. These reports should be thoroughly discussed by the Fund Board.

Pressures to Make Surveillance Effective

80. It is generally accepted that while the Fund's leverage over developing economies has been very large, there is virtually no effective pressure on industrial countries to comply with the Fund's policy advice. For improving effectiveness in surveillance over industrial countries, it will be necessary for the Fund to continuously watch and monitor key economic developments pertaining to these countries and to devise procedures for exercising pressure both during multilateral surveillance and in Article IV consultations.

81. Bilateral consultations with the major industrial countries would have to focus on policy evaluation against this multilateral framework of international adjustment. Once an agreement is reached on the policy changes, deviations in implementing the suggested policy changes should give rise to information notices. The country concerned could raise the matter in the Fund's Executive Board for a full discussion as to how and why the suggested policies could not be put into effect.

82. If the Board is not convinced of the country's explanations, it could request the Managing Director of the Fund to discuss the matter with the country concerned and report back to the Board the outcome of the discussions for further appropriate action.

83. The suggested framework for multilateral surveillance of major industrial countries, and taking it up in detail during the bilateral Article IV consultations, would go a long way toward correcting the current asymmetry in the exercise of the Fund's surveillance function.

84. In this context, it is useful and in fact necessary to distinguish the content of Article IV consultations that the Fund should conduct with major industrial countries from the one that should be had with developing countries. In the case of major industrial countries, the consultations should concentrate on a thorough assessment of their national economic policies, including the exchange rate policies, their domestic and international impact and also their effect on the adjustment efforts of other countries of the world. The consultations should continue to give, as at present, details of current account

developments. Emphasis should also be placed on the developments in the capital account in view of the large mobility of capital in recent years. They should also cover the restrictions placed on the international adjustment mechanism such as trade restrictions and other protectionist measures, market-distorting policies and structural rigidities.

85. The consultation reports of the major industrial countries may contain references to the policy recommendations made by the Fund during the previous consultation and the measures undertaken by the member since then in this regard. For effective surveillance, the Fund may be allowed to make greater use of the supplemental surveillance procedures whenever exchange rate developments or other key developments having an impact on other members or on the functioning of the international monetary system warrant. The procedures outlined in the Executive Board decision in 1979 in this regard could be of guidance in invoking supplemental consultations in between the Article IV consultations.

86. Recommendations of policies for developing country members should be made with a view to promoting adjustment as a part of economic development. The underlying needs of finance for such adjustment should be assessed and methods for providing such finance should be indicated. While making the policy suggestions, the part that exogenous factors play in the adjustment efforts of these countries and also the effects of the actions of other countries, in particular the major industrial countries, should be clearly brought out.

87. In prescribing exchange rate policies for developing countries, it is essential to consider that changes in resource allocation are time-consuming and would need adequate financing. Often changes in exchange rates of developing countries would have to be supported by complementary policies. While exchange rate devaluation may be useful for improving competitiveness and external viability in developing countries, it could also as the experience has shown, stimulate cost inflation, causing economic disruption and negating the intended effects of lowering export prices in terms of foreign currency. It is much less useful in countries that have to rely on

exports of traditional agricultural and mineral commodities; and simultaneous efforts by a number of countries to undercut the export prices of competitors have often resulted in losses for all. In many developing countries, controls to limit capital outflows may become necessary for the stability of exchange and interest rates. Flexibility in regard to use of multiple currency practices is also necessary in certain cases.

88. The underlying confidentiality of the exchange of information and discussions between the members and the Fund should be preserved. As such, no publicity should be given to the conclusions of the consultations either through release of a statement or through release of reports.

Enhanced Surveillance

89. The Fund should continue to play its role in easing the debt burden of developing countries through arrangements for use of Fund resources and also in a catalytic manner for facilitating the flow of resources from banks and other creditors. Deputies expressed concern over the implications of IMF involvement in "enhanced surveillance." It is viewed by the Deputies as yet another evidence of creditor unwillingness to restore normal access to external financing despite significant adjustment efforts. The catalytic role of the IMF should, in principle, be exercised without "enhanced surveillance." However, in cases where it proves necessary "enhanced surveillance" should be considered exceptional and undertaken only at the request of a member country. It is justified only if it secures financing from non-Fund sources in the context of a multi-year debt rescheduling. It is important that in "enhanced surveillance", priority is given to policies aimed at promoting self-sustained growth. However, the Fund's continued analysis and policy advice under "enhanced surveillance" arrangements should be clearly differentiated from the programs under Fund arrangements. The main objective of "enhanced surveillance" should be the early normalization of market relations between the member country and the international financial system. To this end, the period under which the country is under "enhanced surveillance" should be limited to the debt consolidation period or the grace period.

Chapter VI

Management of International Liquidity and the SDR

Management of International Liquidity

90. The changeover to a flexible exchange rate system did not bring about any perceptible decline in the world demand for reserves. The reasons for this are well known. Countries, whether they floated or pegged their currencies, continued to need adequate reserves for intervention purposes. The experience with the floating exchange rate system has also not been satisfactory, especially due to large, and at times, violent swings; this, together with large payments disequilibria and high interest rates, contributed to countries' holding substantial reserves to protect themselves against uncertainties. In addition, larger reserves were needed especially by developing countries to insulate themselves against frequent exogenous 'shocks,' deterioration of terms of trade, protracted recession and increasing protectionism in industrial countries. Adequate reserves were also needed to prove "creditworthiness" and for access to international markets.

91. The supply of international liquidity was in recent years markedly influenced by credit made available by international commercial banks. For some developing countries, they provided a fairly substantial source of liquidity. But there were also a large number of developing countries which could not afford the high cost of commercial credit and which continued to rely on the supply of official finance, SDR allocations and conditional credit for financing their balance of payments needs.

92. Dependency on commercial banks as a source of liquidity brought with it substantial debt-service requirements often too large in relation to receipts from trade. Floating interest rates, together with their volatility in the last four years, increased the variability of interest payments. Bunching of maturities also made it difficult to refinance their debt. And borrowed reserves were in fact withdrawn when they were most needed. Since mid-1982, bank lending sharply declined.

93. Developing countries are now facing a severe shortage of external real resources. A number of countries had to run large trade surpluses to service their debt and to build up minimum reserves required for normal transaction and precautionary purposes. This situation has been exacerbated by the falling commodity prices which are at the lowest level since 1980. Oil prices as well as prices of certain manufactures exported by developing countries are also on the decline. Low-income countries which have only limited access to commercial borrowing are experiencing an equally severe liquidity problem. Official assistance to them fell in real terms in recent years. Many of these countries had accumulated arrears. They have to approach the Fund for support, but often have to face reduced access limits and tightened conditionality without the provision of adequate liquidity.

94. The conditions of supply of international reserve assets and the availability of liquidity relative to the needs, including the manner in which their supply is distributed among countries, are more important than the size of world aggregate reserve holdings. The present inadequacy as well as unevenness in international liquidity cannot be corrected or even controlled through market processes. It is often held that access to commercial credit would depend on "creditworthiness", which in turn is dependent upon adjustment. But despite vigorous adjustment policies pursued by developing countries leading to a sizable improvement in their current account position, "creditworthiness" was not restored; nor was there a reversal of the decline in bank lending. Reserves have to be built up first to earn "creditworthiness" and, for obtaining such a position, developing countries will have to either generate current account surpluses or depend upon other non-market sources.

95. Improvements in the operation of capital markets, whether through risk evaluation by banks or by increased deregulation, will not automatically improve the liquidity position of developing countries. In fact, the conditions that determine the availability of reserves through the capital markets are similar to the conditions that influence the performance of the borrowing countries, or their "creditworthiness". Improvement in reserves on which "creditworthiness"

hinges, would take place only when balance of payments position is strengthened. It is necessary to recognize that movements of exchange rates, inflation rates and growth of output and trade that affect the balance of payments of these countries are themselves subject to the influence of the domestic policies pursued by major industrial countries. These policies have not been internationally consistent and coordinated and have therefore not promoted international adjustment.

