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August 27, 1980

To: Members of the Executive Board

From: The Acting Secretary

Subject: Review of Fund Policies and Procedures on Payments Arrears

The attached paper reviewing Fund policies and procedures on payments arrears will be brought to the agenda for discussion on a date to be announced.

Att: (1)

INTERNATIONAL MONETARY FUND

Review of Fund Policies and Procedures on Payments Arrears

Prepared by the Exchange and Trade Relations Department

(In collaboration with Legal and Other Departments)

Approved by C. David Finch

August 26, 1980

I. Introduction

A staff memorandum in 1970 1/ reviewed the Fund's experience with respect to arrears on payments and transfers for current international transactions and analyzed a number of factors relating to the emergence of arrears and the effects of arrears in the member countries in which they occur. It considered various approaches used by members in seeking to eliminate arrears and summarized the Fund's treatment of arrears, including the treatment of arrears in the context of programs supported by use of the Fund's resources. In completing its review of SM/70/139 the Executive Board endorsed a number of conclusions. 2/ Among these conclusions, the Executive Board noted that undue delays in the availability or use of exchange for current international transactions that result from a governmental limitation are payments restrictions under Article VIII, Section 2(a) and Article XIV, Section 2. Particular emphasis was placed on the adverse effects that arrears may have on the creditworthiness of a debtor country and on the smooth functioning of the international trade and payments system. The staff was therefore called upon to aim in consultation reports at a more systematic treatment of exchange restrictions involving payments arrears. In addition, the Executive Board set forth the circumstances in which the Fund would grant approval of such arrears. Finally, a number of requirements were prescribed, in terms of performance criteria and policy understandings, for members having payments arrears and seeking financial assistance from the Fund.

The period of about 10 years that has elapsed since the issuance of SM/70/139 has witnessed a substantial increase in the incidence of payments arrears. This has been especially marked in the last few years. The widespread occurrence of payments arrears and the sharp increase in the total amount of arrears outstanding since the mid-1970s reflect the prolonged and severe external payments imbalances and related adjustment problem experienced in a growing number of countries. Executive Directors have expressed their concern at these developments, most recently in the 1980 Annual Report on Exchange Arrangements and Exchange Restrictions (SM/80/98, 5/2/80 and Rev. 1), and on several recent occasions have asked for a further review by the staff of the experience with payments arrears and the factors giving rise to them.

1/ "Payments Arrears in Current International Transactions", (SM/70/139, 7/6/70).

2/ Executive Board Decision No. 3153-(70/95), adopted October 26, 1970.

The present paper reviews the Fund's policies on payments arrears in light of the experience over the period since 1970 and examines some of the policy problems that have emerged in this area. Particular attention is given to the circumstances of countries in which payments arrears have emerged in recent years, including those members for which the Fund has provided financial assistance in support of programs of adjustment. The paper also focuses on operational problems in dealing with payments arrears, as well as on aspects of payments arrears that involve the Fund's approval jurisdiction under Article VIII. In some of these areas the staff is seeking guidance from Executive Directors in a re-evaluation of existing guidelines and in the formulation of new ones.

The paper is organized as follows. Section II examines the policy setting and implications of payments arrears, while Section III is concerned with the definition, identification and measurement of arrears. Section IV deals with the question of payments arrears as exchange restrictions and their treatment in consultation reports, and Section V discusses the treatment of payments arrears incurred by governments and government entities. Section VI discusses various techniques that have been applied in eliminating arrears and reviews the experience and the modalities of dealing with arrears in programs supported by use of the Fund's resources. The concluding section proposes a set of operational guidelines.

