Mr Polak

MEMORANDUM

TO: Mr. Rhomberg
Mr. Ridler

March 10, 1967

FROM: J. Marcus Fleming

SUBJECT: Compensatory Financing--Double Compensation--
Sequence of Ordinary Drawings

Quite probably we shall soon have to deal with the question of improving the procedure for calculating double compensation in the event of a sequence of ordinary drawings occurring within the shortfall period of the compensatory financing drawing. One possible solution was outlined in the earlier drafts of the annex of the Colombia paper but was dropped. I would like you to consider the relative merits of that solution and of one or two other possibles:

1. Calculate the compensatory element attributable to each of the ordinary drawings as if it had been the only ordinary drawing in the period, and subtract the largest of these compensatory elements from the shortfall calculated with respect to the compensatory drawing.

2. Consider as compensation already paid either the prorated shortfall associated with the latest ordinary drawing or the sum of the prorated portions of all the ordinary drawings, whichever is the less.

There may be other and better solutions.

We ought also to consider how to assess the compensatory element in an ordinary drawing which takes place after the end of the shortfall period associated with the compensatory financing request but before the said request.

Mr Polak

Mr. Ridler

February 24, 1967

J. Marcus Fleming

Niger--Compensatory Financing

We can deal with the question of ex-French colonies receiving some sort of an export support from France or the European Community when the problem arises. My present prejudice would be in favor of adopting some convention under which any sums paid to countries with respect to export or price shortfalls should be counted in our compensatory financing calculations as if they were export receipts.

cc: Mr. Rhomberg

Mr Polak

Mr. Ridler

February 24, 1967

J. Marcus Fleming

Compensatory Financing--New Zealand
Your Memorandum to Mr. Schwartz of January 30

A drawing by New Zealand would be the first time that a more-or-less developed primary producer made use of the facility, and New Zealand would be rather wise to have a good case and not one that depended too much on optimistic export projections.

I think we should be a little wary of becoming too much involved in the export forecasts of members. We do not wish to get into a position in which we have more or less committed ourselves to their reasonableness in advance of an actual application. Forecasts are always to be made by the Fund, and the burden of proof that they are unreasonable should lie on the country.

I feel very doubtful about the propriety of going over to a basis of exchange control receipts from exports rather than export shipment values. While I would agree that the exchange control receipts might often be more relevant to the purpose of compensatory financing, nevertheless this need not always be so (e.g., there might be lags and leads due to exchange speculation), and besides the primary consideration is the equality of treatment as between different countries. I certainly do not think that countries should be given a choice on each occasion as to whether exchange receipts or export shipments should be used. If we do admit exchange control receipts, I think we shall have to require countries to choose once for all on which basis they wish their fluctuations to be measured.

cc: Mr. Rhomberg
Mr. Beveridge

MEMORANDUM

TO: Mr. Fleming (on return) February 13, 1967

FROM: J. J. Polak

SUBJECT: Compensatory Financing--Ceylon

The lawyers had some difficulty in the outgoing cable to Ceylon because they wanted to be assured that the calculation of Ceylon's entitlement did not hinge on a particular way for double compensation which might later be reversed. I assured myself, with Mr. Ridler's help, that Ceylon would be entitled to one quarter of its quota on any reasonable or unreasonable way of treating the double compensation issue.

The lawyers wanted the door left open for calculations of the norm for earlier dates in this connection, which were based on forecasts as they would have been made earlier in the shortfall year. I told them I would in no event agree to the making of such retroactive forecasts.

I am somewhat concerned, however, about the fact that norms calculated for earlier dates in the shortfall year may deviate considerably from the norm calculated for the year as a whole, even in cases where the time lag is as little as one month. I should like you to consider, therefore, whether we could not adopt the convention that for purposes of these calculations we combined the three statistical years preceding the ordinary drawing that might possibly overlap with the compensatory drawing, with the same two future years that we use to estimate the shortfall. These years have, in any event, somewhat of the character of normal years in the near future rather than the specific two years following the shortfall year. This technique would have the advantage that as preceding drawings were closer to the compensatory drawing, they would be based on a norm that increasingly approached the norm for the shortfall year. The gap between the statistical years and the forecasted years would increase as one went back; but at the same time the weight would decline. In any event, this would be a convention which I believe as such might be better than the convention of simply taking the statistical average.

cc: Mr. Rhomberg
Mr. Ridler

Mr. Ridler February 13, 1967

J. J. Polak

Ceylon--Compensatory Financing

You are quite right that the Legal Department's memo could have been written better, but I would not bother to suggest to them to change it.

cc: Mr. Fleming
Mr. Rhomberg

Office Memorandum

TO : Mr. Polak

DATE: February 13, 1967

FROM : Duncan Ridler DR

SUBJECT : Ceylon - Compensatory Financing

With reference to the last paragraph of Mr. Evans' memo to files of February 10, rephrasing would be appropriate, possibly:

> .....the Research Department has informed us that, according to the rules set out in SM/65/101 and used in the Ghana case, no part of these drawings would be considered to have compensated for the shortfall for which the compensatory financing drawing request is made. On the basis of the statistical formula, no shortfall existed at the time of the January and June stand-by drawings. Although no determination of shortfall was made by the export forecast method at the time of these drawings, it was the view of the Department that even if the procedure were to use shortfalls determined by the export forecast method for purposes of double compensation, the compensable shortfall now existing would still be at least 25 per cent of quota.

cc: Mr. Fleming
Mr. Rhomberg

Mr. Polak

February 10, 1967

MEMORANDUM FOR FILES

Subject: Ceylon - Compensatory Financing Drawing

Ceylon has indicated that it would like to ask for a compensatory financing drawing in the amount of 50 per cent of its quota or $39 million. The Fund has responded to this inquiry on two points as follows:

1. Export shortfalls as a result of a "disaster or major emergency". - Ceylon was told that they had not presented a case which indicated that the shortfall resulted from "disasters or major emergencies" as stipulated in paragraph 5 of the Compensatory Financing Decision for a drawing up to 50 per cent of quota. The "emergency" situation they cite is that "Ceylon is facing a major emergency owing to the rapid decline of export earnings at a time when import prices have been rising and her external assets have reached dangerously low levels". And further, that the situation was "all the more urgent when the deterioration in the terms of trade is brought about by an increase in prices of an important food import". Leaving aside the point that compensatory financing does not compensate for increases in import prices, the size of the shortfall does not determine whether it resulted from a "disaster or major emergency".

Export earnings did decline due to difficulties resulting from a strike of workers in exporting firms. However, this event cannot be classified as a "disaster or major emergency".

2. Double compensation. - The period for which export data is available and for which the shortfall is calculated is December 1, 1965 through November 30, 1966. The shortfall calculated by the statistical formula amounts to $23 million, and by the export forecast method is predicted to be well above $30 million. The Ceylonese have calculated $39 million on the basis of their own export forecasts. During the shortfall period, Ceylon made the following drawings under outstanding stand-by arrangements:

January 1966	$7.50 million
March 1966	$4.0 "
June 1966	$7.50 "
September 1966	$3.75 "
December 1966	$7.50 million

The drawing of $4 million was in connection with payment of the gold tranche for an increase in quota and is therefore not involved in the problem of double compensation.

With respect to the drawings in January and June of 1966 amounting to $15 million the Research Department has informed us that it has made calculations of the export shortfall over the 12 months immediately preceding each drawing using both the statistical formula and the export forecast method. They said that under either calculation there was no export shortfall. Therefore, these drawings could not enter into the problem of double compensation. Since the shortfall for the period of December 30, 1966 to December 1, 1967 is predicted to be well above $30 million, no question of double compensation arises with respect to the last two drawings in September and December of 1966 amounting to $11.25 million. Even if all of these are assumed to have compensated for part of the shortfall and deducted from it, the balance is still larger than the amount of one tranche of Ceylon's quota, which is equal to $19.5 million.

James G. Evans, Jr.
Senior Counsellor

cc: Mr. Gold
Mr. Polak
Mr. Woodley
Mr. Nicoletopoulos
Mr. Ridler

Office Memorandum

CONFIDENTIAL

TO : Mr. Polak

DATE: February 7, 1967

FROM : Duncan Ridler

SUBJECT : Compensatory Financing - Ceylon

The advance notice of a shortfall situation in Ceylon (Mr. Rajapatirana's letter of February 3, 1967) appears to be well-founded. Their own export forecasts are probably not unreasonable, and on that basis the shortfall would amount to somewhere between $37-39 million. Allowing for compensation imputed to previous stand-by drawings, in accordance with the rules used in the Ghana case, leaves an uncompensated shortfall of the order of $26 million. Twenty-five per cent of Ceylon's quota is $19.5 million.

There would not seem to be any question of waiving the double compensation rule as suggested by the Ceylonese authorities, although there was no express anticipation of an export deterioration at the time of the stand-by arrangement. The question of double compensation would pose no difficulty if Ceylon were content with a request for a drawing of 25 per cent of quota, but as a request for 50 per cent of quota is intimated, the issue could be seriously raised.

The case for permitting a drawing of more than 25 per cent of quota under the emergency clause will have to be considered. The authorities stress (and have done so in the past) terms of trade problems. However, the situation which led to the sudden emergence of the present large shortfall was one of strike-bound exports during the whole of November. Presumably a good part of these have now been shipped. Personally, I should feel they do not have a very strong case for claiming an emergency for compensatory financing purposes.

I understand that there may be some difference of opinion on the extent to which Ceylon has been cooperating with the Fund, a condition for any drawing of more than 25 per cent of quota. Some members of the Board apparently pressed for more consideration of devaluation at the time of the stand-by arrangement. It is interesting that Ceylon now attributes part of the shortfall to the Indian devaluation. The higher cost of rice, also stated to be part of the emergency, is also related to Fund advice to reduce food subsidies.

On the whole, a solid case could probably be made for a 25 per cent drawing, and it would seem much more satisfactory if the authorities could be persuaded to limit the request to this amount.

cc: Mr. Fleming
Mr. Rhomberg

Mr. Rhomberg December 6, 1966

J. J. Polak

Compensatory Financing and Stabilization Schemes, Your Memorandum of July 20, 1966

As I mentioned to you a few weeks ago, I think this paper would be improved by turning the second section (page 4 ff.) around. I would begin with contributions in kind. Of these, all one would have to decide would be that they were not considered exports, since they did not yield export proceeds. I see no need to compute any valuation for these contributions. One could then follow this up by stating that commodities sold to a buffer stock would be considered as exports but that the financial contributions made for this purpose should be taken as negative exports. This treatment would not, however, necessarily apply to all financial contributions made to all commodity arrangements. Some of these contribution are for the purpose of commodity propaganda, and we have not followed the practice of treating exports net of the imports of goods and services they required.

cc: Mr. Fleming
Mr. Ridler

Draft: R. R. Rhomberg
July 20, 1966

Fund Assistance Under the Compensatory Facility to Countries Cooperating in ~~Commodity Stabilization~~ Schemes

The Fund's compensatory financing facility aims at a reduction of the fluctuations around a medium-term trend in members' export "availabilities," i.e., export proceeds plus compensatory drawing or minus repurchase of such a drawing. Two questions of Fund policy with respect to the compensatory facility arise in cases where members--as a group, and at some cost to themselves--undertake to reduce the instability of their export earnings through a commodity stabilization scheme:

(1) Under what circumstances is a member eligible to receive assistance under the compensatory facility if it has taken measures, in accordance with its obligations under a commodity agreement, designed to alter its export receipts either in a shortfall year or in the two years preceding it?