96. The scope for international liquidity policy is, therefore, limited by the willingness of major countries to consider the international impact of their policies and to respond to the urgings made in the representative international fora. The Fund is given the tasks of overseeing the international monetary system and ensuring that members collaborate with the Fund and with other members in pursuit of the objective of "better international surveillance of international liquidity" (Article VIII, Section 7). Therefore, in addition to stricter surveillance over exchange rate and other macroeconomic policies of the major industrial countries, the Fund should be enabled to influence the liquidity needs of the world economy through a more efficient SDR creation and distribution than it has so far been able to do.

The SDR

97. The Articles of Agreement of the Fund provides for creation of additional liquidity through the allocation of SDRs. The Second Amendment of the Articles of Agreement, which became effective as late as 1978, provides that the members of the Fund should collaborate with the objective of making the SDR "the principal reserve asset" in the international monetary system. The main purposes of the allocation of SDRs are: to meet the growing liquidity needs of the world, to make supply of international liquidity less dependent on the settlement of balances of a few countries, and to enable non-reserve countries to acquire reserves without having to generate balance of payments surpluses.

98. The SDR has not yet assumed a major role in the international system mainly because of its meager allocation. So far only SDR

21.4 billion have been allocated. This constitutes 5.3 percent of the total non-gold reserves. There have been sporadic allocations in two basic periods but since 1981, in spite of a substantial liquidity shortage, there has been none.

99. There is also the need to improve the quality of the SDR as a reserve asset and as an increasingly acceptable unit of account in private transactions. The evolution of a multi-currency reserve system has not reduced the need for an internationally controlled reserve asset such as the SDR. On the contrary, SDRs would provide stability to the international system more effectively than the multi-currency reserves by reducing the effects of volatility of exchange rates. By assuring adequate supplies, the SDR system would obviate the necessity of depending on one or two countries for supply of international liquidity. Besides, the SDR has an important role to play in a system where borrowed reserves are not available for most countries facing severe balance of payments adjustment.

100. The ratio of non-gold reserves to imports, which constitutes one of the important indicators for the measurement of demand for reserves, continues to be around 21 percent, much lower than the 28 percent in 1982 and 23 percent in 1978, when the previous allocation in the third basic period was agreed. The modest rise in the non-gold reserves, evidenced recently, was from an extremely low level of 1982, and it occurred basically on account of a substantial accrual of such reserves to a handful of countries; in the case of nearly 30 out of 64 non-oil developing countries for which data are available up to 1984, the level of non-gold reserves was lower than that at the end of 1979. Many of them had reductions in their reserves ranging between 50 and 90 percent. In addition, curtailment of access to financial markets has seriously affected the availability of borrowed resources to many countries. This has compelled developing countries to carry larger reserves. Even among those countries which had increased their reserves many had accomplished it not by large increases in export earnings, but by a substantial curtailment of imports. Currently, the ratio of non-gold reserves to aggregate trade imbalances is more or less at the same level as in 1980, which was the lowest since 1974. If total reserves

including gold valued at market prices are reckoned, their proportions to imports and aggregate trade imbalances would still show declines since 1979. Total reserves of all countries, had declined by about 19 percent over this period.

101. The recent World Economic Outlook exercise implied a continuing expansion of world trade in SDR terms throughout the remainder of the 1980s. Even if the non-gold reserve holdings were to rise to a level that establishes the average reserve ratio for the period 1973-83 (21.5 percent), they would have to grow at an annual rate of about 10 percent per annum till 1990 (or in six years), implying an increase of about SDR 300 billion. According to this calculation, the proposal contained in the 1984 G-24 Revised Program of an annual allocation of SDR 15 billion would be much lower than what is warranted by the long-term global need of liquidity.

102. One fear that has often been expressed is that SDR allocations would increase the stock of world reserves and fuel inflation. This fear, however, is not well founded. The supply of reserves is demand determined and the SDR is a substitute for other forms of reserves. The total reserve stocks do not rise in the long run as a result of additional allocations. The first round effect of an allocation may be increased spending by liquidity-constrained countries. But considering their magnitudes, it is far fetched to suppose that SDR allocations even on a scale sufficient to satisfy the reserve accumulation needs of developing countries would create excess demand and stimulate inflation in industrial countries. On the contrary, industrial countries should welcome a consequential increase in export demand from the developing countries, which would reduce the pressures created by their need to accommodate the improvement in the current account balance of the developing countries. The spill-over effects of an SDR allocation on industrial countries would thus be positive.

103. The objective of making the SDR the principal reserve asset in the international monetary system, as expressed in Article VIII, Section 7, has not been promoted. On the contrary, SDRs constitute a smaller proportion of total reserves now than they did in 1976.

Private use of the SDR too has languished. The motive for the original commitment to make the SDR the principal reserve asset was a desire to construct as symmetrical a system as possible, so as to avoid the tensions, instability and inequity of arrangements in which one or a few countries supply reserve currencies and all other countries have to earn or borrow their reserves. There is no good reason for abandoning this objective, especially when the multiple currency reserve system has contributed to serious volatility and misalignment of exchange rates of major currencies.

104. To make the SDR the principal reserve asset as required under the Articles, SDRs should be issued on a regular annual basis with a view to ensuring that their proportion in reserves rises progressively. Such allocations would permit pursuit of adjustment policies without too high and additional austerity in a number of developing countries and help stimulate demand for exports of developed countries.

105. Countries which do not have access to international financial markets are dependent on other sources of finance for acquisition of reserves in the absence of SDR allocations. Concessional financing could be a substitute for additional SDR allocation. But only limited sums of mildly concessional financing are at present available and that too on highly conditional terms. This source of financing is too inadequate to meet the reserve needs of these countries or even to promote "creditworthiness" to increase their access to capital markets. Only an unconditional SDR allocation could provide the required reserves strength for most of these countries. As the 1984 G-24 Revised Program has stressed, the unconditional use of SDR must remain inviolate.

106. The circumstances governing the supply of liquidity differ sharply as between different groups of Fund members. Industrial countries have an interest in acquiring adequate reserves and their liquidity needs have been largely met by capital flows. With the withdrawal of commercial bank lending to developing countries, and if official finance is not raised substantially, the only way to meet the liquidity requirements of developing countries is by an adequate

allocation of SDRs. In this context, a link between allocation of SDRs and development would not only meet the unfulfilled absorptive capacity of developing countries but also reduce the pressures on the industrial countries to accommodate an improvement in the current account balances of developing countries. While allocations to industrial countries do not augment their liquidity, those to developing countries would offer benefits to all members of the world community. It is, therefore, difficult to see any reason for not adopting the link.

Chapter VII

Role of the IMF

107. The purposes of the International Monetary Fund were set out in the Article I of the Articles of Agreement, which remained much the same even after the two amendments to the Articles. The role of the Fund was to change depending on the changes in the international monetary and financial system so as to achieve those purposes.

108. During the past forty years, the Fund certainly played an important role in the pursuit of some of these purposes. But it was not very successful in fulfilling the aspirations of a large number of developing countries which today hold over a third of the Fund's voting power and an overwhelming majority of the Fund membership. Developments in the international economy in the late Seventies and early Eighties affected most countries adversely and developing countries found to their cost that they were more vulnerable than others. As pointed out in the 1984 G-24 Revised Program, "the conventional response to the international monetary disarray has been to find ad hoc solutions. The result has been that we have lived from one crisis to another."

109. The International Monetary Fund is expected to play a central role in the operation of the international monetary system. It provides a forum for consultation and cooperation in international monetary relations, but, in many respects it falls far short of needs. Its surveillance so far has not ensured that the policies of major members are consistent with the requirements of international economic growth and financial stability; it has not been able to supplement adequately the stock of international reserves through SDR allocations and promote the SDR as the principal reserve asset as required under the Articles; while it tried to smoothen the process of adjustment of international payments with some success, its concept of adjustment has not always been found appropriate.