II. Payments Arrears--Their Causes and Effects

Estimates of outstanding external payments arrears in member countries known to be incurring payments arrears at the end of 1979 are given in Table 1. The data should be viewed with caution since for some countries (primarily those for which the Fund is not currently providing financial assistance) the staff is able to obtain information on arrears only at infrequent intervals. For this reason, data of arrears for some countries are less up-to-date and possibly less reliable than for others. The figures reported in Table 1 relate to total external arrears outstanding. Even with allowance for shortcomings of the data, however, there is no doubt that payments arrears have reached a disturbingly high level in recent years. At the end of 1979 outstanding arrears totaled more than SDR 5 billion, equivalent to 0.5 per cent of total world merchandise exports. Of even more concern is the widespread nature of the problem of arrears. Over the period covered by the review they were reported in one or more years in 26 countries. Illustrating the severity of the problem of arrears, seven of the countries listed in Table 1 would have required more than one half of the proceeds from merchandise exports in 1979 to be allocated to the liquidation of arrears in order to clear the backlog. In some of these countries the proportion was close to 100 per cent or even more. While several countries were able to eliminate arrears during the period, there were a number which remained in arrears throughout the period. Some of the latter countries were among those with difficult balance of payments problems for which the Fund's financial support was being provided to soften the impact of adjustment measures.

Table 1. External Payments Arrears Outstanding, 1975-79 1/

(In millions of SDRs; where applicable, end of period)

	1975	1976	1977	1978	1979	End-1979 arrears as percentage of 1979 exports 2/
Bolivia*	--	--	--	--	42	7
Central African Republic*	...	35	39	44	39	39
Chad	9	12	18	22	...	26 3/
Congo*	...	11	23	42	23	9
Dominican Republic	--	11	--	--	17	2
Ghana*	201	259	261	375	303	37
Grenada*	xx	xx	xx	2	1	6
Guinea	50	79	109	138	152	52
Guinea-Bissau	1	6	7	8 4/	...	...
Guyana*	--	--	27	17	20	9
Jamaica*	--	--	22	48	42	7
Madagascar	...	...	...	1 5/	13	4
Mauritania*	--	xx	9	23	15	13
Nicaragua*	--	--	--	31	88 6/	6 3/
Sierra Leone*	4	9	12 7/	22	54	48
Sudan*	68	241	498	610	607	143
Tanzania	--	--	--	50	118	29
Togo*	--	--	16	43	79	34
Turkey*	--	201	1,409	1,523	1,888	100
Uganda*	37	39	21	79	129	38
Zaire*	218	385	671	950	1,118	120
Zambia*	136	223	394	495	350	32
Total	724	1,511	3,536	4,523	5,098	

Sources: Country authorities; and staff estimates.

* Financial program supporting use of the Fund's resources in effect during 1979 or early 1980.

1/ Includes members known to be incurring payments arrears at the end of 1979.

2/ Merchandise exports, f.o.b.

3/ End 1978 arrears as a percentage of 1978 exports.

4/ November 1978.

5/ May 1978.

6/ March 1979.

7/ September 1977.

Note: xx: Arrears less than SDR 0.5 million.
...: Information not available.
--: Payments arrears nonexistent.

Notwithstanding the important changes that have taken place in the international payments system since 1970, recent experience in countries with arrears indicates that the reasons for the emergence of arrears are essentially the same as those set forth in SM/70/139. When payments arrears occur, they inevitably follow a period of sustained pressure on a country's balance of payments that has led to the exhaustion or near exhaustion of foreign exchange reserves. It follows that arrears are often incurred in countries in which external debt servicing has become a major concern for economic management. Underlying this situation in most cases are serious shortcomings in fiscal, monetary, and exchange rate policies. However, the high rates of inflation throughout much of the 1970s, the continued instability of commodity prices, and the generally unfavorable performance of the world economy in the aftermath of the oil price increase of 1973, as reflected in the relatively slow growth of world trade, have contributed to the more widespread incidence of arrears in member countries.

Typically, payments arrears occur in countries which have experienced prolonged difficulties in balance of payments management. The policy response to an emerging imbalance in external payments is usually one in which the authorities react initially by drawing down external reserves and/or intensifying direct or indirect restraints on external trade and payments, in some cases leading to capital flight and to the development of a parallel market for foreign exchange. The resulting loss of reserves, foreign exchange constraints and "leads" in the submission of applications for foreign exchange, in the absence of remedial action, may produce a formal or informal lengthening of the average waiting period for foreign exchange authorization. Experience has shown that the longer the delay in introducing appropriate adjustment policies, possibly including a change in the exchange rate, the greater the difficulty in eliminating payments arrears.