(2) If a member participating in a commodity stabilization scheme must at times make payments to a supra-national agency and at other times receives payments from the agency, should such payments be taken into account in determining the existence and magnitude of an export shortfall (or excess)?

Responsibility for a shortfall

Under the Fund's compensatory financing facility, a member is eligible for assistance only if the shortfall "is largely attributable to circumstances beyond the control of the member." This provision is intended to ensure that members are not compensated for shortfalls that have been brought about by policies reducing, or limiting the growth of, export earnings. As has been discussed elsewhere (SM/66/77, pages 15-16), it is in practice extremely difficult to attribute a shortfall in export receipts to one or several of a large number of factors that could in principle have contributed to it. Even where a member has pursued policies which have clearly had the effect of reducing the volume of exports, a separate judgement as to the price elasticity of demand would often be required in order to permit the assertion that the member has so acted as to reduce the value of exports. For instance, if the average price elasticity of demand for a countries exports is less than unity, any policy (including one leading to outright inflation) which limits the volume of exports would tend to raise export receipts valued in foreign currency and any policy which encourages exports across the board, or the exports of those commodities with particularly low price elasticities, would tend to reduce export receipts. These considerations show that the provision cited above must be interpreted with some care in order to do justice to its intent. It is for instance, not intended to make a member ineligible for a compensatory drawing merely because it has failed to restrict the volume of exports of a commodity in inelastic demand. Broadly speaking the provision is designed to limit the use of the Fund's facility either in flagrant cases of artificially created shortfalls--say, through, deliberate variations in the timing of marketing of major commodities designed to give the appearance of a shortfall in a particular twelve-month period--or in instances where policies adversely affecting exports with a reasonably high price elasticity of demand can be demonstrated.1/

A careful interpretation of the provision with respect to the responsibility of a shortfall is also necessary where a member deliberately alters the volume of its exports by acting in compliance with the provisions of an international commodity agreement to which it is a signatory. Two cases may be singled out for discussion. First, a member may have reduced export sales of a principle export commodity in compliance with an export quota imposed by the agency administering the commodity agreement. If the member nevertheless has an export shortfall, this should not be attributed to the action of the member regardless of what is judged to be the price elasticity of demand for the exports of the individual member. Since such agreements are generally concluded in the case of commodities the world demand for which is inelastic with respect to price, the member's export receipts would have

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1/ Even in these cases it would be necessary to show that the same policies have not also reduced the volume of those exports which are in inelastic demand so as to offset the adverse effect on export receipts from commodities the demand for which is price elastic.

been ~~even~~ lower than they actually turned out to be if all producers of the commodity had sold larger amounts than were allocated to them under the agreement. The fact that the individual member could conceivably have increased its export proceeds from the commodity in question <u>in that year</u> by withdrawing from the agreement should not be interpreted to mean that failure to withdraw places the responsibility for the shortfall upon the member.

A second case which might arise would be that of a shortfall in a year in which a previously existing commodity agreement has ceased to exist and in which an increase in export sales causes a sharp price decline in the world market compared to the two preceding years, in which the agreement was still in force. Here again, adherence by a member to the commodity agreement in the two preceding years should not be taken as evidence that the current shortfall is attributable to the countries' policies in the past.

The general principle by which the Fund should be guided in compensatory financing cases where the member adheres, or has adhered in the past, to a commodity agreement is straightforward where the agreement can be judged to have, in general, the effect of stabilizing the export receipts of participating producing countries. Although stabilization may not, in fact, always be achieved in the normal operation of the commodity agreement, and members' proceeds from the commodity may in some instances be destabilized by (a) the introduction of a commodity agreement, (b) its cessation, or (c) major changes in its provisions, it can be taken at face value that each participating member entered into, and continued to adhere to, the agreement in the expectation that its export proceeds from the commodity in question would over the longer run tend to be stabilized. The matter is somewhat more complicated in the case of commodity agreements whose ~~policy~~ purpose is not clearly to stabilize the export receipts of participant producing countries but, say, to raise the export proceeds in the longer run without regard to the question of medium-term stability of export proceeds. Nevertheless, where an assessment of the provisions of an agreement indicate that it is clearly in the longer-run interest of the primary producing countries concerned, it behooves the Fund to take a liberal view with regard to the attribution of export shortfalls to policies prescribed to the country under the agreement.

Computation of Shortfalls

When a member takes steps, involving some foreign exchange cost, intended to improve its export performance or to stabilize its export proceeds, it can be argued that the Fund should make allowance for such foreign exchange cost in determining the assistance which can be extended to the member under the compensatory financing facility. Any effort of this nature by an individual member would be a partial substitute for Fund assistance, compensatory or otherwise, and make this assistance--which in view of the Fund's limited resources must always remain limited--to that extent more effective. The Fund should not, therefore, counteract--and should, if possible, re-enforce--any incentive inducing members to take steps designed to increase or stabilize export receipts.

Participation by a member in a commodity stabilization scheme of the bufferstock type may give rise to situations in which this general consideration becomes applicable. The potential contribution of the Fund to the financing of commodity stabilization schemes is limited in two ways. First, the Fund can provide assistance only to member countries but not to a supra-national organization set up by a group of countries for the purpose of administering a commodity stabilization scheme. Second, the Fund extends only short-term assistance and would, therefore, be an appropriate source of financing, only with respect to temporary requirements that would, in the course of the operation of the stabilization scheme, tend to be reversed within a relatively short period of years.

Within these limitations, the Fund could extend assistance to a member country which experiences temporary balance of payments difficulties that may in part be caused by fulfillment of its obligations under a specific commodity agreement. For instance, under some agreements, countries must make contributions, either in foreign exchange or in kind, to a supra-national agency in order to endow the agency with financial resources or working stocks of the commodity necessary to carry out intervention in the commodity market. Such contributions were required under the International Tin Agreement and are now being discussed in the group considering an international cocoa agreement. Provided that the operations of the agency result in greater stability of the export earnings of the participating countries, contributions in foreign exchange or in kind can be considered a necessary cost incurred by partiepating producing countries to ensure a more stable flow of export earnings from the commodity in question.

When a participating country makes a contribution in foreign exchange which increases an existing balance of payments deficit, it can have recourse to the Fund ~~and~~ under existing policies on general drawings. It would be reasonable to extend the scope for Fund assistance in these cases by permitting producing countries to take advantage of the policy on compensatory financing of export fluctuations in the following way. Foreign exchange contributions by the participating country to the agency would be deducted from export receipts for purposes of determining the export norm and any shortfall. As a result, an existing export shortfall would increase by one half of the amount of the foreign exchange contribution (assuming that there were no such contributions in prior years), or the contribution could give rise to a shortfall where none existed when only the export data alone are taken into account.

Similarly, if a commodity agreement provided for payments by the agency to producing countries which could be considered as restitution of contributions made earlier by the country in question, such amounts would have to be added to exports proceeds for the years involved in the calculations in order to determine the amount of a shortfall, or excess, of exports compared to the norm.

The rationale for making such an allowance in the determination of an export shortfall or excess under the compensatory financing policy would seem to be as follows: the contribution by a participant country to the agency serves the purpose of preventing a decline in export receipts, either in the year in which the contribution is made or in some subsequent year, by an amount which would generally be larger than the amount of the contribution itself. This would, at any rate, tend to be so in the case of commodities with inelastic world demand, i.e., in the case of those commodities for which the question of a bufferstock arrangement is likely to arise. Partial compensation for the foreign exchange contributions made by participant countries would, therefore, take the place of partial compensation for larger export shortfalls which would be likely to have manifested themselves in the absence of the commodity agreement and would thus constitute a saving of Fund resources.

If the contribution of a participant country to the agency consists of stocks of the commodity in question, the amount of export earnings foregone should be treated in the same manner as any cash contributions discussed above. With regard to the valuation of the contribution two principles could be followed. First, the quantity contributed could be valued at average market prices during the twelve-month period with respect to which a shortfall or excess is to be determined. Such a valuation base would leave out of account the fact that in the absence of such a contribution in kind the market price may have been lower. Second, the contribution could be valued in terms of a hypothetical price that would have resulted if the amounts contributed by all participating countries had actually been sold in the market.

There would be two reasons for choosing the first valuation basis rather than the second. In the first approach computations would be based on actually recorded, rather than hypothetical, prices. Considerable uncertainty would exist in many cases with respect to the assumptions under which the hypothetical prices should be computed. For one thing, it would be necessary to make an assumption about the price elasticity of demand for the commodity. Moreover, it would be necessary to assume the portion of the amount contributed by participant countries to the agency that would have been sold in the market rather than stored or otherwise withheld by producing countries.

The second reason may be even more important. A provision for making an allowance in the shortfall computation for contributed stocks valued at hypothetical prices that are lower than current market prices would simply lead to shadow transactions, whereby participating countries nominally contribute foreign exchange to the agency and the agency in turn purchases, at current prices, the stocks which would otherwise have been contributed directly by the participating countries. The ultimate effect on shortfall computations would thus be the same as if contributed stocks had been valued at current prices at the outset.

Mr. Polak,

Mr. Rhomberg October 19, 1966

J. Marcus Fleming

Table 1 of 1963 Report on "Compensatory Financing of Export Fluctuations"

We have been requested by the UNCTAD Intergovernmental Group on Supplementary Financing to prepare an updating with data as recent as possible of Table 1, on page 19 of our 1963 Report on "Compensatory Financing of Export Fluctuations." Could this be set in hand?

We have also been requested to prepare, in consultation with the Bank, an estimate of the effects of recent changes in our compensatory financing facility on the annual cost of the supplementary financing scheme.

The Bank has also been asked to prepare, in consultation with us, a study on the relative importance of shortfalls and other causes of instability on the external financing of development, and, to the extent possible, estimates of the effects of these causes on selected countries.

Could we discuss these last two studies?

cc: Mr. Polak
Mr. Schwartz

Office Memorandum

TO : Mr. J.J. Polak

DATE: October 14, 1966

FROM : Duncan Ridler DR

SUBJECT : Compensatory Financing

Over the last few weeks, we have looked into the position of the following countries for purposes of compensatory financing. The initiative came either from government representatives, area departments or from this office.

Ghana	Colombia
Ceylon	Dominican Republic
Syria	Haiti
Tanzania	Tunisia
India	
Several CFA currency countries	

Most of these were not at the moment in a shortfall position; the exceptions are Ghana, Dominican Republic, Tunisia and India. The Indian case is, hopefully, a very temporary result in the weeks immediately following devaluation. The other three are probably serious preliminaries. Some CFA currency countries have shortfalls, but there appears to be no real question of calling on the facility.

We are being asked more by Area Departments to attempt to forecast a shortfall to the month; in addition to projecting the two years following. This seems useful in giving more time for preliminary discussion and consideration in relation to other drawing or standby applications.