110. The previous chapters dealt with the Fund's role in surveillance over member governments' policies, and in the provision of

international liquidity. This chapter discusses the Fund's role in promoting balance of payments adjustments, the provision of required finance, its resource base and related issues.

111. When discussing payments imbalances, it is conventional to distinguish between transitory imbalances, which should be financed, and persistent imbalances, which require both finance and adjustment. The Fund has a role to play in both of them.

Transitory Balance of Payments Problems

112. Transitory payments problems are met by international reserves, borrowing from capital markets or drawing on Fund facilities. Because of the liquidity squeeze to which developing countries have been subjected, and their difficulty in borrowing from international capital markets, the Fund's facilities have for some years been used much more by developing than by industrial countries.

113. The Compensatory Financing Facility (CFF) was the Fund's first attempt to relate the provision of its low-conditionality finance to the events outside the control of the borrowing country that produce export fluctuations and thereby a payments deficit which could be assumed to be transitory. It has been extensively used by developing countries, especially since the liberalization of access in 1976.

114. In 1981, compensatory finance was extended to cover increased costs of cereal imports as well as shortfalls in the value of export receipts. Instead of extending the principle of low-conditionality finance for deficits due to factors beyond the control of the members, the Fund has since 1983 proceeded to emasculate one of its most successful operations, by making access under the CFF highly conditional. The access limits were also reduced from 100 percent to 83 percent of quota. These were retrograde steps imposed at a time when developing countries were exceptionally short of liquidity.

115. The high conditionality in the CFF should be reversed and the access should be restored to 100 percent of quota, in order to diminish the vulnerability of developing countries to exogenous shocks. The CFF should be extended to cover not only the export

shortfalls but also a deterioration in terms of trade that is quantifiable. Further, CFF drawings should be related to calculated shortfalls rather than to quotas. CFF should compensate the full amount of the calculated shortfall, and should be offered on a virtually automatic basis. As recessions have tended to become deeper and the cycles longer in the recent past, the balance of payments stress on most developing countries has increased and therefore the repayment period of the CFF should be extended.

116. Large variability in interest rates in recent years, had a severe impact on indebted developing countries. Therefore, a new facility to provide financing for interest rate increases needs to be introduced. Moreover, there is a strong case for creating a comprehensive CFF to provide low-conditionality finance to cover deficits resulting from any exogenous factor that can be presumed to be temporary. It would help countries to manage their economies rationally and to provide a counter-cyclical influence on the world economy. Different facilities, such as those relating to export earnings, cost of cereal imports, increase in interest rates, commodity-specific export shortfalls as proposed by the UNCTAD or practised by STABEX, could all be components of such a comprehensive facility.

Persistent Imbalances Requiring Adjustment

117. In contrast to transitory payments imbalances, deficits that threaten to be persistent require both large scale finance and adjustment. The Fund is enjoined by its Articles to promote adjustment without members resorting to measures destructive of national or international prosperity (Article I(v)). This requires that adjustment measures should not invariably lead to lowering of economic growth and development in the deficit countries. Correction of deficits through deflationary measures should be considered only as a last resort.

118. Clearly, policies should be devised according to the nature of the underlying disequilibrium. If payments disequilibria arise from excess domestic demand, more restrained fiscal and monetary policies will be in order. If they arise from exchange rate misalignment, the appropriate remedy lies in correcting the exchange rate. In

either case, the policies should try to minimize their adverse impact on the growth of real output and income distribution. However, in most cases, persistent payments disequilibria in developing countries are structural. Because of low short-run elasticities of substitution, a country producing raw materials will not be able to switch resources quickly into alternatives needed to restore equilibrium. External balance can then be achieved by lowering domestic demand, implying idle resources; but the preferred course would be structural adjustment which raises the economy's capacity to produce tradables. When improvement of the trade balance requires a supply response, either through increasing productivity or provision of specific inputs and technology or expansion of capacity, demand restraint is rarely sufficient, and often not even a part of the appropriate response to a balance of payments disequilibrium.

119. Recognition of the need in many cases for supply response or structural adjustment contributed to the development of multi-year adjustment programs, and specifically to the creation of the Extended Fund Facility (EFF). However, the design of some of these programs has not always focused on promoting the necessary shifts of productive resources within the context of policies for investment and economic growth. Nor do they take into account the adverse consequences for income distribution or inflation in the short run.

120. Reorientation of conditionality criteria from demand deflation to growth-oriented structural adjustment implies a need to lengthen program periods, and to increase the level of financing. In fact, it may at times be appropriate to finance a transitory deterioration in the payments balance, if imported raw materials and investment goods are needed to reactivate or expand capacity in the tradables sector. Moreover, longer programs provide an opportunity to ensure that the needed structural reforms are undertaken. There is the danger in a short-term stabilization effort that a transitory recovery of the balance of payments will be achieved through demand deflation, while necessary structural adjustments are neglected.

121. In the past two years there has been a considerable underplaying of the EFF, with more and more of the programs supported by

the Fund being stand-by arrangements. This development could contribute to unnecessary economic destabilization in many developing countries. In fact, excepting in cases where imbalances to be corrected are comparatively of a mild nature, the EFF should be used extensively.

122. It is recognized that the balance of payments problems of most low-income countries are structural in nature, caused mainly by persistent deterioration in their terms of trade, disproportionately large debt service burden, decline in the flow of ODA, and very limited capability to attract external resources from non-official sources. These problems have been seriously compounded by devasting droughts of unprecedented proportions that have hit many African countries. Of late, the majority of low-income countries have experienced net outflows of resources, including to the multilateral financial institutions. In view of the particularly difficult structural problems of these countries, it is essential that the Fund provide larger and longer-term financing in support of their structural adjustment programs than has been done so far.

123. Some Fund programs have broken down in recent years because of excessively rigid performance criteria, which were not revised in the light of unforeseen developments beyond the control of the borrowing country. There is a need for greater flexibility in the application of such criteria. The Fund's operations are dependent on the revolving character of its resources and it is necessary that repayment obligations to the Fund are settled on time. In cases where the balance of payments situation, made adverse by exogenous factors, makes it practically impossible for a country to repay according to a fixed schedule, mechanical application of sanctions available under the Articles of Agreement would be self-defeating and would not serve the purpose of the loan sanctioned to the country concerned. It may be necessary for the Fund to be more flexible in the application of Article V, Section 7(g) which provides for postponement of obligations "because discharge on the due date would result in exceptional hardship for the member." However, to help these countries become current in their obligations to the Fund, new mechanisms should be evolved, in collaboration with the World Bank and regional development institutions,

to provide longer-term assistance for orderly adjustment of these countries.

Need for Concessionality in Fund Lending

124. It is recognized internationally that there is a need to provide finance at concessional rates to developing countries especially the low-income countries. However, the burden of costs of Fund resources has fallen disproportionately on the borrowing countries in recent years. On account of inadequacy of Fund quotas, the Fund resorted to borrowing to supplement its own resources and to provide financing to borrowing members increasingly by using a mix of borrowed and quota resources and passed on the cost of borrowed resources fully to borrowing members. Besides, due to the steep increases in the rate of charge to borrowers, the borrowing costs of deficit developing countries have greatly increased over the recent years. The grant element in the rate of charge fell steeply from about 30 percent during 1980-82 to negligible levels currently.

125. While interest rates in international markets have been declining, Fund charges on the use of quota resources have been raised during the last two years. By discouraging low-income members from borrowing from the Fund at reasonable cost, the Fund's capacity to promote orderly adjustment has been undermined. It is therefore important to establish facilities and mechanisms within the Fund such as an Interest Subsidy Account on a stable basis to ameliorate the situation. Moreover, in view of the extremely difficult situation in which many developing countries are placed, it is necessary to revive the Trust Fund and to make concessional loans to eligible countries.

The Volume of IMF Resources

126. Because of the special role that the IMF is expected to play in the international adjustment process, quotas must remain the primary source of the Fund's financial resources. However, the IMF quotas had, in the aggregate, formed only about 5 percent of total imports at the end of 1984, as against 12 percent in the Sixties.