In terms of their impact, payments arrears impose serious disadvantages on both the debtor and the creditor sides, though in differing degrees. The existence of payments arrears inevitably has a damaging effect on the creditworthiness of the debtor country and therefore on its ability to approach international capital markets for new borrowing, with accompanying adverse effects on investment. At times these effects have been found to continue for some time after the arrears, and the factors giving rise to them, have been eliminated. Moreover, the very existence of payments arrears may give rise to speculation about the appropriateness of the prevailing exchange rate, which in turn could lead to adverse market reaction in the form of leads and lags in external transactions, a development that further complicates the task of balance of payments management. Exchange rate expectations generated under such circumstances are apt to have a negative effect on trade and on capital inflows, as well as on foreign exchange sales by the public to the banks. 1/

1/ In some developing countries, the problem of arrears is compounded by smuggling activities, with the attendant loss of exchange earnings from exports withheld from the official market.

A country with a history of payments arrears is also likely to experience related additions to costs in its foreign trade. Exporters in trading partner countries are likely to seek added protection against the possibility of delay in settlements by requiring letter of credit financing by importers. Quoted prices for exports to such a country are often raised because of uncertainties about the timing of payments and the duration of arrears, reflecting the variable length of the waiting period. Between exporters and importers (in the case of invisible transactions, remitters and recipients), these circumstances entail the risk of disrupting business relationships and goodwill that may have been built up over a long period. In the area of export credit insurance, undue deferral of payments leads to increased premium costs and even the suspension of such insurance cover. Depending on the magnitude of the arrears problem, the practice of recouping expected losses by mark-ups of prices or other charges could directly or indirectly compound significantly the inflationary developments and balance of payments pressures in the country that is in arrears. Payments arrears are likely to have an additional, undesirable element resulting from their impact on trading partner countries. Unlike generalized exchange restrictions, which are applied on a nondiscriminatory basis before a payments obligation is incurred, payments arrears arise only after the incurrence of a payments obligation. Consequently, additional costs for suppliers may be involved because of uncertainties regarding the terms of settlement. In addition, payments arrears may create the possibility of discrimination. As such they constitute a major disincentive for potential trading partners to enter into commercial transactions with the country in arrears.

III. Problems of Definition, Identification, and Measurement

Governmentally imposed limitations on the availability of foreign exchange which give rise to payments arrears may occur when the authorities formally impose a delay so as to ration foreign exchange--through the establishment of a queueing procedure for exchange applications--or when delays arise on an informal or ad hoc basis. From the standpoint of the Fund, the presence of payments arrears very often is not recognized until some time after their emergence; indeed, on many occasions the first indications that they exist come from reports or complaints by creditor countries, or from statements lodged with export credit agencies. It has been the experience of the Fund that the establishment of formal procedures to settle payments obligations on a delayed basis, according to a program or schedule for their liquidation, usually follows a period in which arrears have accumulated as a result of gradually increasing delays by the authorities in meeting all bona fide requests for foreign exchange.

The conclusions of SM/70/139 contained an unequivocal description of arrears in the nature of exchange restrictions, viz.:

> In all cases where payments arrears arise from a governmental limitation on, or interference with, the availability of foreign exchange at the time a payment for a current

> international transaction falls due, or with the timely transfer of the proceeds of such transactions, the payments arrears should be treated...as evidence of a payments restriction.

However, uncertainties have surfaced in recent years with regard to the identification of arrears which have the characteristics of the informal or ad hoc payments delays referred to above. Such a difficulty was in fact anticipated in the following statement in SM/70/139, (p. 2):

> Not every officially caused delay in authorizing payments or transfers is an exchange restriction, however. Reasonable time for the administrative examination of the bona fides of an application for exchange is an inherent part of exchange control, as is the requirement of compliance with reasonable documentation of exchange applications. These aspects of official control, which are generally incidental to the restriction of capital movements, are part of the normal processing of applications for exchange and do not in themselves give rise to a restriction on current payments and transfers. At times, however, inadequacy or inefficiency in the administration of capital controls has also led to undue delays.