My usual procedure now is to review the position of all primary producing members about every two months, and in cases considered advisable to contact the Department concerned. The number of cases of shortfall brought up by the periodic review has been increasing through the year; to eleven at the beginning of September;

Burma	Cameroon
Dominican Republic	Ivory Coast
Ghana	India
Sudan	Syria
Tanzania	Vietnam
New Zealand	

For various reasons some of these were not in the running for more detailed investigation of the position.

cc: Mr. Fleming
Mr. Rhomberg

OUTGOING MESSAGE

OFFICIAL

INTERNATIONAL MONETARY FUND
WASHINGTON · D.C.

FOR PREPARING OFFICER
- [X] Night Letter
- [ ] Full Rate
- [ ] Code

SPECIAL INSTRUCTIONS

cc: Mg. Dir.
Dep Mg. Dir.
ETRD
RES
LEG
TRE
SEC

To: Marcus Fleming
Interfund Geneva

Re your cable October 12. We agree that if a request is made we will not be able to refuse it. However we would very much hope that it will not be ~~raised~~ made. Regards

Southard

Drafted By ESturo/am

Department ETRD

Date October 12, 1966

AUTHORIZATION

/s/Frank A. Southard, Jr.
Signature

Second Signature When Required

DISPATCHED
OCT 12 1966
IMF
CABLE
ROOM

FOR CODE ROOM
Time Received 5:00 PM
Time Dispatched 5:07 PM
No. of Words 43
73451
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DO NOT TYPE BELOW THIS LINE

Third Draft: R. R. Rhomberg
September 23, 1966

Developments in the Fund's Facility on
Compensatory Financing of Export Fluctuations

In February 1963, the International Monetary Fund established a new facility for compensatory financing of export fluctuations. Under this facility, which is designed particularly to benefit primary exporting countries, a member may obtain financial assistance from the Fund up to 25 per cent of its quota to compensate for temporary shortfalls in export receipts from the medium-term trend value of exports. This trend value is estimated partly on the basis of a statistical formula applied to current and past exports and partly from an assessment of the country's export prospects. The policies of members drawing under this facility do not have to meet the tests that the Fund applies in the case of ordinary drawings. (In accordance with the Fund's "tranche policy," these tests increase in stringency as drawings outstanding account for a larger percentage of a member's quota.) However, members do have to satisfy the Fund that they are encountering payments difficulties, that the shortfall is of a short-term character and is largely attributable to circumstances beyond the member's control, and that the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

To date, this facility has been used by three countries: Brazil and the United Arab Republic in 1963 and Sudan in 1965. The fact that compensatory drawings have not been requested more frequently during the last three years is the result of a number of special circumstances, particularly a generally favorable trend in prices of primary products over much of this period. It would seem likely, however, that the facility will be used more frequently in the future.

During the past year, the Fund has studied ways in which this facility could be made more useful to members and has, through a recent decision of the Fund's Executive Directors, made a number of changes in the facility to this end. THE NEW DECISION AND ACCOMPANYING REPORT WILL BE PUBLISHED ON SEPT 26. The principal features of the new policy are as follows:

First, whereas heretofore compensatory drawings outstanding could not normally exceed the amount equivalent to 25 per cent of a member's quota, the facility has now been amended to permit outstanding compensatory drawings up to an amount equivalent to 50 per cent of a member's quota, with the qualification that, except in the case of shortfalls resulting from disasters or major emergencies, outstanding drawings may not increase by more than 25 per cent of quota in any twelve-month period. Compensatory drawings in excess of 25 per cent of quota will be granted only when the Fund is satisfied that the member has been cooperating with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

Second, the compensatory facility will henceforth be separate from other drawing facilities of the Fund, in the sense that the amount of outstanding drawings under the compensatory facility will not affect members' ability to draw from the Fund under the Fund's policies regarding ordinary drawings in the various quota tranches. This means that the facility will be, so to speak, "floating."

Third, a member may within six months of an ordinary drawing reclassify all or part of it as a compensatory drawing and thus restore to that extent its normal drawing rights for future contingencies, provided that, in the circumstances existing at the time of the request for reclassification, the member could make a compensatory drawing for that amount.

Fourth, consideration has been given to the repayment system appropriate in the case of compensatory drawings. It was decided to retain the present system under which members repay the Fund within an outside limit of three to five years. At the same time, in order to encourage members to reduce fluctuations in their export receipts, net of the amounts of transactions under the facility, the Fund decided to recommend that members repay in the years following a drawing under the facility an amount approximately equal to one half of any excess of exports over the medium-term trend value of exports.

MEMORANDUM

TO: The Files

October 10, 1966

FROM: J. J. Polak

SUBJECT: Compensatory Financing--Dominican Republic

After a lengthy discussion it was agreed:

(a) That civil war, etc., should be considered as among the factors outside the countries' control that would entitle a country to Compensatory Financing.

(b) That the actual situation in the Dominican Republic was not of disaster or major emergency, so that the question of a second 25 per cent could not arise in this case.

The legislative history cited by the lawyers did seem to indicate, however, that "disasters or major emergencies" would include noneconomic events such as civil disturbances. It was also noted that the Dominican Republic did meet the second test for the second tranche in the sense that it had "been cooperating with the Fund -----------," although this cooperation had not led to agreement on a program.

cc: Mr. Fleming
Mr. Rhomberg
Mr. Ridler

Mr. Hicks October 10, 1966

J. J. Polak

Compensatory Financing Decision and Members' Fund Positions

I agree with you that it is not practicable at the present time to redefine countries' Gross Fund Positions on the basis of 250 per cent of quota. The greatest difficulty in this connection is perhaps to distinguish between countries that can and those that cannot avail themselves of the Compensatory Financing Decision. The Decision itself does not make any such distinction and you will recall that Ed Dale made quite something of the theoretical possibility of the U.S. drawing under this facility. While the two compensatory tranches are, of course, available only if a country runs into an export shortfall, that does not make their use less likely than say the fourth credit tranche. We may, therefore, at sometime in the future want to define Gross Fund Positions from a 250 per cent base, or we may at least indicate in a less statistical context that this would be a reasonable alternative way of measuring them.

The position is different with respect to the measurement of the gold tranche, since the compensatory facility is not automatic in the gold tranche way. I would see no basis, therefore, on the basis of the present policy to suggest that the gold tranche availability ought to be measured from a 150 per cent of quota base.

As to the particular treatment in *International Financial Statistics*, I agree with your new definition of the total tranche position. I would think, however, that we should avoid complicating further the definition of the gold tranche. Since the number of cases where gold tranche type drawing facilities will arise in the credit tranches as a result of outstanding compensatory drawings would probably be quite rare, I would suggest that you handle them by making a footnote allowance for this possibility in your definition of the Reserve Position in the Fund. I would add a footnote there, or a sentence in parenthesis, indicating that, for countries whose currency the Fund holds in an amount less than the quota, disregarding holdings arising from compensatory drawings, the gold tranche position is replaced by the excess of the quota over Fund holdings not arising from compensatory drawings.

Two other points: In addition to the footnotes you suggest, I think one would also be necessary in the reserves table and perhaps to line 1b on the country pages, but of course, only if this particular aspect of a compensatory drawing applied.

Secondly, may I mention that the words "and separately" ending the little paragraph on "lendings to the Fund" is perhaps a little cryptic even after the section on "Fund borrowing." I would suggest "either under the General Arrangements to Borrow or otherwise," or perhaps even better, a reference back to the section on Fund borrowing instead of the last clause.

Office Memorandum

TO : Mr. Polak

DATE: October 7, 1966

FROM : Earl Hicks E.H.

SUBJECT : The Compensatory Financing Decision and Members' Fund Position

The Compensatory Financing Decision, by establishing drawing possibilities outside the tranche schedule and by providing that such drawings may carry Fund holdings beyond the 200 per cent limit, complicates the conception of members' Fund positions. Reserves, it seems to me, consist in the moneys available for use in the finance of deficits. The assurance of moneys in the event of a deficit arising from the most likely source of deficit would therefore seem to increase the Gross Fund Positions of raw material countries to 250 per cent of quota minus Fund holdings of their currencies, and to increase their Gold Tranche Positions to 150 per cent of quota minus Fund holdings.

I doubt that anyone would agree to this presentation. I suppose therefore that we should instead redefine the terms to read:

> Gold Tranche Position = quota - /Fund holdings - those arising from outstanding balances on "compensatory" drawings/.
>
> Total Tranche Position = 200 per cent of quota - /Fund holdings - those arising from outstanding balances on "compensatory" drawings/.

This is palatable to me since near zero must be the drawing right value of drawings to which one is entitled on the formula:

$$1/2 \left(\frac{X_{-2} + X_{-1} + 2X_0}{4} - X_0 \right)$$

with the further limits of 1/4 Q and confirmation by market analysis that X_1, X_2, or X_3 will substantially exceed X_0. Perhaps it could be made understandable to readers if entries in

> columns 6 and 10 of Table I
> sections A and B of Table II
> line 2d of the Country Pages

were footnoted to identify the compensatory drawings and their repayment, the amounts of compensatory drawings in the figures, or the amounts included in the Fund's holdings of a members' currency arising from compensatory drawings and if a paragraph were added to the text (after the paragraph on Stand-bys) reading:

"Compensatory Finance. Countries dependent on raw material exports may also draw amounts up to 25 per cent of quota in each of two years to compensate partially for a short fall in export proceeds. These drawing possibilities are additional to those against tranche positions, may be made without regard to the 200 per cent of quota limit on Fund holdings of a members' currency, and re-establish themselves upon re-payment. Such drawings must be repaid under the rules that apply to ordinary drawings, or earlier if export proceeds recover rapidly."

I have always found it not possible to discuss the question of so-called compensatory financing without anger. Why should we wish to make a formal statement saying that if, as in the 1930's, the winds of deflation should blow in the industrial countries the Fund will do nothing either to help the raw material countries or to relieve the industrial countries from the repercussions of a downward spiral of exports? Is this question wholly academic?

"Compensatory finance. A member may draw amounts up to 50 per cent of quota to compensate for a shortfall in export proceeds from the medium-term trend value of exports, with the qualification that, except in the case of shortfalls resulting from disasters or major emergencies, outstanding drawings under the compensatory facility may not increase by more than 25 per cent of quota in any 12-month period. These drawing possibilities are additional to ordinary drawings in the various quota tranches, may be made without regard to the 200 per cent of quota limit on Fund holdings of a member's currency, and are re-established upon repayment. Such drawings must be repaid under the rules that apply to ordinary drawings and, in addition, the Fund recommends that a member repay in the years following a drawing under the facility an amount approximately equal to one half of any excess of exports over the medium-term trend value of exports."

Mr. Polak

Mr. Mervin

Sept. 12, 1966

Duncan Ridler

Compensatory Financing--Ghana

I attach a suggested cable draft for Qureshi as discussed. Mr. Polak agrees that from our point of view the application could proceed.

Since an application by Ghana would be considered under the revised facility, there are two provisions which have not been formally communicated, though I imagine that neither would affect the application. The first is the reclassification provision (paragraph 9 of the new Decision) which would allow Ghana, if it desired, to reclassify as a compensatory drawing the $16.4 million ordinary drawing made in June. Secondly, there is the provision recommending, but not obligating, repurchase to the extent of half of the export excesses occurring in the four years following the drawing. Otherwise, repurchase obligations are those of the present facility.

cc: Mr. Polak
Mr. Fleming
Mr. Rhomberg

For Qureshi

Discussion of Decision on revised compensatory financing facility now in sufficiently advanced stage. Report and Decision expected available shortly, but new provisions do not change possible current drawing entitlement under case outlined in Ridler memo of 8/16. Suggest you proceed advise application. Two letters required. First covering currencies and other representation matters in form first letter annexed EBS/63/142 and EBS/65/86 referring previous compensatory financing applications already sent you. Second containing broad statement of causes of export shortfall and effect on balance of payments position. Statement regarding policy intentions not obligatory in second letter. See section on policy conditions SM/66/77, page 16.