127. The ratios of Fund quotas to world trade and to current account deficits are useful indicators of the shortage of Fund resources. Both these ratios have been declining sharply. While non-gold reserves and international bank lending rose some six- or seven-fold between 1970 and 1982, the size of the IMF, as measured by the sum of the quotas, the borrowing arrangements and the SDR allocations, increased only three-fold and the quotas barely doubled. However measured, the quantitative contribution of the IMF to balance of payments financing and to world reserves has declined sharply both in relation to the needs and in relation to other sources.

128. During the Eighth General Review of Quotas, the majority of the Fund membership favored a doubling of the Fund quotas as being essential to enable the Fund to discharge its responsibilities. This recommendation did not take into account the increase needed due to the impact of the pressures on the balance of payments of the debtor countries from mid-1982 onwards and the withdrawal of new lending by commercial banks. The increase in quotas that was eventually adopted amounted to only 47.5 percent. Despite the inadequacy of the quota increase, normal annual access limits were reduced in stages from 150 percent to 95-102 percent of quota, from 450 percent to 280-395 percent over three-year periods, and from 600 percent to 408 percent cumulative. Higher limits were to be considered only in exceptional circumstances. Access limits were also reduced for the CFF from 100 percent to 83 percent of quota.

129. As a result, the adjustment programs undertaken by developing countries could not be financed adequately and had more stringent conditionality than was appropriate for the structural changes that their situations warranted. The inadequacy of resources stood in the way of the Fund playing its due role in financing and adjustment.

130. There is, therefore, the need for a substantial increase of quotas under the Ninth General Review, which should be advanced. In order to avoid the political and procedural difficulties of negotiating quota increases, it may be desirable to tie quotas to some appropriate measure of the size of the world economy. In the absence of such an automatic link, the normal interval of quota review should be reduced to three years.

131. Pending the Ninth General Review, it will be necessary for the Fund to supplement its resources adequately by resorting to borrowing, preferably from official sources, so that real access to Fund resources is not reduced in these difficult times. Until such time as the size of quotas bears an appropriate relationship to some appropriate measure of the size of the world economy, it is imperative to maintain the policy of enlarged access without dilution.

Enlarged Access Policy and Access Limits

132. Enlarged Access Policy of the Fund introduced in 1981 has been a useful instrument in making finances available to a number of countries that were affected by large payments imbalances. Developing countries consider that despite some improvement in the world economy in the last two years, recovery has been weak, fragile and uneven. The outlook for 1985 at present is in fact bleak. A large number of developing countries continue to experience serious balance of payments difficulties. There is no reason to believe that their requirements of financing will fall to permit a reversal of the policy of enlarged access. Indeed, they consider that the present access limits as a result of the recent reductions, are too meager and should be enhanced.

133. Developing countries consider that the policy of enlarged access cannot be dealt with appropriately except in conjunction with the question of adequacy of quotas. Until an appropriate relationship is re-established between Fund quotas and size of the world economy, access limits should be enhanced.

134. The fact that the drawings on the Fund in 1984 were lower than in 1983 by no means implies that there was any reduction in the size of the members' needs. One of the main reasons for the shortfall is the increasing difficulties faced by the member countries in meeting high conditionality and performance criteria of growing complexity, leading to suspension of many programs. In addition, the semi-automaticity of the CFF was replaced by reduced access and high conditionality. There was also a noticeable shift towards reduction in the actual access in determining the amount of finance in Fund programs. Given the severe compression of imports in many countries in

the past few years, output growth rates, imports and the aggregate current account deficits would have been higher had there been additional external financing consistent with the countries' longer-term debt servicing capacity on suitable terms.

135. The external account prospects of developing countries will be subject to great uncertainties in the coming years. For many of the countries that have had adjustment programs with the Fund, continued Fund support will remain essential for their progress towards balance of payments viability. In addition to large interest repayments, the highly indebted countries face a large hump in debt servicing over the coming years which would require substantial financing. Even to mobilize funds from commercial banks, Fund financing may have to play a catalytic role.

136. Considering the continuing and serious strain on the international monetary system, high levels of debt service burdens on developing countries that are expected to accentuate in the next few years, and the inadequacy of Fund resources to meet the requirements of members facing balance of payments difficulties, it is important that the criteria for activating the General Arrangements to Borrow (GAB), should be relaxed. The GAB and other similar arrangements, however, are not a substitute for adequate growth in quota resources.

Fund-Bank Collaboration

137. Developing countries consider that coordination between the IMF and the World Bank should not lead to cross-conditionality but should help further their mutual objectives of providing resources to developing countries. Closer contacts between the management and staff of the two institutions could help in understanding each other's points of view. However, it would not be advisable to seek some kind of uniformity of advice. Such a step would be counter-productive and could lead to cross-conditionality and would dilute the respective responsibilities of the two institutions and become a means of exerting a concerted pressure on borrowing developing countries. Any policy advice by these institutions would therefore have to be in keeping with their respective roles. If there were to be a coordination of policy

advice on a country, it would be essential that the country's consent is also obtained in this process.

138. As far as the World Bank (IBRD) is concerned, its primary role should continue to be one of commitment to development, growth, and poverty alleviation, as enshrined in its Articles of Agreement. Developing countries consider that there should not be an undue emphasis on conditional lending or increasing conditionality linked to quantum of lending. The World Bank should play a role in supporting debtor countries so that adjustment in these countries takes place in an environment of growth. The Bank should take effective steps quickly to negotiate a General Capital Increase so as to enable its lending to be expanded sufficiently to fully meet the needs of developing countries. In this context, developing countries are concerned that the net transfers from the World Bank to them are projected to decline over the medium-term and would turn negative by the end of the decade, a development which needs to be avoided by an institution whose main purpose is to transfer resources to developing countries to promote economic growth.

The Decision-Making Process

139. The 1984 G-24 Revised Program has made the following recommendations on the decision-making process in the international financial institutions which the Deputies wish to reiterate:

> "The role of developing countries in the decision-making process in the international financial institutions needs to be substantially increased. The system of weighted voting has led to a situation where, after the Eighth Quota Review, developing countries as a group have no more than 38 percent of total votes. While the principle of weighted voting may be unavoidable in financial institutions, a better balance in the voting pattern is needed for a more equitable and effective functioning of these institutions.

The share of developing countries in the total votes in the multilateral financial institutions should be increased to 50 percent. For this purpose, consideration might be given to, inter alia, an increase in basic votes. The present geographical representation of developing country regions in the Boards of the Bank and the Fund should be preserved."

Chapter VIII

The Debt Problem and Transfer of Resources

Problems Relating to External Debt

140. External indebtedness of developing countries increased substantially during the Seventies. This increase had four characteristics: first, private bank lending became the single most important channel for the transfer of resources from surplus to deficit countries; second, the conditions on which these credits were provided were harder and the maturities shorter than development financing provided by international development finance institutions; third, the bulk of debt was largely accounted for by a relatively small number of countries; and finally, bank financing flows and the conditions on which these were provided showed a pro-cyclical pattern tending to increase on softer terms when export commodity prices were favorable and to retrench and harden when export earnings declined.

141. As a result of these factors, by the beginning of the Eighties the external debt situation of the developing countries had registered an overall deterioration in its average term structure, adding a huge proportion of servicing burden and significant element of instability to the international monetary system. By the middle of 1982 a number of exogenous factors, which were described in the earlier chapters, combined to produce the debt crisis. Their effect was compounded by significant shortcomings in the policies of many debtor countries. Tightening of regulations by bank supervisory authorities may also have had an impact on the availability of bank finance. A crisis of confidence had developed regarding the ability of some major borrowers to meet their external commitments. It affected not only these countries but also other borrowers as well as the commercial lending institutions.

142. The combination of a decline in capital inflows with continuing high interest rates has resulted in massive negative resource transfers from the developing countries. For Latin America as a whole,

debt service payments to banks are estimated to have amounted to $30 billion in 1983 and $27 billion in 1984, requiring large trade surpluses to be generated.