It therefore seems appropriate to reconsider the question of what constitutes an undue delay of payments. Two approaches are possible. Under the first approach any officially caused delay that goes beyond the due date of payment would be treated as an undue delay. This interpretation allows for little or no flexibility, especially since it does not take into account variations in administrative capabilities as between individual members or within any one member country over time. Nor, for instance, does it take account of the nature of certain invisible transactions (e.g., unrequited transfers, profit remittances) for which there may be no due date of settlement, but for which, nevertheless, settlement may be delayed by official action. As a result of these considerations, the use of the criterion of due date as the determinant of the existence of payments arrears is subject to serious limitations.

An alternative and more flexible approach is one that views as undue a delay in payments which exceeds the period reasonably needed to complete the administrative procedures considered necessary to ascertain the bona fides of an exchange application. This period may vary as between members, and may be different for any one member depending on the nature of the application (e.g., for trade, or for invisibles, etc.). Any delay that extends beyond this period, either on an ad hoc basis or as a result of specific governmental action, would be regarded as undue. In applying this approach in a member country in order to ascertain the possible existence of arrears, the staff would need to determine whether the period required to process an application is reasonable in the light of experience in other member countries. This would provide a broad measure against which the extent of delays in payments and transfers in a specific country could be assessed.

The alternative definitions of undue delay discussed above have significance for the sources and availability of data on arrears. Since, at least in the early stages when arrears are emerging, the existing administrative

machinery of a country is not normally geared to collecting detailed data on payments and transfers that have been subjected to undue delay, information on the existence of arrears usually becomes available initially from the creditor rather than the debtor side. The staff has invariably encountered difficulty, especially in the early stages, in verifying the existence of arrears and in measuring their volume. Generally, it is only as arrears increase in size and over time, and as the need for their orderly elimination is recognized, that attention has been given by the debtor country to the systematic collection of data. In many cases, the information on the nature and magnitude of arrears has been collected in the context of programs supported by use of the Fund's resources.

In measuring arrears, experience has shown that the use of data on foreign exchange applications that have been unduly delayed in the approval pipeline tends to exaggerate the value of outstanding arrears. Applicants normally have no incentive to withdraw applications for official exchange, even when settlement of the underlying transactions has taken place through alternative channels, e.g., via a parallel market. Consequently, the demand for foreign exchange reflected in overdue exchange applications often involves, in part, disguised capital outflow. The problem of upward bias to measured arrears could be lessened by requiring exchange applications awaiting approval (in the case of contractual payments, applications held beyond the due date) to be fully backed by counterpart deposits in domestic currency. Such a requirement would serve not only to support the bona fides of applications, but also to weaken the attraction of exporting capital illegally. From the standpoint of the authorities, the withdrawal of liquidity that occurs when the banks are subject to reserve requirements in respect of these deposits, or when the deposits are held in the accounts of the monetary authorities would also be regarded as a useful and desirable supplementary tool of monetary control. When counterpart deposits are sterilized in this manner (i.e., when they are held with the central bank, or when held with a commercial bank and they are made subject to a 100 per cent reserve requirement), the foreign exchange risks may be assumed by the authorities. 1/

1/ Where such deposits are noninterest bearing, or where the foreign exchange needed to liquidate an external obligation is provided at a future date in exchange for the deposit at the rate of exchange in effect on the due date of deposit rather than at the rate of exchange in effect when the deposit was made, the loss of interest income or any additional cost involved in the purchase of foreign exchange may give rise to a significantly different effective exchange rate and may involve a multiple currency practice. The divergence in the effective rate of exchange, however, will be reduced if interest is paid on such deposits; it will be eliminated if the monetary authorities pay sufficient interest, or if they assume the obligations arising from payments arrears and effectively guarantee the exchange rate to be applied at settlement.