September 9, 1966

Mr. W. L. Hebbard

George P. Nicoletopoulos

Subject: Compensatory Financing

Attached are the texts of the two attachments to my memorandum of September 8 to the Managing Director revised in the light of yesterday's discussion.

cc: The Managing Director
The Deputy Managing Director
Mr. Altman
Mr. Gold
Mr. Polak
Mr. Finch
Mr. Colebv

ATTACHMENT I

Repurchase Provision of Proposed Decision on Compensatory Financing

(7) A member requesting a drawing under paragraph (5) will be expected to represent that it will make a repurchase corresponding to the drawing in accordance with the principles of E.B. Decision No. 102-(52/11) of February 13, 1952. With a view to an application of these principles appropriate to drawings under paragraph (5), the Fund recommends that, as soon as possible after the end of each of the four years following a drawing under paragraph (5), the member repurchase an amount of the Fund's holdings of the member's currency approximately equal to one half of the amount by which the member's exports exceed the medium-term trend of its exports. Calculations of export excesses for this purpose will be made with respect to successive 12-month periods following the period of the shortfall with respect to which the drawing was made and on the basis of statistical information only.

Explanation of Repurchase System (11)

As indicated on page 2 of SM/66/104, in the case of System No. 11 the repurchase provision (i.e., paragraph (7)) of the decision would contain a clause recommending that members use one half of any export excesses that they may have in any year to repurchase any outstanding drawings under paragraph (5). I should like to make it clear that this clause would not create a legal obligation for members. I believe that this calls for further explanation.

A member's representation as to repurchase under System (11) would be the same as that made in cases of ordinary drawings, i.e., that the drawing member would comply with the principles of the Decision of February 13, 1952. As Executive Directors are aware, such representations do not, as such, create a legal obligation, although they are often made binding on members as terms of a waiver under Article V, Section 4. The recommendation to members to use in repurchase one half of their export excesses would not create a legal obligation for members even in such cases, i.e., where the member's representation that it will repurchase in accordance with the principles of the 1952 Decision has been made legally binding under a waiver.

The purpose of the clause would be to express the hope of the Fund, based on what it would regard as an appropriate application of the principles of the 1952 Decision, that members would use export excesses to repurchase drawings under paragraph (5) still outstanding, but members which did not act in accordance with that recommendation would not be violating an obligation.

Office Memorandum

TO : Mr. J. J. Polak

DATE: September 8, 1966

FROM : R. R. Rhomberg

SUBJECT : Compensatory Financing Decision

My initial suggestion to Mr. Nicoletopoulos regarding the second part of paragraph (7) of the Decision was to add a separate sentence explaining the period with respect to which the calculation of excess exports will be made. He felt, however, that this would give too much emphasis to the nature of the calculation in a passage that would not refer to a legal obligation of the member but merely to a Fund recommendation. Mr. Nicoletopoulos therefore suggested the wording in the new version of Attachment I, leaving it open for you to raise the point once more in the meeting with the Managing Director this afternoon.

I believe the wording is still somewhat misleading. I think there is a minimum correction the words "each of" in the penultimate line should be crossed out and the word "periods" should be changed to the singular "period."

In the alternative formulation first suggested by me the sentence would have ended after the words "medium-term trend of its exports." The paragraph could end there with the method of calculation left implied or explained more fully in the text of the paper. If, however, a reference to the 12-month period for which the excess is to be calculated is found to be necessary, it would be possible to add a new sentence: "The excess of exports over the medium-term trend will be calculated with respect to each of the four 12-month periods following the period of the shortfall with respect to which the drawing was made."

I also mentioned to Mr. Nicoletopoulos the question of the medium-term trend calculation in the content of repurchase preference. I believe that it has always been in Mr. Fleming's mind that calculations of export excesses for purposes of repurchases would be strictly in accordance with a statistical formula and not on the basis of market analysis. The present language of paragraph (7), which merely refers to the medium-term trend would imply that this trend is to be established as stated in paragraph (6) of the Decision, i.e. based partly on appraisal of export prospects. It is Mr. Nicoletopoulos' understanding that this is indeed now the intended interpretation. The method of determining the medium-term trend established in paragraph (6) has great justification in the case of shortfalls, where it leads to a Board Decision on a drawing, then in cases of export excesses, where it leads to a recommendation to the member presumably without Board Decision. I believe that the introduction of market analysis into this repurchase recommendation procedure might cause considerable difficulty.

Call Geo. as soon as

Mr. Polak

The Managing Director — September 6, 1966

G. Nicoletopoulos

Compensatory Financing

Attached are (1) a draft of the repurchase provision of the proposed decision that we could circulate to the Board in case Repurchase System (11) is found acceptable; (2) a statement explaining the legal nature of the recommendation under Repurchase System (11) that members use one half of their export excesses in repurchase of drawings under paragraph (5).

I understand that a member of the Executive Board (the Alternate Director for Brazil) may ask at tomorrow's meeting whether drawings under paragraph (5) already outstanding (those of Brazil, U.A.R. and Sudan) would become "floating" if the proposed decision is adopted by the Board. The answer to this question is in the affirmative. We regard these cases as covered by the second sub-paragraph of paragraph (10) of the proposed decision which reads as follows:

> Moreover, the Fund will apply its tranche policies to drawing requests by a member as if the Fund's holdings of the member's currency were less than its actual holdings of that currency by the amount of any drawings outstanding under paragraph (5).

I should like to draw your attention to one additional point. Should the Board adopt Repurchase System (11), the words "and makes the representation .. ... repurchase representation" at the end of paragraph (9) would have to be deleted.

The attachments have been cleared by Messrs. Gold and Polak.

Attachments (2)

cc: The Deputy Managing Director
Mr. Altman
Mr. Gold
Mr. Polak
Mr. Finch
Mr. Coleby

Attachment I

Repurchase Provision of Proposed Decision on Compensatory Financing

(7) A member requesting a drawing under paragraph (5) will be expected to represent that it will make a repurchase corresponding to the drawing in accordance with the principles of E. B. Decision No. 102-(52/11) of February 13, 1952. ~~With a view to an~~ As regards the application of these principles appropriate to drawings under paragraph (5), the Fund recommends [urges] that, ~~in~~ at the end of each of the four years following a drawing under paragraph (5), the member ~~[illegible]~~ repurchase an amount of the Fund's holdings of the member's currency equal to one half of the amount by which the member's exports in the respective 12-month period subsequent to the shortfall period ~~estimated~~ exceed the medium-term trend of its exports, ~~in each of the four~~ respective 12-month periods following the period of the shortfall with respect to which the drawing was made.

~~For purposes of this provision~~ The excess of exports ~~and the m~~ over the medium-term trend will be calculated with respect to

Explanation of Repurchase System (11)

As indicated on page 2 of EB/56/104, in the case of System No. 11 the repurchase provision (i.e. paragraph (7)) of the decision would contain a clause recommending that members use one half of any export excesses that they may have in any year to repurchase any outstanding drawings under paragraph (5). I should like to make it clear that this clause would not create a legal obligation for members. I believe that this calls for further explanation.

A member's representation as to repurchase under System (11) would be the same as that made in cases of ordinary drawings, i.e., that the drawing member would comply with the principles of the Decision of February 13, 1952. As Executive Directors are aware, such representations do not, as such, create a legal obligation, although they are often made binding on members as terms of a waiver under Article V, Section 4. The recommendation to members to use in repurchase one half of their export excesses would not create a legal obligation for members even in such cases, i.e., where the member's representation that it will repurchase in accordance with the principles of the 1952 Decision has been made legally binding under a waiver.

The purpose of the clause would be to express the hope of the Fund, based on what it would regard as an appropriate application of the principles of the 1952 Decision, that members would use export excesses to repurchase drawings under paragraph (5) still outstanding, but that members which did not act in accordance with that recommendation would not be violating an obligation. It would be hoped that members would generally act in conformity with that recommendation, and, of course, the Fund would, in formulating its attitude toward future drawing requests by a member, take into account the record of members in this respect.

Explanation of Repurchase System (11)

As indicated on page 2 of SM/66/104, in the case of System No. 11 the repurchase provision (i.e., paragraph (7)) of the decision would contain a clause recommending that members use one half of any export excesses that they may have in any year to repurchase any outstanding drawings under paragraph (5). I should like to make it clear that this clause would not create a legal obligation for members. I believe that this calls for further explanation.

A member's representation as to repurchase under System (11) would be the same as that made in cases of ordinary drawings, i.e., that the drawing member would comply with the principles of the Decision of February 13, 1952. As Executive Directors are aware, such representations do not, as such, create a legal obligation, although they are often made binding on members as terms of a waiver under Article V, Section 4. The recommendation to members to use in repurchase one half of their export excesses would not create a legal obligation for members even in such cases, i.e., where the member's representation that it will repurchase in accordance with the principles of the 1952 Decision has been made legally binding under a waiver.

The purpose of the clause would be to express the hope of the Fund, based on what it would regard as an appropriate application of the principles of the 1952 Decision, that members would use export excesses to repurchase drawings under paragraph (5) still outstanding, but members which did not act in accordance with that recommendation would not be violating an obligation.

Mr. Polak

Revision of SM/66/77 from page 23 onwards
on the assumption that Repurchase System 8
of SM/66/97 is adopted

(never circulated)

[The following passage, to the end of the section on "Compensatory Facility and Fund Liquidity," diverges substantially from the corresponding passage from the foot of p. 22 to p. 26 inclusive in SM/65/101, and proposes a type of mixed repayment system for compensatory drawings different from that proposed in SM/65/101. These changes were made to meet the point made by a number of Executive Directors that repurchases out of export excesses, though avoiding the difficulties that would arise from repurchase requirements occurring at a time of poor or mediocre exports, might have difficulties of their own in that the amount of the repurchase obligation would not be known in advance. The system now proposed attempts to avoid or mitigate both sets of difficulties, in a manner not unduly expensive to the Fund.]

Two difficulties arise with respect to this fully compensatory system of repurchases out of export excesses. [The first concerns the predictability of repurchase obligations.] In the first place, countries might occasionally find it difficult to repurchase compensatory drawings to the full extent of any excess of actual over trend value of exports, partly because an expansion in exports would probably entail some increase in import requirements, and partly because the obligation to repay would not be known with certainty until after the event. This difficulty should not be exaggerated. Owing to the manner in which export excesses are calculated, only one half of any increase in exports over the average level in the two years preceding the excess year could give rise to a repurchase, and if serious problems on repurchase should nevertheless arise owing to circumstances affecting other items in the balance of payments, it would always be possible for the Fund, under appropriate conditions, to agree to an ordinary drawing at the time of the compensatory repurchase. Nevertheless, it is interesting to see what would be the effect on the performance of the scheme if repurchases were required to the extent not of the entire excess of exports but only of a part--say, one half--of such excess. [It is possible that countries might prefer to have their repurchase obligations expressed in a more predictable form.]