143. Debtor countries have undertaken strenuous adjustment efforts in response to the external environment. The consequential adjustment process is having strong social and political consequences for many debtor countries, including a serious decline in their standards of living and a deterioration in their social fabric. In spite of their harsh adjustment efforts, external debt servicing continues to impose a very heavy burden. The situation requires imaginative solutions involving debt restructuring over the long term and there is an urgent need to move towards a "positive" type of adjustment, consistent with sustained growth of output in the medium and the long run.

144. Capital flight has been a specially acute problem for several of these countries in recent years, accounting for a sizable proportion of their accumulated debt. It is recognized that unstable conditions in debtor countries have on occasions triggered such capital flows. But in order to ensure financial stability, developed countries should, through their regulatory agencies, support the efforts of the authorities of developing countries to discourage capital outflows from those developing countries which are facing acute capital flight problems.

145. Multi-year restructuring of bank debts has been a helpful development since it prevented a bunching of maturities. However, it does not by itself solve the debt problem since, after restructuring, debtor developing countries are left with a major resource transfer problem due to debt servicing requirement, a result with severe adverse effects on their economies. Moreover, this outcome also poses serious questions on the stability of the international monetary system. In this connection, urgent consideration may have to be given to evolving mechanisms that would roll over or refinance a certain proportion of interest payments, i.e., those above the long-term trend real rate of interest.

146. A question arises whether in the advent of continuing or increasing reverse transfers (and they will increase as long as the rate of growth of net lending is less than the rate of interest) sufficient resources for expanding investment in export capacity will be available with these countries. If exports do not increase sufficiently, debt service difficulties could increase over time. More broadly, the issue is whether heavily-indebted countries can combine the attainment of satisfactory rates of growth with meeting debt service payments in full. Several elements will have a bearing in solving this issue in a satisfactory manner. Among these are (a) the future rate of growth of the major industrial countries; (b) the international level of interest rates and the dollar rates; (c) the access of developing countries' exports to industrial country markets and the expansion of world trade; (d) the flow of resources to developing countries from financial intermediaries including international financial institutions; and (e) sustained adjustment efforts on the part of debtor countries over the medium term, coupled with reallocation of resources in favor of exports.

147. There are, however, considerable uncertainties regarding the manner in which each of these elements would develop. In fact, it would be easy to envisage circumstances in which the unfavorable evolution of one or more of these factors would have a cumulative adverse impact on the others. Thus, a slowdown in the world economy, higher rates of interest and growing protectionism could add considerably to the heavy debt service burden, posing the risk that for at least some debtors the situation would become unsustainable. Without clear signs of economic progress the governments of debtor countries would be faced with political and social pressures that will make it difficult for them to reconcile the objectives of restoring growth in their countries with the prospective payments of debt service.

148. Since the debt crisis may be seen as a result of excessive lending by the commercial banks, abrupt policy changes, and, in some cases, an unbalanced policy mix by industrial countries leading to historically high interest rates, and inadequate policies by many debtor countries, it is necessary to find realistic formulae and viable mechanisms for its solution. The problem requires the cooperation of debtor

and industrial countries, commercial banks, and international financial institutions in the discharge of their respective responsibilities; also required is the co-responsibility of debtors and creditors, symmetry of adjustment and cooperative efforts aimed at a durable solution to the debt problem in a global framework.

149. Present problems have arisen to a considerable extent due to the absence of adequate sources of development finance which led many developing countries to resort to short- and medium-term financing from international capital markets. The sources of finance from capital markets are bound to be greatly reduced in the future. Besides, the earlier pattern of recycling which had a destabilizing influence on the international monetary system has generated serious doubts as to the adequacy of the role of commercial lending in the system. The lesson learnt from recent experience is that heavy reliance on medium- and short-term borrowing for development financing is bound to give rise to liquidity problems in the medium term, even if such financing were directed to sound and viable projects. Consequently, there is a need to design new financing mechanisms for orderly resource transfer to developing countries, and, in this context, the need to expand the resource base of existing financial institutions such as the World Bank, the regional development banks and the IMF becomes all the more imperative to enable them to play a much larger role in the recycling process in the years to come.

Trade and Finance

150. In recognition of the interdependence of money, finance and trade in the global economy, it is important to emphasize the close relationship between an expanding world trade and the solution of balance of payments problems including the indebtedness of developing countries. Developed countries should therefore roll back protectionist measures, refrain from introducing new restrictions, and improve access for exports of developing countries to their markets.

Transfer of Resources to Developing Countries

151. The recent record regarding the transfer of real resources to developing countries has been disappointing. The transfer of resources from official sources has not even made up, in the recent years, for the unprecedented losses incurred by developing countries on account of the adverse movements in the terms of trade and high interest rates. The quality and composition of aid have also witnessed a considerable deterioration.

152. In the low-income countries, slow growth does most to perpetuate and accentuate poverty. Most human development and poverty alleviation programs have long gestation lags and their output is not directly tradable and often is not even marketable. Commercial financing of such investment is unrealistic. The decline in official aid to low-income countries has resulted in under-utilization of capacities, a slowdown of priority investments, and disruption of development projects.

153. Within the framework of official development assistance, the International Development Association (IDA) constitutes a major source of concessional assistance to developing countries, and has played a crucial role in the development of low-income countries through high net transfers, proven effective utilization of resources, alleviation of poverty and provision of technical assistance. Resources made available to IDA through successive replenishments should represent a substantial increase in real terms. It is of vital importance to maintain the integrity of IDA and avoid the repetition of the regrettable experience of IDA VI and IDA VII. During the mid-term review to be conducted shortly by the IDA, additional resources should be made available to restore the IDA VII Replenishment to US$12 billion. It is essential that funding for IDA VIII should be substantially larger than that for IDA VI, and efforts should be made to restore the historical rates of growth in IDA. The negotiations for IDA VIII should be started at an early date.

154. There is an urgent need to accelerate the flow of concessional aid to developing countries. Developed countries which have not yet reached the internationally agreed target of 0.7 percent of

GNP as official development assistance (ODA) should, as agreed in UNCTAD VI, redouble their efforts to achieve that target as early as possible and in any case not later than in the second half of the decade. Each developed donor country should establish its program and make binding commitments for the annual growth rate of official development assistance disbursements. This should result in a general increase in real terms and an improvement in the quality of official development assistance flows to developing countries. It should include program and quick-disbursing aid tailored to development and short-term requirements at macro and sectoral levels respectively. It should increasingly cover local and recurrent costs, be untied to the maximum extent possible, and be provided on an assured, continuous and predictable basis. In respect of low-income countries, the Resolution 165 (S-IX) of the Trade and Development Board of UNCTAD relating to the adjustment of the terms of the past bilateral official assistance so as to improve the net flows in appropriate forms and on highly concessional terms should be implemented fully and expeditiously.

155. There is an equally urgent need to augment the flow of resources from multilateral development institutions. It is disquieting that at currently projected commitment levels of multilateral development institutions, particularly the IBRD, both net disbursements and net transfers show a significant decline even in nominal terms. It is estimated that IBRD commitment levels would have to increase at an annual rate of at least 6.2 percent in real terms over the levels reached in FY 1983 if net disbursements and net transfers are to remain relatively steady. This would call for an increase of the capital base of IBRD. It is essential to take immediate steps to negotiate a General Capital Increase of adequate size to permit the IBRD to expand its lending. Similarly, there is need to increase the capital base of the regional development institutions to ensure that their commitments increase at a satisfactory rate. In this context, it is imperative that donor countries should channel a greater proportion of their development assistance through multilateral institutions and reaffirm their commitment to multilateralism.

156. Structural adjustment lending which is quick disbursing should be made less conditional to improve its usefulness to borrowing countries. There is need for an increase in program lending of multilateral financial institutions to at least 25 percent of total loans. The lending programs of these institutions should also become increasingly responsive to the overall priorities, and in particular to sectoral priorities, of the recipient developing countries.