IV. Payments Arrears and Exchange Restrictions

When the authorities of a country are responsible for undue delay in approving applications or meeting bona fide requests for foreign exchange for payments for imports or for other current transactions as defined in Article XXX, Section (d) that results in payments arrears, the undue delays are exchange restrictions under Article VIII, Section 2(a) and Article XIV, Section 2. 1/ Arrears on payments relating to the settlement of capital transactions are not restrictions within the meaning of these provisions of the Articles of Agreement. 2/3/

With only a few exceptions, the payments arrears currently existing in member countries and described in Section II above are exchange restrictions subject to the approval of the Fund under Article VIII. In its review of payments arrears in 1970, the Executive Board requested the staff to aim in consultation reports at a more systematic treatment of restrictions on payments and transfers that produce payments arrears, and indicated that the staff should establish whether payments arrears exist by ascertaining whether excessive delays occurred in granting applications for foreign exchange. In addition, the Executive Board stated that when requesting the Fund's approval for the existence of arrears, a member should submit a satisfactory program for their elimination. Approval, when granted, should be only for a temporary period, generally with a fixed terminal date, and should be wherever possible in terms of the level of arrears outstanding.

Since the review of 1970, there has been rather diverse treatment of payments arrears in consultation reports and in the manner in which arrears involving exchange restrictions have been dealt with in decisions under Article VIII and Article XIV. This has been due, in large measure, to differences in the availability of information on arrears in individual countries. The staff can report, however, that since the Second Amendment of the Fund's Articles more attention has been given in consultation reports to the identification of exchange restrictions, including the problem of payments arrears. This has been especially evident since the review by the Executive Board of several staff papers dealing with questions relating to decisions under Article VIII and Article XIV. 4/ In light of this review, the staff

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1/ SM/70/139, p. 1.

2/ Article VI, Section 3 states that no member may exercise capital controls "in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b) and in Article XIV, Section 2."

3/ In the context of programs supported by the use of the Fund's resources, however, performance criteria for the reduction or elimination of arrears are not necessarily confined to payments and transfers for current international transactions.

4/ Decisions Under Article VIII and Article XIV (SM/78/162, 6/19/78); Annual Review of Regular Consultations and Other Issues Related to Article IV (SM/78/287, 12/11/78); and Decisions Under Article VIII and Article XIV (SM/79/88, 4/2/79).

was requested by the Executive Board to adopt a more systematic treatment of restrictive exchange practices in consultation reports. Thus, in the latest Article IV consultation with the members shown in Table 1 (page 4) details of the arrears situation were given in the staff reports and in the papers on recent economic developments; the policy aspects of arrears were dealt with specifically in the staff appraisal. In 17 of the countries identified the arrears involved exchange restrictions. For two of these countries no formal consultations have taken place since the incurrence of arrears. A separate reference to arrears, regardless of whether they were approved, was made in consultation decisions in all but three of the remaining 15 cases involving exchange restrictions.

In the period since the 1970 review, the Executive Board has granted approval for the existence of payments arrears only when the member concerned has submitted a program for the reduction and/or eventual elimination of its arrears. In virtually all such cases, the program has formed part of a comprehensive stabilization program supported by the use of the Fund's resources. Thus, Executive Board approval of existing arrears under Article VIII was given in 8 of the 15 cases involving exchange restrictions mentioned above. In 6 of the 8 Executive Board decisions, there was a specific reference to payments arrears. In the remaining two cases, the Fund's approval was implicit in the general coverage of the approval granted for the member's exchange practices. In all eight cases, the Executive Board fixed a terminal date for the period of approval. Finally, when arrears remained outstanding at the terminal date they were not necessarily approved in the decision taken at the conclusion of the next consultation. For two countries whose payments arrears extended over a period of years, the Fund's approval lapsed and was subsequently reinstated only when a more sustained effort to eliminate arrears was proposed by the member.

V. External Payments Arrears Incurred by Governments

There are payments arrears which do not result from governmentally imposed delays on payments and transfers for current international transactions. Such arrears may arise when a government or government entity whose financial operations form part of the budgetary process fails to meet an external payments obligation. It is difficult to treat these arrears as coming within the jurisdiction of the Fund although their economic effects are the same as those that involve exchange restrictions. Such arrears should therefore be treated as a default. On the other hand, where a public sector entity is clearly independent of the government's day-to-day budgetary controls and has at its disposal domestic currency resources with which to meet its external payments obligations, payments arrears which arise because of an inability to obtain the requisite foreign exchange are evidence of an exchange restriction. The financing arrangements of public entities and the relationship of these entities to the central government therefore need to be examined on a case-by-case basis to arrive at the correct determination.