From Table 4 it can be seen that a system with semi-compensatory repurchases--i.e., repurchases equivalent to one half of any export excess in the preceding twelve months--would show slightly better smoothness and approximation ratios than would one with fully compensatory repurchase, at least where outstanding compensatory drawings are subject to a limit. This at first sight somewhat surprising result is attributable to the fact that the repurchases are spread over a number of "excess" years, for which export availabilities would otherwise have remained in their original unadjusted state. The average amount of drawings outstanding is somewhat greater under the semi-compensatory than under the fully compensatory system of repurchase but less than under the present fixed-term system.

The second difficulty [arises from the fact that under the] about systems of repurchase out of export excesses is that a proportion of the repurchases [of compensatory drawings] would probably remain outstanding for longer periods than has hitherto been deemed compatible with the temporary character of Fund assistance. This does not mean that repayment would normally be more delayed than under the 3 to 5 year rule. Indeed, if, as indicated in Table 4, the amount of compensatory drawings outstanding is generally likely to be less when repayments [are geared to exports] are fully compensatory or semi-compensatory than when they are made under the 3 to 5 year rule, the average length of time for which a drawing remains outstanding will also probably be less in [the former than in the latter case.] either of the two former cases than in the last-mentioned case. More direct measurements of probable periods for which compensatory drawings would remain outstanding if repayments were [also] on a fully or semi-compensatory basis are given in Table 5, which is based on the experience of the years 1951-64. From this it can be seen that, under a fully compensatory repurchase system, even with an unqualified limit of 50 per cent of quota, some two thirds of all compensatory drawings would be repaid within 3 years, and more than four fifths within 5 years. The residue remaining outstanding beyond 8 years might be about 1 per cent. Under a semi-compensatory system, the proportion of drawings remaining outstanding at the end of any given period is naturally somewhat greater. In considering these results, it should be borne in mind that the repurchase obligations under Article V, Section 7, would, of course, continue to apply--a fact which could not be taken into account in the calculations set forth at Table 5.

Table 4. Compensatory Financing: Fund Scheme with Varied Forms of Repayment, 1951-64[1]

Repayments System	Fixed Term[2]	Compensatory[3]	Semi-Compensatory[4]	Mixed [4/]	[5]
		25 Per Cent of Quota Limit			
Approximation Ratio[6]	.023	.028	.031	[.026]	.030
Smoothness Ratio[7]	.029	.045	.048	[.036]	.047
Average Drawings Outstanding[8]	.29	.17	.21	[.26]	.20
		50 Per Cent of Quota Limit (Unqualified)			
Approximation Ratio	.034	.042	.044	[.041]	.042
Smoothness Ratio	.046	.072	.073	[.060]	.071
Average Drawings Outstanding	.48	.36	.47	[.48]	.38
		50 Per Cent of Quota Limit (Qualified)			
Approximation Ratio	.035	.043	.046	[.042]	.043
Smoothness Ratio	.047	.071	.073	[.060]	.071
Average Drawings Outstanding	.45	.28	.38	[.42]	.32
		No Limit			
Approximation Ratio	.100	.155	.168	[.160]	.120
Smoothness Ratio	.121	.216	.199	[.205]	.166
Average Drawings Outstanding	1.36	1.49	2.05	[1.77]	1.17

1/ Weights of .50, .25 and .25 applied to years t, t-1, and t-2, respectively, for estimating calculated norm. 100 per cent compensation of calculated shortfall.

2/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

3/ 100 per cent of export excesses applied to repayment in all years.

4/ 50 per cent of export excesses applied to repayment in all years.

[4/ Repayment in five equal instalments, beginning in the year following the shortfall year: repayments on past drawings are deducted from exports for the purpose of computing shortfalls.]

5/ 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

6/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

7/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

8/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

[If the requirement that the Fund assistance be "temporary" could be deemed to be adequately met by the manner in which export shortfalls and excesses are calculated, and by the statistical probability that the average period of repayment will be short, this change is one which it would be advisable to adopt. However, it is considered that this requirement] It is considered that the requirement that Fund assistance be temporary would not be adequately met by a mere statistical probability that the average period of repayment will be short, but calls for a fixed maximum term for every drawing. [which would make it] This being so, it would be difficult to adopt [the repayment system under consideration] either the semi-compensatory or even the fully compensatory repurchase system in an unmodified form.

A "mixed" system on the following lines would [seem to meet] do something towards meeting both of the difficulties referred to above and [to] would combine many of the advantages of "compensatory" and "fixed term" repurchase respectively:

[The original text to the end of Section IX on page 26 is omitted.]

(a) If any export excesses should occur in the first four years following the shortfall year with respect to which a compensatory drawing had been made, an amount equivalent to one half of the excess would be devoted to repurchase.

(b) If the amount of the drawing to be repurchased under (a) above with respect to the fourth year following the shortfall year were less than half of the amount of the drawing still outstanding before that repurchase, an additional amount equal to the difference would be repurchased.

(c) In the fifth year following the compensatory drawing the drawing country would repurchase any amount of the drawing still outstanding.

However, to avoid double counting, if more than one compensatory drawing were outstanding at the same time, no repurchases out of export excesses would be required on any drawing while such repurchases could still be required on an earlier drawing. For example, where two compensatory drawings were outstanding concurrently no repurchases out of export excesses would be made on the second drawing until after the first drawing had been running for four years, or had been completely repaid.

For the reasons mentioned at page 22 above, the calculation of the export trend with respect to which export excesses are incurred for the purpose of establishing repurchase obligations would be made by the Fund, in consultation with the member, solely on the basis of the statistical formula used in the estimation of export shortfalls, i.e., without any attempt to forecast future exports.

Table 5. Duration of Drawings under Compensatory Repayments Systems 1/

(Period = 1951-64)

	25% of Quota Limit		50% of Quota Limit (Qualified)		50% of Quota Limit (Unqualified)	
	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings
			Fully Compensatory System[2]			
Total Drawings	.89	100	1.24	100	1.45	100
Repaid:						
Within 3 years	.74	83	.97	78	.97	67
Outstanding after:						
Fifth year	.09	10	.15	12	.27	18
Eighth year	.01	about 1[3]		about 1[3]		about 1[3]
			Semi-compensatory System[4]			
Total drawings	.69	100	1.01	100	1.20	100
Repaid:						
Within 3 years	.41	59	.49	49	.54	45
Outstanding after:						
Fifth year	.12	17	.33	33	.43	36
Eighth year	.03	about 4[3]	.13	about 14[3]	.21	about 20[3]

1/ Coefficients of .5, .25 and .25 applied to years t, t-1, and t-2, respectively, to compute shortfalls.

2/ One hundred per cent of excesses applied to repayment.

3/ Since some of the drawings in question were still outstanding at the end of the period but had not yet reached their eighth year, this figure is an estimate.

4/ Fifty per cent of excesses applied to repayment.

As will be seen from Table 3, the performance of this "mixed" system of repurchase, over the years 1951-64, as measured by the approximation ratio and smoothness ratio, would have been better than that of the "fixed term" (3 to 5 years) system of repurchase, equivalent to that of the fully compensatory system, and only slightly inferior to that of the semi-compensatory system of repurchase out of export excesses, irrespective of the severity of the limits on outstanding drawings.

The "cost" in terms of drawings outstanding is much lower than under the present system of fixed term repurchase, and almost as low as under fully compensatory repurchase.

X. Changes in the Compensatory Facility and Fund Liquidity

[On page 19 above an estimate was made of the possible charge on Fund liquidity that might arise from additional drawings associated with an extension of individual country limits on outstanding compensatory drawings from 25 per cent to 50 per cent of quota. At this point, a similar calculation is in order as to the charge on Fund liquidity that might result from adopting both of the] It may be appropriate, at this point, to estimate the possible charge on Fund liquidity that might result from additional drawings with the adoption of the two principal measures suggested above, viz., (a) the extension of the limit from 25 per cent to 50 per cent with the qualification that the increase in outstandings in any year should not exceed 25 per cent, and (b) the adoption of the "mixed" system of repurchase discussed above in place of the fixed-term system of repurchase which applies at present. Some additional claims on Fund resources might also arise from the proposed separation of the compensatory facility from the other drawing facilities of the Fund, but this cannot be quantified and is unlikely to be large.

As can be seen from Table 4, if the compensatory facility had existed over the period 1951-64, and if all the 48 countries covered by the Table had made full use of the facility, the transition from "fixed term" repurchase with a 25 per cent of quota limit, to a "mixed" system of repurchase with a qualified 50 per cent of quota limit would [over the 1951-64 period] have involved an increase in the average level of [potential] compensatory drawings outstanding over the period from \$290 million to [\$420]\$320 million, i.e., an increase of[\$130] \$30 million . From the standpoint of Fund liquidity, however, what matters is not so much the average amount of compensatory drawings outstanding as the amount liable to be outstanding at peak periods. It is estimated that, on the assumption set forth above, the maximum level of [potential] compensatory drawings outstanding would likewise have risen from \$400 million (in 1955) to [\$560] \$470 million (in 1958), i.e., by [\$160] \$70 million. On the assumption that peak year potential compensatory drawings outstanding have expanded since 1955-8 in proportion to quotas, the proposed changes in limits and repurchase systems might, under present conditions, raise maximum potential compensatory drawings from \$1,100 million to [\$1,500] \$1,300 million, i.e., by [\$400] \$200 million. [Allowing for failure to use the full entitlement to compensatory drawings and other factors,] Since, however, countries with adequate reserves will often not use opportunities for compensatory drawings that are open to them, and since any use made of the compensatory facility is likely to reduce to some extent requests for ordinary drawings, it seems unlikely that the increase in peak year drawings occasioned by the proposed changes would in practice exceed [\$200 million] half the amount mentioned above, viz., \$100 million.

XI. Conclusions for Action

More than three years have now elapsed since the creation of the compensatory financing facility, and though it has not been extensively used the Fund has had sufficient experience with it to review and reappraise its application and scope. As a result it has been deemed desirable both to clarify the circumstances under which the facility can be used and to introduce into it certain modifications designed to increase the effectiveness of the assistance which the Fund provides to members.

In determining the medium-term export trend for the purpose of calculating the export shortfall the practice hitherto has been to give approximately equal weight to statistical and qualitative estimates, respectively. Experience suggests that qualitative estimates based on commodity analysis gives a closer estimate of the trend; consequently qualitative estimates will receive a greater weight in the future.

At present, the Fund is prepared to waive the requirement that total outstanding drawings may not exceed the Fund holdings of a member's currency beyond 200 per cent of quota either to accommodate compensatory drawings or, to the extent that compensatory drawings are outstanding, to accommodate other drawings. However, drawings under the compensatory facility are included in Fund holdings of the member's currency in applying the tranche policies of the Fund to subsequent drawings. Full recognition of the special circumstances which give rise to compensatory drawings would make it desirable to separate this facility from normal drawing facilities of the Fund so that additions to the amount of compensatory drawings outstanding would not in any way affect the tranche policies applicable to other drawings.