157. The early implementation of the recommendations of the United Nations Conference on the Least Developed Countries held in Paris in September 1981 would go a long way towards relieving the plight of these countries. In particular, donor countries should attain, by 1985 or as soon as possible thereafter, the objective of 0.15 percent of their GNP as ODA for these countries within the overall target of 0.7 percent.

158. Sub-Saharan African countries have been facing particularly acute and persistent problems. The Special Assistance Facility established for Sub-Saharan Africa is inadequate and it would be necessary to substantially increase the level and quality of funding in this respect. And the program to tackle the problems of these countries must be urgently implemented.

ANNEX

INTERGOVERNMENTAL GROUP OF TWENTY-FOUR

ON

INTERNATIONAL MONETARY AFFAIRS

REVISED PROGRAM OF ACTION

TOWARDS

REFORM OF THE INTERNATIONAL
MONETARY AND FINANCIAL SYSTEM

Washington, D.C.
September 21, 1984

CONTENTS

I. Preamble

1. In 1979, the Group of Twenty-Four prepared an Outline for a Program of Action on International Monetary Reform which was endorsed by the Group of 77 and presented to the international community on the occasion of the Bank/Fund Annual Meetings of that year. Since then, major changes have taken place in the world economy. The experience of the last few years has re-emphasized that the present international monetary and financial arrangements are grossly inadequate to achieve the basic objective of international monetary stability and sustained growth.

2. For the most part, the 1970s were marked by high inflation, expansionary fiscal and monetary policies, extreme volatility and misalignment of exchange rates and absence of sufficient coordination of economic policies among the major industrial countries. Subsequently, excessive reliance on monetary policy by the industrial countries to control inflation depressed economic activity and international trade. This in its wake brought about a long and deep worldwide recession in the early 1980s marked by the collapse of commodity prices, increasing protectionism and a severe debt crisis exacerbated by excessively high interest rates. As a consequence, the growth process in developing countries suffered a serious setback. So far the transmission of the gains of the recent recovery in the industrial world to developing countries has been weak. All these developments have brought to the fore the inadequacy and fragility of the international monetary system.

3. The conventional response to the international monetary disarray has been to find ad hoc solutions. The result has been that we have lived from one crisis to another. While developments in the international economy have affected most countries adversely, the developing countries have found to their cost once again that they are more vulnerable to the current international monetary turbulence. With the increasing resort to inward-looking protectionist policies by the major industrial countries, the problems for the developing countries have been compounded. Aid flows have not shown any appreciable increase in real terms. IDA's operations have been seriously disrupted. The lending program of IBRD and the regional banks has proved inadequate. The volume and direction of private capital flows including commercial bank lending tended to be unstable. Recent experience has demonstrated the limitation of the international banking system in alleviating the financing problems of developing countries. As for the IMF, its ability to provide assistance has been constrained by an inadequate growth of its own resources and a hardening of its policies.

The stern discipline which the Fund enjoins on its borrowing members contrasts with its less than effective influence on the policies of major industrial countries, and underscores the asymmetry in the adjustment process.

4. The continuing volatility in exchange rates has added to the problems of developing countries. A decade's experience with the present floating exchange rate system has shown its limitations. It cannot claim to have succeeded in improving the operation of the adjustment process nor can it be said to have helped the growth of world trade and output. An exchange rate system to overcome the recognized rigidities of a par value system and the destabilizing uncertainties of floating rates has still to be found.

5. The record with respect to creation and management of international liquidity has been equally unsatisfactory. The internationally agreed objective of making the SDR the principal reserve asset and the centerpiece of the international monetary system is far from being achieved, and progress made in this direction so far has been grossly inadequate. In this, as in other shortcomings, the absence of political will on the part of the major industrialized countries has hindered progress.

6. The Group of Twenty-Four therefore felt it urgent and necessary to formulate a Revised Program of Action Towards Reform of the International Monetary and Financial System, taking into account the developments that have taken place in the international economy and the monetary system since the earlier proposals made in 1979. These proposals are presented in the paragraphs that follow. While some of these proposals can be implemented quickly within the present institutional framework, others would have to be pursued by way of a reform of the present monetary and financial system. The proposals that need to be implemented quickly include, among others, increases in SDR allocation, quota resources in the Fund, IDA supplementary resources, general capital of the World Bank, real flows of official development assistance, roll-back in protectionism, and alleviation of the debt burden.

II. The Size of Fund Resources

7. The inadequacy of resources has stood in the way of the Fund playing its due role in financing and adjustment. The demand for Fund resources has clearly outstripped supply. The relative size of the Fund has been declining with respect to the scale of world trade. In 1960 aggregate

quotas in the Fund represented about 12 percent of world trade. By the end of 1983, even after the quota increase under the Eighth General Review had become effective, the figure had declined to about 5 percent. The overall size of the Fund should be such as to enable it to deal effectively with the problems of financing and adjustment that are within its competence and that are likely to be encountered in the years ahead.

8. Quotas must remain the primary source of financial resources for the Fund's operations. The Eighth Review of Quotas is not adequate for the effective discharge of the Fund's responsibilities. Despite the strong case for at least a doubling of quotas, the Eighth General Review limited the increase to only 47.5 percent. This underlines the need for a substantial increase of quotas under the Ninth General Review, which should be advanced. The normal interval for quota reviews should be reduced to three years. Besides, the decline of quotas as a proportion of world imports needs to be reversed through an agreed rate of quota increases. Pending the Ninth General Review, it will be necessary for the Fund to supplement its resources adequately by resorting to borrowing, preferably from official sources, so that real access to Fund resources is not reduced in these difficult times. Until such time as the size of quotas bears an appropriate relationship to world trade, it is imperative to maintain the policy of enlarged access without dilution.

9. Considering the continuing and serious strain on the international monetary system, high levels of debt service burdens on developing countries that are expected to accentuate in the next few years, and the inadequacy of Fund resources to meet the requirements of members facing balance of payments difficulties, it is important that the General Arrangements to Borrow and other similar arrangements be activated early. These arrangements, however, are not a substitute for adequate growth in quota resources.

III. Allocation and Distribution of SDRs

10. Recent trends in the state of international liquidity and the conditions of the world economy have greatly strengthened the case for a fresh allocation of SDRs. This is all the more so in view of the greatly reduced flow of resources from the private capital markets to developing countries. Given that there is a significant underutilization of world productive resources, a substantial allocation of SDRs would promote world recovery, reduce the liquidity problems of a large number of Fund members, and contribute to an orderly adjustment without adverse inflationary consequences.

11. The creation of international liquidity should be effected through truly collective international action in line with the requirements of an expanding world economy and the special needs of developing countries. The total supply and distribution of international liquidity should not be unduly influenced by the balance of payments position of any country or group of countries.

12. Substantial annual allocations of SDRs are necessary in order to attain the objective of making the SDR the principal reserve asset. They would also improve the composition of international liquidity. Since 1972 the ratio of SDRs to non-gold reserves has fallen sharply. In these circumstances, an annual allocation of SDR 15 billion in the Fourth Basic Period is overdue, and should be made effective, not later than January 1, 1985. It is imperative that the unconditional character of SDR allocations be maintained, as conditional use of the allocated SDRs would contravene the letter and spirit of the Articles of Agreement.

13. The current system which results in sporadic and uneven allocations has not promoted the objective of making the SDR the principal reserve asset of the international monetary system as required by the Articles of Agreement of the Fund. This objective should be given much greater weight in considering allocations than has been the case so far. To help achieve this objective, it will be necessary to issue SDRs on a regular annual basis with a view to ensuring that their proportion in non-gold reserves rises progressively. The present system under which SDRs are allocated in proportion to member countries' quotas results in large allocations to reserve currency countries and in relatively small allocations to developing countries which need them most. This does not serve the purpose of improving the distribution of reserves. It is therefore necessary that in addition to quotas, due weight should be attached to the need for liquidity of member countries. In this context, the case for establishing a link between the allocation of SDRs and development assistance continues to be strong.