Another example concerns payments arrears incurred by governments participating in a common central bank. On several occasions recently, Executive Directors have inquired about the treatment of such arrears that occur when the authorities of a country belonging to a regional or joint central bank are unable to meet payments obligations abroad because of an inability to obtain domestic currency with which to purchase needed foreign exchange. This type of arrears has been incurred, for example, by the governments of some of the member countries listed in Table 1 which are also members of the West African Central Bank (BCEAO) or the Bank of Central African States (BEAC). 1/ In this connection, questions have been asked as to how these arrears should be dealt with in Executive Board decisions under Article VIII and Article XIV. In these countries arrears have emerged in respect of external payments (as well as domestic payments) because, given the statutory limit on central bank lending to the government, the authorities did not have adequate recourse to domestic currency in order to purchase foreign exchange from the common central bank, even though the central bank, for its part, stood ready to meet all proper requests for foreign exchange. The emergence of payments arrears in these countries to some extent reflects a weakening of the formerly strong discipline that characterized government financial operations. Several Fund members belonging to a regional central bank and incurring external arrears of this type have received financial assistance from the Fund in support of adjustment programs which have sought, inter alia, to eliminate arrears on both domestic and foreign payments. The payments arrears described here have not been treated by the Fund as evidence of exchange restrictions and have been considered not to fall within the Fund's approval jurisdiction under Article VIII. Rather, they have been dealt with as a default of the governments concerned. When reviewing members' policies in connection with Article IV consultations, some Executive Directors have observed that while in such cases the need to eliminate payments arrears is discussed explicitly in the staff appraisal of the consultation report and in the Chairman's summing up, the decisions concluding the Article XIV consultation may include a commendation to the member for maintaining an exchange system free of restrictions. This apparent inconsistency arises because these decisions are confined to matters coming within the jurisdiction of the Fund.

There is no doubt that payments arrears incurred by governments as a result of default are as damaging to a country's credit standing and to the effective functioning of the world's payments system as the other forms of payments arrears discussed earlier in this paper. For this reason, it is appropriate for the Fund to urge members incurring such arrears to remove them at the earliest opportunity, irrespective of the nature and origin of the arrears. Consultation reports should therefore continue to take note of the existence of arrears arising from default. This approach is consistent with that accorded to arrears of member countries that are treated as evidence of exchange restrictions within the meaning of Article VIII.

1/ The problem has also emerged in at least one other member country belonging to a regional monetary arrangement.

VI. Elimination of Payments Arrears

For any country with external payments arrears, a program to restore equilibrium to the balance of payments should give high priority to the speedy elimination of arrears and the restoration of a system of prompt payments. Various techniques have been adopted by members to eliminate arrears, often within the context of programs supported by use of the Fund's resources. The management of arrears and the ability of the authorities to integrate the phased reduction of arrears with overall financial policies are facilitated when arrears are mandatorily centralized by the monetary authorities (central bank). Under such arrangements, when arrears are represented by deposits in domestic currency held as counterpart funds, any reduction in arrears is automatically reflected in a drawdown of these deposits. A similar result may be achieved if such deposits are held with commercial banks in blocked accounts. However, if arrears are not treated in this manner, and applications for foreign exchange in respect of delayed payments are not backed by the domestic currency counterpart, arrears cannot be adequately monitored (as indicated in Section III), and the results of a program to reduce and eliminate them may be much less assured.

Another aspect of procedures to eliminate arrears concerns the method of settlement of individual outstanding payments obligations. The choice will depend on a range of factors, including the nature (i.e., whether current or capital) and extent of the arrears, the overall balance of payments problem, and the institutional arrangements in the country concerned. One approach to the elimination of arrears gives primacy to the first-in first-out (FIFO) principle, and can be supported on the grounds of equity since it seeks, in an orderly manner, to eliminate arrears chronologically in the order in which they were incurred. A major drawback of this system is that it does not immediately lead to the restoration of a system of prompt payments for current obligations; it may therefore serve to dilute the country's effort to regain a good standing in the international capital markets. Furthermore, adherence to the FIFO method may be impractical because of the lumpiness of individual transactions.