While the use of the compensatory facility is most needed when a shortfall appears, members may be precluded or deterred from requesting use of the facility at that time since the full amount of shortfall can be known only after the interval of several months. To meet this problem it is proposed that within six months of any drawing, members should be enabled to reclassify all or part of it as a compensatory drawing and thus to restore to that extent their normal drawing rights for future contingencies.

Under the 1963 Decision outstanding drawings under the compensatory facility are limited normally to 25 per cent of quota. It is believed that an extension of the limit on outstanding drawings from 25 to 50 per cent of quota would add substantially to the value of the assistance provided. At the same time it is important to avoid such changes as would tend to weaken the ability of the Fund to exert its influence with members toward early adoption of sound corrective policies. It is, therefore, proposed that compensatory drawings outstanding may amount to a maximum of 50 per cent of quota, but that during any twelve-month period the amount of such drawings outstanding may not increase by more than 25 per cent of quota and that requests which would increase outstanding compensatory drawings beyond 25 per cent of quota should be met only if the Fund is satisfied that the member has been [following reasonably sound export policies.] [making reasonable efforts to solve its balance of payments problems.]

The question of repurchases of compensatory drawings has also been reconsidered in light of the possibility that the course of export receipts may make it [difficult for a member to repurchase drawings fully] undesirable for members to concentrate repurchases within 3 to 5 years after the drawings. On the other hand, repurchase terms should not be so changed as to undermine the revolving nature of Fund resources. Balancing these considerations, it is proposed that [compensatory drawings should be repayable in equal annual instalments over a five-year period but that the member should be able to offset such repurchases against actual export receipts for the purpose of determining the amount of any new compensatory drawings if it is able to satisfy the Fund that it has been pursuing reasonably sound export policies] in the first three years of a compensatory drawing half of any export excess should be repaid, in the fourth year half of any export excess or half the amount outstanding, whichever is the higher, and in the fifth year repayment should be completed.

XII. Decision

In the light of the foregoing considerations, Decision No. 1477-(63/8) of February 27, 1963, on Compensatory Financing of Export Fluctuations is hereby amended by the deletion of paragraphs (5) through (8) and the substitution of the following paragraphs:

"(5) The Fund has reviewed its policies to determine how it could more readily assist members, particularly primary exporters, encountering payments difficulties produced by temporary export shortfalls, and has decided that such members can expect that their requests for drawings will be met where the Fund is satisfied that

(a) the shortfall is of a short-term character and is largely attributable to circumstances beyond the control of the member; and

(b) the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

Drawings outstanding under this paragraph may amount to 50 per cent of the member's quota provided that: (i) such drawings will not be increased by a net amount of more than 25 per cent of the member's quota in any 12-month period, and (ii) requests for drawings which would increase the drawings outstanding under this paragraph beyond 25 per cent of the member's quota will be met only if the Fund is satisfied that the member has been [following policies reasonably conducive to the development of its exports.] [making reasonable efforts to solve its balance of payments problems.]

[10] (6) In order to identify more clearly what are to be regarded as export shortfalls of a short-term character, the Fund, in conjunction with the member concerned, will seek to establish reasonable estimates regarding the medium-term trend of the member's exports [on the basis of appropriate statistical data in conjunction with qualitative information about its exports prospects.] based partly on statistical calculation and partly on appraisal of export prospects.

[6] (7) [A member requesting a drawing under paragraph (5) will be expected to represent that it will make a repurchase corresponding to the drawing in equal annual instalments to commence one year after the drawing and to be completed not later than five years after the drawing. However, in estimating export shortfalls for the purpose of drawings under paragraph (5), the Fund will, if the member so requests, deduct from the figures for actual exports an amount equivalent to any repurchases made with respect to past drawings under paragraph (5) within 12 months of the request for the new drawing. A request for a drawing with respect to a shortfall which results in whole or in part from such deductions will be met by the Fund if it is satisfied that the member, in addition to fulfilling the requirements of paragraph (5), has been following policies reasonably conducive to the development of its exports.]

A member requesting a drawing under paragraph (5) will be expected to represent that, within five years from the date of the drawing, it will repurchase an equivalent amount of the Fund's holdings of the member's currency, as follows:

(a) Subject to (b) below, not later than 30 days after the end of each of the four years following the drawing, the member will repurchase an amount of the Fund's holdings of its currency equal to one half of the amount by which the member's exports exceed the medium-term trend of its exports in each of the four 12-month periods following the period of the shortfall with respect to which the drawing was made.

(b) Repurchases pursuant to (a) above in respect of a later drawing under paragraph (5) will be abated as long as repurchases can still be made pursuant to (a) above in respect of an earlier drawing under paragraph (5).

(c) If the amount of the repurchase to be made not later than 30 days after the end of the fourth year pursuant to (a) or (b) above is less than half the amount of the drawing remaining outstanding before that repurchase, the member will repurchase an amount equivalent to that difference not later than 30 days after the end of the fourth year.

(d) Not later than the end of the fifth year following the drawing, the member will repurchase any amount of the drawing still outstanding.

[7] (8) Whenever the Fund's holdings of a member's currency resulting from an outstanding compensatory drawing under paragraph (5) are reduced, by the member's repurchase or otherwise, this will restore *pro tanto* the member's facility to make a further compensatory drawing under that paragraph, should the need arise.

[8] (9) When drawings are made under paragraph (5), the Fund will so indicate in an appropriate manner. Within six months from the date of any drawing which is not under paragraph (5) and to the extent that it is still outstanding, a member may request that all or part of the drawing be reclassified and treated, for all purposes of this decision, as a drawing made under paragraph (5). The Fund will agree to such a request if at the time of the request the member meets the requirements for a drawing of an equal amount under paragraph (5) and makes the representation as to repurchase appropriate to such drawings, which representation will then be substituted for the original repurchase representation.

[9] (10) In order to implement the Fund's policies in connection with compensatory financing of export shortfalls, the Fund will be prepared to waive the limit on Fund holdings of 200 per cent of quota, where appropriate. In particular, the Fund will be prepared to waive this limit (i) where a waiver is necessary to permit compensatory drawings to be made under paragraphs (4) and (5) above, or (ii) to the extent that drawings in accordance with paragraph (5) are still outstanding.

Moreover, the Fund will apply its tranche policies to drawing requests by a member as if the Fund's holdings of the member's currency were less than its actual holdings of that currency by the amount of any drawings outstanding under paragraph (5).

(11) The provision of credit to deal with the balance of payments effects of export fluctuations provides immediate relief for a country's short-term difficulties. In many cases, however, it will also be necessary to introduce measures of a policy character in order to attain a satisfactory and lasting solution to a country's balance of payments problems. Members generally have actively cooperated with the Fund to find and adopt the measures necessary to this end. Beyond immediate balance of payments difficulties, the primary exporting countries are, in many instances, facing unfavorable long-term export trends, and all are trying to meet the challenge of achieving more rapid and sustained development through a strengthening and broadening of their economies. The last-mentioned problem will require action in many fields and over many years by both the primary exporting countries and the industrial countries, separately and in concert, including readier access to the markets of the developed countries for the products of the developing countries and an appropriate and sustained flow of technical and financial assistance to the developing countries. The Fund considers that its activities can provide valuable assistance in helping to establish a climate within which longer-term measures can be more effectively pursued.

(12) The Fund will review this decision in the light of experience and developing circumstances."

FOR AGENDA

Mr. J. J. Polak

Room 504 F

#1

SM/66/77
Revision 1
Supplement 1

August 26, 1966

To: Members of the Executive Board

From: The Acting Secretary

Subject: Compensatory Financing of Export Fluctuations: Draft Decision

The attached redraft of the proposed decision on Compensatory Financing reflects the changes discussed at Executive Board Meeting 66/73, on August 19, 1966. It omits the paragraph on the repurchase provision which is the subject of a separate paper, SM/66/104.

It is anticipated that this topic will be brought to the Board Agenda during the first week after the recess.

Att: (1)

Other Distribution:
Department Heads
Division Chiefs

Compensatory Financing of Export Fluctuations

Draft Decision

(To replace Section XII, pages 28-30, in SM/66/77, Revision 1)

In the light of the foregoing considerations, Decision No. 1477-(63/8) of February 27, 1963, on Compensatory Financing of Export Fluctuations is hereby amended by the deletion of paragraphs (5) through (8) and the substitution of the following paragraphs:

(5) The Fund has reviewed its policies to determine how it could more readily assist members, particularly primary exporters, encountering payments difficulties produced by temporary export shortfalls, and has decided that such members can expect that their requests for drawings will be met where the Fund is satisfied that

(a) the shortfall is of a short-term character and is largely attributable to circumstances beyond the control of the member; and

(b) the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

Drawings outstanding under this paragraph (5) may amount to 50 per cent of the member's quota provided that (i) except in the case of shortfalls resulting from disasters or major emergencies, such drawings will not be increased by a net amount of more than 25 per cent of the member's quota in any 12-month period, and (ii) requests for drawings which would increase the drawings outstanding under this paragraph (5) beyond 25 per cent of the member's quota will be met only if the Fund is satisfied that the member has been cooperating with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

The existence and amount of an export shortfall for the purpose of any drawing under this paragraph (5) shall be determined with respect to the latest 12-month period preceding the drawing request for which the Fund has sufficient statistical data, and any excess of a shortfall over the drawing made under this paragraph (5) in respect to that shortfall cannot be carried forward and covered by a later drawing under this paragraph (5).

(6) In order to identify more clearly what are to be regarded as export shortfalls of a short-term character, the Fund, in conjunction with the member concerned, will seek to establish reasonable estimates regarding the medium-term trend of the member's exports based partly on statistical calculation and partly on appraisal of export prospects.

(7) [A repurchase provision is not included at this time. Alternative repurchase schemes in the light of the discussion at last Friday's Executive Board meeting are described in SM/66/104.]

(8) Whenever the Fund's holdings of a member's currency resulting from an outstanding compensatory drawing under paragraph (5) are reduced, by the member's repurchase or otherwise, this will restore pro tanto the member's facility to make a further compensatory drawing under that paragraph, should the need arise.

(9) When drawings are made under paragraph (5), the Fund will so indicate in an appropriate manner. Within six months from the date of any drawing which is not under paragraph (5) and to the extent that it is still outstanding, a member may request that all or part of the drawing be reclassified and treated, for all purposes of this decision, as a drawing made under paragraph (5). The Fund will agree to such a request if at the time of the request the member meets the requirements for a drawing of an equal amount under paragraph (5) and makes the representation as to repurchase appropriate to such drawings, which representation will then be substituted for the original repurchase representation.

(10) In order to implement the Fund's policies in connection with compensatory financing of export shortfalls, the Fund will be prepared to waive the limit on Fund holdings of 200 per cent of quota, where appropriate. In particular, the Fund will be prepared to waive this limit (i) where a waiver is necessary to permit compensatory drawings to be made under paragraphs (4) and (5) above, or (ii) to the extent that drawings in accordance with paragraph (5) are still outstanding.

Moreover, the Fund will apply its tranche policies to drawing requests by a member as if the Fund's holdings of the member's currency were less than its actual holdings of that currency by the amount of any drawings outstanding under paragraph (5).