IV. The Adjustment Process, Including Surveillance and Conditionality

14. Recent developments in the international economy have once again emphasized the vulnerability of developing countries to exogenous factors adversely affecting their balance of payments. Inflation, global recession, high interest rates, exchange rate volatility, increasing protectionism at a time of weak and stagnant demand for their exports, and serious deterioration in their terms of trade have aggravated the problems of their external sector in recent years. The financing of these imbalances has become difficult and costly. With the reduced availability of finance from commercial banks and the inadequacy of official aid,

developing countries have had to drastically reduce their imports with deleterious consequences for investment and growth. The burden of adjustment thus continues to fall disproportionately on developing countries.

15. The adjustment process must be adapted to the present global economic environment and the need for promoting development. The design of national economic policies, both by developed and developing countries, must aim at reversing the present low-growth environment and stagnation of world trade.

16. In view of the high degree of interdependence of the world economy, the success of economic policy followed by one country often depends on actions by others. Overcoming the present difficulties could be facilitated by a greater degree of policy coordination and the framing of national policies by major countries within an international framework.

17. The economic policies of the major industrial countries have far-reaching effects on the international economy given the key position they occupy in the system as a whole. In this context, the surveillance function of the Fund is of crucial importance and needs to be further strengthened so that it can effectively influence and help coordination of policies in these countries for promoting world economic recovery and trade expansion in a manner supportive of growth in developing countries. At present, notwithstanding its urgings, protectionism continues unabated, the mix of monetary and fiscal policies in some countries is inappropriate, excessively high interest rates and misalignment of some major currencies persist. On the other hand the influence of the Fund has been effectively felt by the users of its resources, mostly developing countries with balance of payments deficits. The lack of effective surveillance on the major industrial countries has placed an undue burden of adjustment on developing countries. As a result, the deficit countries have been faced with harsher adjustment and the world economy with a lower level of activity than would otherwise be necessary. In the process, the basic asymmetry in the Fund's surveillance function has intensified and the international adjustment process has been seriously biased.

18. In this perspective, developing countries expect the Fund to take into account the structural and conjunctural nature of the difficulties faced by them and to adapt its policies to support adjustment without undue adverse consequences for growth and social conditions. Greater priority should be given to the production and employment aspects of adjustment within the context of the specific economic, social, and political circumstances of each country. Fund conditionality tends to rely too heavily on domestic demand management and restrictive policies and on rather rigid performance criteria. These policies are frequently accompanied by wage reduction and import compression which would be unsustainable over the medium term. If structural adjustment is to be successful, it must be

integrated into a growth-oriented investment program. There is need for greater flexibility in the application by the Fund of performance criteria in cases where the thrust of the economic performance is in the right direction and the divergence from the performance criteria is not significant. In the case of the poorest countries including low income small island economies, multilateral institutions should devise conditionalities and performance criteria which take into account the special circumstances of these countries.

19. It cannot be overemphasized that adjustment for developing countries has become difficult because of exogenous factors. The prescriptions of adjustment and the review of performance should attach due weight to the time required for successful adjustment and to unforeseen events which are beyond the control of the countries concerned, including natural calamities, increases in interest rates, worsening of the terms of trade and intensification of protectionism. Consideration should be given to improving and extending present facilities to take account of these aspects.

20. On account of inadequacy of Fund quotas, the Fund has had to resort to borrowing to supplement its own resources and to provide financing to borrowing members increasingly by using a mix of borrowed and quota resources. Besides, due to the steep increases in the rate of remuneration on the use of quota resources and the consequent rise in the rate of charge to borrowers, the borrowing costs of deficit countries have greatly increased over the recent years. Apart from placing a considerable financial burden on low-income countries, this has also constrained the level of Fund financing in several instances. This evolution, which has been taking place in an environment of high interest rates and increasing debt service burdens, would hinder orderly adjustment. It is therefore important to establish facilities and mechanisms within the Fund such as an Interest Subsidy Account on a stable basis to ameliorate the situation.

21. In view of the extremely difficult situation in which many developing countries are placed, it is necessary to revive the Trust Fund and to make concessional loans to eligible countries.

22. In view of several exogenous factors affecting the external sector character of imbalances of developing countries, the recent tightening of conditionality associated with the Compensatory Financing Facility and reduction in its access limits are unwarranted. There is an urgent need for reversing these trends. The Compensatory Financing Facility should be extended to cover not only export shortfalls but also a deterioration in terms of trade that is quantifiable. Insofar as this Facility is designed to compensate for temporary shortfalls in export

earnings, conditionality has little relevance, and credits under this Facility should be provided on a virtually automatic basis. The quantum of accommodation under this Facility should be related to calculated shortfalls rather than to quotas. For the poorest countries, an arrangement similar to the Lomé Convention's STABEX scheme should be set up.

23. In the application of their policies, the multilateral financial institutions should recognize the special needs and characteristics of low-income countries.

V. The Exchange Rate Regime

24. The system of floating exchange rates was adopted in the hope of assisting the adjustment process and fostering the growth of world trade and output. Experience has belied these expectations. Exchange rates of major currencies have shown a persistent misalignment and have fluctuated widely, due in part to lack of coordination in the economic policies of these countries and in part to speculative pressures and destabilizing short-term capital movements. The volatility in exchange rates has especially hurt the developing countries. An exchange rate system should be devised to overcome the recognized rigidities of a par value system and the destabilizing uncertainties of floating rates. Besides, the improved functioning of the exchange rate system requires the recognition by major countries that both fixed rate and floating rate regimes need rules of the game relating to domestic macroeconomic policies. Obviously, this implies greater effort on the part of the developed countries to achieve a substantial degree of discipline and coordination in the conduct of their national policies. It is important that this coordination should take account of the needs of developing countries.

VI. The Debt Problem

25. The external debt of developing countries has grown greatly, their debt servicing capacity has been strained and, in some cases, has become critical due largely to exogenous factors and the inadequacies of the international financial system. Global recession, a steep fall in export earnings of developing countries, inadequacy of official development assistance, inability of the international financial institutions to expand their assistance sufficiently due to resource constraints, recourse to costly commercial bank credit, lack of coordination of macroeconomic policies of important industrial countries, excessive reliance on monetary policy by major developed countries to control inflation resulting in

historically high nominal and real interest rates and increases in debts of shorter maturities, have been the major factors in the recent aggravation of the debt problem. By all accounts, the debt problem has reached such proportions as to threaten not only the growth and development of the debtor countries, with serious social and political implications, but also the stability of the international financial system, with damaging impact on the world economy and the industrial countries themselves.

26. The solution of the debt problem requires the cooperation of debtor and industrial countries, commercial banks, and the international financial institutions in the discharge of their respective responsibilities. Besides, an overall improvement in the debt situation can only result from by sustained expansion in world economic activity, the elimination of protectionism, improvement in the terms of trade of developing countries, increased flow of official development assistance in real terms and restoration of interest rates to more normal levels following the abatement of inflation. Steps need to be taken to maintain the flow of commercial bank credit to developing countries at adequate levels and on appropriate terms and conditions. In addition, there is need for a substantial improvement in international policies and arrangements governing debt rescheduling to promote the adoption of a multiyear restructuring of debt, taking care that debt service payments do not claim an unreasonable proportion of export earnings. These policies and arrangements should ensure that longer-term financing and development requirements of debtor countries are taken fully into account and that they are treated equitably. The elements of a multilateral framework for dealing with debt problems contained in UNCTAD Resolutions No. 222 and No. 161 should be fully implemented and further elaborated as necessary so as to evolve a comprehensive multilateral framework for dealing with debt problems. On their part, the debtor countries should intensify cooperation among themselves for sharing information and experience on various aspects of the debt issue.

27. To alleviate the external debt burden of the low-income countries and make it more consistent with their repayment capacity and development requirements, there is need for the expeditious and full implementation of Trade and Development Board Resolution 165 (S-IX) and for the conversion of their outstanding bilateral official development assistance loans into grants.