A second broad approach is one that aims at the immediate restoration of prompt payment of current obligations and the avoidance of new arrears, while stretching out the settlement of existing arrears. A variant of this approach involves a priority (or discretionary) reduction of arrears depending on the type of transaction, e.g., import payment obligations (perhaps with a further breakdown according to essentiality) or debt service obligations. This method has the unsatisfactory feature of requiring different waiting periods for the settlement of payments arrears according to the type of transactions involved. Yet another method is the use of a uniformly applied schedule by which the same percentage reduction is applied progressively, across the board, to all existing arrears as computed on a given date: for example, a goal of eliminating arrears during a specified period could be pursued in terms of reducing the amount outstanding in even monthly steps. Alternatively, a maximum waiting period could be specified beyond which all legitimate payments applications would be eligible for automatic approval,

the objective being to reduce progressively, in line with the evolution of the overall external payments position, the length of the waiting period, up to a point where payments arrears are fully liquidated. A shortcoming of this technique is that it constricts the ability of the authorities to maintain control over either the level of arrears outstanding or the level of gross external reserves. 1/ In summary, there is a wide range of techniques available to address the problem of eliminating payments arrears and the choice in any one country will depend on the circumstances of the member and its institutional arrangements. Regardless of the method chosen, a systematic monitoring of progress is desirable. In the discharge of obligations relating to payments arrears, it is important that settlements to creditor countries be made on a nondiscriminatory basis.

In its review of payments arrears in 1970, the Executive Board emphasized that Fund financial assistance to members with payments arrears should be granted on the basis of performance criteria or policies with respect to the treatment of arrears in recognition of their status as payments restrictions. Paragraph 4 of Executive Board Decision No. 3153-(70/95) reads as follows:

> Fund financial assistance to members having payments arrears should be granted on the basis of performance criteria or policies with respect to the treatment of arrears similar to the criteria or policies described in the preceding paragraph for the approval of the payments restrictions. In general, the understandings should provide for the elimination of the payments arrears within the period of the stand-by arrangement. Such understandings should be based on the concept of a given level of payments arrears and should be reflected in the performance criteria included in stand-by arrangements in the higher credit tranches. To support the policies designed to deal with arrears the letter of intent should include a statement that there would be no imposition of new restrictions or increase in the level of delayed payments. Where Fund financial assistance is being provided, but only through the first credit tranche, the adoption of a viable program directed toward the elimination of the payments arrears should be an important factor in considering whether the country was making reasonable efforts to redress its international financial situation. 2/

As indicated in Table 1 above, 16 of the 22 countries with payments arrears at the end of 1979 had financial programs supported by use of the Fund's resources during 1979 or early 1980; all of these programs included

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1/ To meet this problem, a recent program with a Fund member provided that, during a given period, the authorities would not allow gross official international reserves to rise beyond a specified level unless all payments arrears have been eliminated (see Guyana - Use of Fund Resources - Extended Fund Facility, EBS/80/155, 7/11/80, p. 32).

2/ IMF, Selected Decisions of the International Monetary Fund and Selected Documents, 8th issue, p. 143.

understandings or targets with respect to the reduction of arrears as well as to the avoidance of any new arrears during the program period. For programs relating to the first credit tranche, letters of intent generally included a statement by the member that arrears would not exceed a certain level, or that they would not be allowed to recur during the program period. In most upper credit tranche programs, performance criteria provided for a phased reduction of arrears. Furthermore, the elimination of arrears was generally regarded as a very significant step to be taken by the member in reducing its reliance on exchange restrictions. In one important respect, however, the objectives specified by the Executive Board in 1970 have proved difficult to meet. In a number of countries with Fund supported programs it has not been possible to aim at the complete elimination of arrears over the program period, reflecting the large amounts outstanding and the continuing pressures on the balance of payments which severely limited the amount of exchange available for the liquidation of arrears. In a number of cases, there were also problems of obtaining adequate data on arrears and of establishing effective institutional arrangements for their elimination. This experience has shown that a more flexible approach may be preferable whereby members will not be expected to eliminate arrears over the life of a one-year program, although normally it should remain an objective of programs covering two or three years. As a minimum effort, however, members would be expected to observe a requirement to avoid any further increase in outstanding arrears.