(11) The provision of credit to deal with the balance of payments effects of export fluctuations provides immediate relief for a country's short-term difficulties. In many cases, however, it will also be necessary to introduce measures of a policy character in order to attain a satisfactory and lasting solution to a country's balance of payments problems. Members generally have actively cooperated with the Fund to find and adopt the measures necessary to this end. Beyond immediate balance of payments difficulties, the primary exporting countries are, in many instances, facing unfavorable long-term export trends, and all are trying to meet the challenge of achieving more rapid and sustained development through a strengthening and broadening of their economies. The last-mentioned problem will require action in many fields and over many years by both the primary exporting countries and the industrial countries, separately and in concert, including readier access to the markets of the developed countries for the products of the developing countries and an appropriate and sustained flow of technical and financial assistance to the developing countries. The Fund considers that its activities can provide valuable assistance in helping to establish a climate within which longer-term measures can be more effectively pursued.

(12) The Fund will review this decision in the light of experience and developing circumstances.

X

FOR
AGENDA

Mr. J. J. Polak

Room 504 F

#1

SM/66/104

August 26, 1966

To: Members of the Executive Board

From: The Acting Secretary

Subject: Compensatory Financing: A Short List of Repurchase Systems

The attached paper has been prepared to present relevant statistical data and staff evaluations with respect to those repurchase systems on which discussion at Executive Board Meeting 66/73 on August 19, 1966 appeared to concentrate. As noted in SM/66/77, Revision 1, Supplement 1, the subject, Compensatory Financing, is expected to be brought to the Board Agenda during the first week after the recess.

Att: (1)

Other Distribution:
Department Heads
Division Chiefs

INTERNATIONAL MONETARY FUND

Research and Statistics Department

Compensatory Financing: A Short List of Repurchase Systems

Prepared by Research and Statistics Department

August 25, 1966

The present paper is intended to present relevant statistical data and staff evaluations with respect to those repurchase systems on which discussion at the Executive Board at Meeting No. 73 of August 19, 1966, appeared to concentrate. These are System (6), System (8), a new system, suggested by Mr. Lieftinck, which we may term System (9), a new system suggested from the Chair as a modification of System (9), which we may term System (10), and a modification of System (1), suggested from the Chair, which we may term System (11). These systems are described below, and (with the exception of System (11)), their performance is measured in Tables 1 to 3.

System (6). Repurchase in five annual installments. However, in considering any request for a compensatory drawing, one half of any repurchases on previous compensatory drawings occurring within the preceding twelvemonths may, at the country's request, be subtracted from exports in computing the shortfall, provided that the member has been cooperating with the Fund in an effort to find appropriate solutions for its balance of payments difficulties, and provided that the resulting shortfall exceeds 2 per cent of the member's quota (the 2 per cent "cut-off").

System (8). Half of any export excess accruing in the first three years following a shortfall for which a drawing has been made to be used for repurchase; in the fourth year either half the amount still outstanding or half the excess, whichever is the greater, to be repurchased, the remainder being paid in the fifth year.

System (9). In each year until full repayment is made an amount will be repurchased equal to 20 per cent of the drawing or one quarter of the export excess, whichever is the greater. In computing shortfalls for compensatory drawings one quarter of any repurchases of previous compensatory drawings made in the preceding twelvemonth period could be subtracted from exports, subject to the same provisos as for System (6) above.

System (10). Same as System (6) except that, in computing shortfalls for a compensatory drawing, one quarter (not one half) of any repurchases on previous compensatory drawings accruing in the preceding twelvemonths could be subtracted from exports.

System (11). The existing system of repurchase within a 3 to 5 year period, but with the recommendation to members that one half of any export excess that may occur in the first three years after the drawing should be devoted to repurchase.

The performance of these systems as measured by statistical criteria is set forth in Tables 1 to 3. System (11) is not explicitly mentioned in these tables but, depending on the extent to which the recommendations are observed or not, its performance could approximate to that for System (8) and that for System (1) (the existing repurchase system) respectively.

The Staff is still inclined to regard System (6), on a balance of considerations, as the best available system. Its statistical performance, in terms of the degree of approximation and smoothness attained, and the cost involved, though not as good as Systems (8) or (9), is significantly better than that of the present system. It gives an assurance to countries that they will not be required to repay more than 20 per cent of the drawing in any year. It does something explicit to meet the UNCTAD request to explore ways to refinance compensatory financing obligations if shortfalls should permit. By so doing repurchases will, to some extent be concentrated on years of export excess, thus applying the compensatory principle to repurchase as well as to drawings. Finally, System (6) is easier to administer than Systems (8), (9), or (11).

Systems (8) and (9) both show good performances by statistical tests, and apply the compensatory principle in a logical way to repurchases as well as to drawings. In addition, System (9) pays some regard to the UNCTAD request referred to above. Both Systems, however, and especially System (9) raise difficult though not unsurmountable administrative problems whenever a country has a number of compensatory drawings outstanding simultaneously, with different and overlapping export periods. Conventions will then have to be adopted to avoid double counting of export excesses.

System (10) is a variant of System (6) which, though it does less than System (6)--and much less than System (5)--to meet the request for a refinancing facility, may for that reason be more acceptable.

System (11) may be regarded as an application of the principle encountered in paragraph 2(a) of Decision No. 102-(52/11) of February 13, 1952, according to which "exchange purchased from the Fund should not remain outstanding beyond the period reasonably related to the payments problem for which it was purchased from the Fund." The repurchase provision of the decision will contain a clause urging that members should use half of any export excesses that they may have in any year to repurchase any outstanding drawings under paragraph 5. In accordance with this clause, the Fund will make the necessary calculations of export excesses at appropriate times, and will bring the results to the attention of the member. It is difficult to know how well a system of this kind would work in practice, and it might appear to be a less effective solution than it would prove in practice. At any rate it may be regarded as an interim solution that would keep the compensatory principle of repurchase alive pending the reconsideration of the question promised in the concluding paragraph of the draft of the new decision.

Table 1. Compensatory Financing: Effect of Various Repurchase Systems, 48 Countries (1951-64) and Hypothetical Country B[1]

(Qualified 50 Per Cent of Quota Limit)

	48 Countries			Hypothetical Country B		
	Approximation ratio[2]	Smoothness ratio[3]	Average Drawings outstanding[4]	Approximation ratio[2]	Smoothness ratio[3]	Average Drawings outstanding[5]
System 1[6]	.035	.047	.45	.123	.148	6.2
System 6[7]	.041	.060	.38	.135	.160	4.5
System 8[8]	.043	.071	.32	.120	.141	3.1
System 9[9]	.045	.071	.33	.142	.165	3.4
System 10[10]	.040	.059	.37	.133	.158	4.2

1/ Weights of .50, .25 and .25 applied to years t, t-1, and t-2, respectively, for estimating calculated norm. 100 per cent compensation of calculated shortfall.

2/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

3/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

4/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

5/ Average for all years of total amounts outstanding, in units. (Exports of country B vary between 100 and 238 units, and its quota is assumed to rise in quinquennial steps from 20 to 40 units.)

6/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

7/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

8/ 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

9/ In each year either 20 per cent of the drawings or 25 per cent of any export excesses, whichever is the greater, applied to repayment; 25 per cent of any repurchase is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

10/ Repayment in five equal instalments, beginning in the year following the shortfall year: one quarter of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

Table 2. Compensatory Financing: Effect of Various Repurchase Systems in Hypothetical Country B

Year	Exports	Standard Norm 1/	System 1 2/ Drawings	System 1 2/ Repurchases	System 1 2/ Availabilities	System 6 3/ Drawings	System 6 3/ Repurchases	System 6 3/ Availabilities	System 8 4/ Drawings	System 8 4/ Repurchases	System 8 4/ Availabilities	System 9 5/ Drawings	System 9 5/ Repurchases	System 9 5/ Availabilities	System 10 6/ Drawings	System 10 6/ Repurchases	System 10 6/ Availabilities
1	105	101.2	--	--	105.0	--	--	105.0	--	--	105.0	--	--	105.0	--	--	105.0
2	109	105.7	--	--	109.0	--	--	109.0	--	--	109.0	--	--	109.0	--	--	109.0
3	100	103.5	3.5	--	103.5	3.5	--	103.5	3.5	--	103.5	3.5	--	103.5	3.5	--	103.5
4	101	102.7	1.7	--	102.7	2.1	0.7	102.4	1.7	--	102.7	1.9	0.7	102.2	1.9	0.7	102.2
5	115	107.7	--	--	115.0	--	1.1	113.9	--	3.6	111.4	--	1.7	113.3	--	1.1	113.9
6	120	114.0	--	--	120.0	--	1.1	118.9	--	1.6	118.4	--	1.4	118.6	--	1.1	118.9
7	135	126.2	--	1.7	133.2	--	1.1	133.9	--	--	135.0	--	1.5	133.5	--	1.1	133.9
8	100	113.7	8.4	2.6	105.7	6.9	1.1	105.7	5.7	--	105.7	5.7	--	105.7	6.8	1.1	105.7
9	135	126.2	--	0.9	134.1	--	1.8	133.2	--	4.4	130.6	--	2.1	132.9	--	1.8	133.2
10	125	121.2	--	--	125.0	--	1.4	123.6	--	1.4	123.6	--	1.1	123.8	--	1.4	123.6
11	120	125.0	4.6	--	124.6	5.7	1.4	124.3	5.0	--	125.0	5.3	1.1	124.1	5.3	1.4	124.0
12	140	131.2	--	4.2	135.8	--	2.5	137.5	--	4.4	135.6	--	2.2	137.8	--	2.4	137.6
13	160	145.0	--	4.2	155.8	--	2.5	157.5	--	0.6	159.4	--	3.6	156.4	--	2.4	157.6
14	170	160.0	--	--	170.0	--	1.1	168.9	--	--	170.0	--	0.8	169.2	--	1.1	168.9
15	100	132.5	9.8	2.3	107.5	8.6	1.1	107.5	7.5	--	107.5	7.5	--	107.5	8.6	1.1	107.5
16	130	132.5	2.5	2.3	130.2	3.9	2.9	131.1	2.5	--	132.5	2.9	1.5	131.4	3.2	2.8	130.4
17	115	115.0	--	--	115.0	1.3	2.5	113.7	--	--	115.0	--	2.1	112.9	--	2.4	112.6
18	125	123.7	--	--	125.0	--	2.8	122.2	--	0.6	124.4	--	2.1	122.9	--	2.4	122.6
19	130	125.0	--	4.9	125.1	--	2.8	127.2	--	3.4	126.6	--	2.1	127.9	--	2.4	127.6
20	130	128.7	--	6.2	123.8	--	2.8	127.2	--	4.7	125.3	--	2.1	127.9	--	2.4	127.6
21	144	137.0	--	1.2	142.7	--	1.0	143.0	--	1.2	142.7	--	0.6	143.4	--	0.6	143.4
22	160	148.5	--	--	160.0	--	0.3	159.7	--	--	160.0	--	--	160.0	--	--	160.0
23	192	172.0	--	--	192.0	--	--	192.0	--	--	192.0	--	--	192.0	--	--	192.0
24	218	197.0	--	--	218.0	--	--	218.0	--	--	218.0	--	--	218.0	--	--	218.0
25	218	211.5	--	--	218.0	--	--	218.0	--	--	218.0	--	--	218.0	--	--	218.0
26	200	209.0	9.0	--	209.0	9.0	--	209.0	9.0	--	209.0	9.0	--	209.0	9.0	--	209.0
27	232	220.5	--	--	232.0	--	1.8	230.2	--	5.7	226.2	--	2.8	229.2	--	1.8	230.2
28	208	212.0	4.0	--	212.0	4.9	1.8	211.1	4.0	--	212.0	4.5	1.8	210.6	4.5	1.8	210.6
29	238	229.0	--	--	238.0	--	2.8	235.2	--	4.5	233.5	--	2.7	235.3	--	2.7	235.3

1/ Weights of 0.50, 0.25, and 0.25 applied to years t, t-1, and t-2, respectively.