28. The multilateral financial institutions, particularly the International Monetary Fund and the World Bank, have an important role to play in alleviating the current debt problem. To help debtor countries, the Fund should promote an environment conducive to the resolution of the debt problem and encourage an equitable dialogue between debtors and

creditors on debt issues, including, among other things, a fairer restructuring of debt on appropriate terms and conditions. A Task Force should be established within the framework of the Development Committee to study all aspects of the debt problem, including the feasibility of a special facility for alleviation of the debt burden arising from increases in interest rates. This should not prejudice other initiatives on the part of debtor and creditor countries for alleviating the debt problem.

VII. Transfer of Resources

29. While it is internationally agreed that the transfer of real resources to developing countries is of crucial importance for sustaining and accelerating the process of development, the recent record in this respect has been disappointing. The transfer of resources from official sources, both multilateral and bilateral, has been inadequate. In the recent past, it has not even made up for the unprecedented losses incurred by developing countries on account of the adverse movements in terms of trade and high interest rates. The quality and composition of aid have also witnessed a c nsiderable deterioration.

30. There is an urgent need to accelerate the flow of concessional aid to developing countries. Developed countries which have not yet reached the internationally agreed target of 0.7 percent of GNP as official development assistance (ODA) should, as agreed in UNCTAD VI, redouble their efforts to achieve that target by 1985 and in any case not later than in the second half of the decade. Each developed donor country should establish its program and make binding commitments for the annual growth rate of official development assistance disbursements. This should result in a general increase in real terms and an improvement in the quality of official development assistance flows to developing countries.

31. Official development assistance should be provided in more flexible forms, including program and quick disbursing aid tailored to both development and short-term requirements at both macro and sectoral levels. It should increasingly cover local and recurrent costs, be untied to the maximum extent possible, and be provided on an assured, continuous and predictable basis.

32. Within the framework of official development assistance, the International Development Association constitutes a major source of concessional assistance to, and has played a crucial role in the development of low-income countries. Resources made available to IDA through successive replenishments should represent a substantial increase in real terms. It is of vital importance to maintain the integrity of IDA and avoid the

repetition of the regrettable experience of IDA VI. The Seventh Replenishment should therefore have represented a substantial increase in real terms over the negotiated level of IDA VI, taking into account the much enlarged coverage of recipients, special needs of sub-Saharan Africa, and the increased need to finance projects in the field of energy. It is a matter of deep disappointment that despite proposals of the World Bank Management for a replenishment of $16 billion as representing the minimum requirement, an IDA VII of only $9 billion has been agreed to which represents a steep decline in real terms compared with IDA VI. This disappointment has been accentuated by the lack of success in reaching agreement on Supplementary Funding of IDA so far. It is imperative that the IDA Management perseveres with its efforts to reach agreement on this issue, and that the international community responds favorably without allowing considerations of burden-sharing to stand in the way.

33. There is an equally urgent need to augment the flow of resources from multilateral development institutions. It is disquieting that at currently projected commitment levels of multilateral development institutions, particularly the IBRD, both net disbursements and net transfers show a significant decline even in nominal terms. It is estimated that IBRD commitment levels would have to increase at an annual rate of at least 6.2 percent in real terms over the levels reached in FY 1983 if net disbursements and net transfers are to remain relatively steady. This would call for an increase of the capital base of IBRD. The recent selective capital increase pursuant to the Eighth General Review of Quotas in the Fund, though welcome, has fallen short of the increase warranted on the principle of parallelism adopted in the past. It is essential to take immediate steps to negotiate a General Capital Increase of adequate size to permit the IBRD to expand its lending. Similarly, there is need to increase the capital base of the regional development institutions to ensure that their commitments increase at a satisfactory rate. In this context, it is imperative that donor countries should channel a greater proportion of their development assistance through multilateral institutions.

34. Though structural adjustment lending is quick disbursing, the conditionality associated with it makes it unattractive to borrowing countries. In this sense, it cannot be regarded as a substantial supplement to existing facilities. There is need for an increase in program lending of multilateral financial institutions to at least 25 percent of total loans. The lending programs of these institutions should also become increasingly responsive to the overall priorities, and in particular to sectoral priorities, of the recipient developing countries.

35. The early implementation of the recommendations of the United Nations Conference on the Least Developed Countries held in Paris in September 1981 would go a long way towards relieving the plight of these countries.

In particular, donor countries should attain, by 1985 or as soon as possible thereafter, the objective of 0.15 percent of their GNP as ODA for these countries within the overall target of 0.7 percent.

36. Sub-Saharan African countries have been facing particularly acute and persistent problems. A special action program to tackle the problems of these countries should be urgently evolved and implemented on the basis of the World Bank reports on the region.

37. In recognition of the importance of energy in development, the multilateral development institutions should play a more active role in the development of the energy potential of developing countries and in mobilizing investment resources for this sector. It is essential to explore optimal means of financing an expanded energy program, including the possibility of establishing an energy affiliate and the idea of a pool or trust fund for energy lending.

VIII. Trade Linkages to Money and Finance

38. In recognition of the interdependence of money, finance and trade in the global economy, it is important to emphasize the link between an expanding world trade and the solution of balance of payments problems including the indebtedness of developing countries. The International Monetary Fund and the World Bank in cooperation with GATT and UNCTAD should continue their efforts to encourage an expanding and open world trading system, while remaining sensitive to the special needs of the developing countries.

39. Developed countries should roll back protectionist measures, refrain from introducing new restrictions, and improve access for exports of developing countries to their markets. In this context, the link between the expansion of exports of developing countries and their capacity to service their debt obligations must be recognized. The International Monetary Fund in the exercise of its surveillance function should pay special attention to all these aspects so as to facilitate the adjustment process and help reduce asymmetry.

40. The negotiation of a new multilateral system of safeguards should be urgently undertaken with the full participation of all interested countries to define clearly the circumstances, coverage and duration of any protectionist safeguard actions, which should include special measures in favor of the developing countries.

41. The industrial countries should agree to apply specific measures to facilitate structural adjustment in economic sectors in which they are not competitive and where comparative advantage favors developing countries.

42. Countries that have not yet done so should sign and ratify the Common Fund Agreement so that it may come into effect as early as possible and announce pledges of contributions to the Second Account of the Common Fund with a view to meeting the agreed target.

IX. Developing Countries and the Decision-Making Process

43. The role of developing countries in the decision-making process in the international financial institutions needs to be substantially increased. The system of weighted voting has led to a situation where, after the Eighth Quota Review, developing countries as a group have no more than 38 percent of total votes. While the principle of weighted voting may be unavoidable in financial institutions, a better balance in the voting pattern is needed for a more equitable and effective functioning of these institutions.

44. The share of developing countries in the total votes in the multilateral financial institutions should be increased to 50 percent. For this purpose, consideration might be given to, inter alia, an increase in basic votes. The present geographical representation of developing country regions in the Boards of the Bank and the Fund should be preserved.

X. Monetary and Financial Cooperation among Developing Countries

45. In working toward a reform of the international monetary and financial system, due emphasis should be placed on cooperation among developing countries in pursuance of the Caracas Program of Action.

XI. Towards a Fundamental International Monetary Reform

46. The Intergovernmental Group of Twenty-Four on International Monetary Affairs will continue to study and initiate further measures required in moving towards a fundamental reform of the international monetary and financial system in order to be of maximum assistance to developing countries and coordinating their positions on international monetary and financial matters in all relevant fora.

XII. The Need for an International Monetary and Financial Conference

47. The proposals outlined above include a program of immediate action for resolving the serious difficulties facing the world economy and indicating the broad directions in which the reform of the international monetary and financial system should proceed. In the past, we have witnessed ad hoc, piecemeal and partial efforts at reform. These have, however, not been adequate in view of the fundamental changes that have occurred in the international economy and the emergence of a large number of independent developing countries since the time the Bretton Woods institutions were created. There should be no further delay in moving toward a thorough-going reform of the international monetary system which would secure the objectives of exchange and monetary stability on the one hand, and address itself to the special concerns of the developing countries on the other.

48. An effective reform of the international monetary and financial system requires a convening of an international conference as an important and essential step. The necessary preparations for such a conference should be initiated as early as possible.