In any program to phase out arrears on payments to service external debt, the following additional issues arise. Such arrears usually relate to overdue payments on external public debt, covering both interest and principal. A number of the countries with arrears shown in Table 1 had arrears relating to official debt obligations, and for some of them, progress in eliminating arrears has been dependent, in part, on their success in arranging for debt rescheduling. In recent years there has been increasing resort to the funding of arrears through such arrangements by rescheduling debt payments under a multilateral arrangement such as the Paris Club, or by way of a bilateral rescheduling of arrears. The rescheduling of debt obligations has been associated with several recent programs supported by use of the Fund's resources. While permitting the member a measure of debt relief, such reschedulings in very difficult cases also allow the country concerned to re-enter the capital market and to achieve an increased import flow to assist economic recovery. Issues relating to debt renegotiation will be dealt with in a forthcoming staff paper.

VII. Conclusions

1. In the decade since the Executive Board last reviewed the Fund's policies and procedures on payments arrears, there has been a substantial increase in the number of countries incurring payments arrears and in the total amount of arrears outstanding. The widespread nature of the problem of arrears is a manifestation of the sustained payments pressures and resulting adjustment difficulties experienced by many countries in recent years. The Fund's concern with these developments stems not only from the harmful effects on

creditor countries and their deleterious consequences for the credit standing of the members incurring them, but also from their injurious effects on the smooth functioning of the international trade and payments system.

2. Through the exercise of its approval jurisdiction, the Fund's policies on payments arrears are concerned with exchange restrictions within the meaning of Article VIII, Section 2(a) which arise from governmentally imposed delays on payments and transfers for current international transactions. Because of the damaging effects of arrears on the international trade and payments system, the Fund does not grant approval to payments arrears which are exchange restrictions within the meaning of Article VIII, Section 2, except where the member has presented a program for the reduction and/or the eventual elimination of such arrears. When payments arrears are incurred by a government or by a government entity, the financial operations of which clearly form part of the budgetary process, and in those cases in which arrears arise because a country belonging to a common central bank is unable to obtain domestic currency in order to purchase required foreign exchange, the arrears should be treated as defaults and not as exchange restrictions within the meaning of Article VIII. In the settlement of payments arrears, member countries should observe the principle of nondiscrimination as regards creditor countries.

3. The Fund's policies on payments arrears are also concerned with their treatment in the context of stabilization programs supported by use of the Fund's resources. In these programs, member countries are expected to take steps to reduce and eventually eliminate payments arrears relating to capital transactions as well as to payments and transfers for current international transactions. In formulating policy guidelines in these programs, the staff will continue to be guided by the approach set forth in the Executive Board decision of 1970 (Decision No. 3153-(70/95)), as quoted on pp. 12. This approach will also be followed with respect to payments arrears arising from default. The technique chosen by a member to reduce outstanding arrears will reflect its institutional arrangements, as well as the magnitude of the arrears and the severity of the balance of payments problem. When payments arrears are large in relation to a member's available foreign exchange resources, it may not be possible to aim at the elimination of the arrears within the program period. Special arrangements may be needed for the renegotiation of outstanding debt obligations when debt problems are particularly severe. Depending on the member's circumstances and the length of the program, it may be sufficient, in the early stages of a program, to reach an understanding with the member to avoid any further increase in outstanding arrears.

4. There has at times been uncertainty as to the circumstances in which a delay resulting from a governmental limitation on, or interference with, the availability of foreign exchange would constitute an undue delay and thereby give rise to payments arrears. A flexible and pragmatic approach would seem to be appropriate, whereby an undue delay would be defined as one that exceeds the period reasonably needed to complete the administrative procedures required to establish the bona fides of an application for foreign exchange, having regard to the circumstances of the member concerned.