2/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

3/ Repayment in five equal installments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

4/ 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

5/ In each year either 20 per cent of the drawings or 25 per cent of any export excesses, whichever is the greater, applied to repayment; 25 per cent of any repurchases is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

6/ Repayment in five equal installments, beginning in the year following the shortfall year: one quarter of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

Table 3. Hypothetical Country B: Amounts Outstanding Under Various Repurchase Systems

Year	System 1 1/	System 6 2/	System 8 3/	System 9 4/	System 10 5/
1	-	-	-	-	-
2	-	-	-	-	-
3	3.5	3.5	3.5	3.5	3.5
4	5.2	4.9	5.2	4.7	4.7
5	5.2	3.8	1.6	3.0	3.6
6	5.2	2.7	-	1.5	2.6
7	3.5	1.5	-	-	1.5
8	9.2	7.3	5.7	5.7	7.2
9	8.4	5.5	1.4	3.6	5.5
10	8.4	4.1	-	2.5	4.1
11	13.0	8.4	5.0	6.6	8.1
12	8.8	5.9	0.6	4.4	5.6
13	4.6	3.4	-	0.8	3.2
14	4.6	2.3	-	-	2.1
15	12.1	9.8	7.5	7.5	9.6
16	12.3	10.8	10.0	8.9	10.1
17	12.3	9.6	10.0	6.8	7.7
18	12.3	6.8	9.4	4.7	5.3
19	7.4	4.1	5.9	2.6	3.0
20	1.2	1.3	1.2	0.6	0.6
21	-	0.3	-	-	-
22	-	-	-	-	-
23	-	-	-	-	-
24	-	-	-	-	-
25	-	-	-	-	-
26	9.0	9.0	9.0	9.0	9.0
27	9.0	7.2	3.2	6.2	7.2
28	13.0	10.3	7.2	8.9	9.9
29	13.0	7.5	2.7	6.2	7.2

1/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

2/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

3/ 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

4/ In each year either 20 per cent of the drawings or 25 per cent of any export excesses, whichever is the greater, applied to repayment; 25 per cent of any repurchase is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

5/ Repayment in five equal instalments, beginning in the year following the shortfall year: one quarter of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

September 8, 1966

To: Members of the Executive Board

From: The Secretary

Subject: Compensatory Financing of Export Fluctuations

Mr. Wass has proposed the following amendment to the draft decision contained in SM/66/77, Revision 1, Supplement 1:

At the end of paragraph 12 add:

"and in particular of any further international arrangements which may be established in the future for compensating shortfalls in export earnings."

FOR AGENDA

SM/66/77
Revision 1

August 5, 1966

To: Members of the Executive Board

From: The Secretary

Subject: Compensatory Financing of Export Fluctuations: Developments in the Fund's Facility

The attached revision of the draft report on Compensatory Financing of Export Fluctuations is circulated for consideration by the Executive Directors at a meeting tentatively scheduled for Monday, August 15, 1966.

Att: (1)

Other Distribution:
Department Heads
Division Chiefs

INTERNATIONAL MONETARY FUND

Compensatory Financing of Export Fluctuations:
Developments in the Fund's Facility

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The attached paper represents a revised version of the draft Report attached to SM/66/77. The sections dealing with repurchase have been revised on the assumption that Repurchase System (6) of SM/66/97 is adopted.

In order to facilitate comparison with the first draft of the Report, changes have been typed on the original stencils, except for page 25 and page 27. These pages, where the changes were fairly extensive, have been retyped, the new material being indicated by underlining, and the omitted material enclosed in square brackets.

Compensatory Financing of Export Fluctuations: Developments in the Fund's Facility

Introduction: the 1963 Decision

In February 1963, in response to an invitation extended by the United Nations Commission on International Commodity Trade at its tenth session in May, 1962, the Fund issued a report entitled "Compensatory Financing of Export Fluctuations." This report, after reviewing the problems involved in Fund financing of fluctuations in exports of primary exporting countries, set forth in its concluding chapter an Executive Board Decision[1/] covering two points: (a) quotas and (b) drawing policies.

With respect to quotas, the Fund declared its willingness to give sympathetic consideration to requests for the adjustment of the quotas of certain primary exporting countries, particularly those with relatively small quotas, to make them more adequate in the light of fluctuations in export proceeds and other relevant criteria.

As regards drawing policies, the Fund introduced a new facility, of which the principal features are as follows:

(1) It is open to all member countries, but designed in particular for primary producing countries.

(2) It is designed to compensate for temporary shortfalls in export receipts, rather than in export prices or in the terms of trade, or in the importing power of exports.

(3) By temporary shortfalls are meant deviations from a medium-term trend in export receipts.

(4) Compensation is paid in the form of a drawing subject to the normal conditions of repayments for Fund drawings, including an outside limit of 3 to 5 years.

(5) Compensation has been paid to the full extent of the calculated shortfall, subject to the proviso that the total of compensatory drawings outstanding should not normally exceed 25 per cent of quota.

(6) The policies of members drawing under the facility do not have to meet the tests that the Fund would apply in the case of a non-compensatory drawing in the same tranche. However, members do have to satisfy the Fund that they are encountering payments difficulties, that the shortfall is of a short-term character, and is largely attributable to circumstances beyond the member's control, and that the member will cooperate with the Fund in an effort to find solutions, where required, for its payments difficulties.

1/ Decision No. 1477 (63/8) of February 27, 1963, Selected Decisions, Third Issue, p. 40.

Subsequent Developments

I. Quota Adjustments and Export Fluctuations

The Decision on Compensatory Financing has now been in operation for over three years, and the time has arrived when certain of its aspects can appropriately be reviewed.

In Paragraph 3 of that Decision, the Fund recognized that some quota adjustments might be required or desirable, as follows: "The quotas of many primary exporting countries, taken in conjunction with a reasonable use of their own reserves, are at present adequate for dealing with export fluctuations such as have occurred during the past decade. In those instances, however, where adjustment of the quotas of certain primary exporting countries, and, in particular, of countries with relatively small quotas, would be appropriate to make them more adequate in the light of fluctuations in export proceeds and other relevant criteria, the Fund is willing to give sympathetic consideration to requests for such adjustment."

Since February 1963 the Fund has taken steps--apart from the general quota increase which came into effect on February 23, 1966--to implement this paragraph in several ways.

In the first place, it has approved more than 22 quota increases under a special policy applied to developing countries with relatively small quotas; 15 other countries appear to be eligible for such quota increases under that policy.

Secondly, the Fund facilitates drawings by such countries to enable them to purchase the amount of gold that must be paid in connection with the quota increases referred to above. This gives them the benefit of a quota increase immediately, and makes it possible to spread the reserve cost of the increase over a number of years.

Finally, in considering applications for individual quota increases, even from countries other than the above, the Fund has modified the formula which is taken into account in calculating quotas in such a way as to improve the position of developing countries. Variability of trade, which was a component of the so-called Bretton Woods formula, has now been defined in terms of standard deviation around a five-year moving average. This new definition provides a more accurate measure of variability and is thus more favorable to quota calculations of raw materials exporting countries. The Fund has also modified the formula to give greater weight to trade and ~~the~~ variability ~~to~~ of trade, and less weight to national income and international reserves.

II. The Fund's Compensatory Facility

It might have been expected that the drawing facility established by the Fund in February 1963 to provide compensatory financing for export fluctuations would by this time have been used often enough to provide

ample illustrations of the type of problems that were liable to arise in applying it, and possibly also to indicate ways in which it could be improved. In fact, however, few countries have had even a prima facie case for using it, and three countries have actually drawn: (1) Brazil in June 1963 for the sum of $60 million (21 per cent of quota); (2) the United Arab Republic in October 1963 for the sum of $16 million (18 per cent of quota); and (3) Sudan in June 1965 for the sum of $11.25 million (25 per cent of quota).1/ This infrequency of use is largely attributable to the fact, illustrated in Table 1, that price developments over the past three or four years have been such as to permit the export earnings of less developed primary producing countries to show a generally upward trend, though one that tended to flatten out in 1965. Even the substantial declines in price of tropical foodstuffs (other than coffee), which began in spring 1964 and continued through the greater part of 1965 have not reacted sufficiently on earnings to evoke many opportunities for the use of the facility.

Despite the small number of instances of use, there has been enough experience and enough reflection on the variety of situations that might present themselves to permit of a reconsideration of several of the features of the 1963 Decision. Moreover, a number of suggestions have been made both inside the Fund--notably at the recent Annual Meeting of the Board of Governors--and outside the Fund, as to ways in which the Fund's compensatory financing facility might be amended or improved.

Most of these suggestions are summed up in the three recommendations made by the United Nations Conference on Trade and Development of 1964 to Governments members of the Fund as to changes that might be made in the facility, and in the request which it addressed directly to the Fund. The UNCTAD resolution containing these recommendations and request is reproduced at Appendix A. Passages dealing with compensatory financing excerpted from speeches of Governors at the 1965 Annual Meetings are reproduced at Appendix B. It will be seen that most of the points made by the Governors are covered in the UNCTAD Resolution referred to above, except for the reference to automatism in the speech of Governor Pugliese of the Argentine, and the reference to terms of trade and import prices in the speech of Governor Wanninayake of Ceylon.

Application and Development of the Facility

I. Nature of Shortfall

Drawings under Paragraph 5 of the Compensatory Financing Decision of 1963 may be made only when the requesting member experiences payments difficulties produced by a temporary export shortfall, i.e., by an export shortfall which is "of a short-term character." Such shortfalls, according to Paragraph 7 of the Decision, are to be identified on the basis of "estimates regarding the medium-term trend of the member's exports." In the 1963 Decision itself, no definition of the medium-term trend is given.

1/ The quotas referred to in these percentages are those applicable at the time the drawing was made.

Table 1. Changes in Prices and Export Earnings for Primary Producers in 1962 to 1965

Commodity	Prices[1/] Percentage increase or decrease (-) from previous year 1963	1964	1965	Export Earnings: Countries mainly dependent on specified commodities[2/]	Percentage increase from previous year 1963	1964	1965[3/]
Metals and minerals[4/]	3	21	13	Metals and minerals	9	24	13
Agricultural products	20	-	-12	Agricultural products	12	10	4
Food	31	-	-17				
Coffee	4	30	-5	(a) Coffee	12	8	7
Sugar	185	-31	-64	(b) Mixed tropical foodstuffs	11	11	3
Cocoa	20	-8	-26				
Wheat	1	4	-5	(c) Mainly temperate products	14	12	2
Non-food	4	-	-5	(d) Fibers and rubber	10	2	9
Cotton	2	29	-6				
Wool	18	-	-13				
Rubber	-7	-5	-1	(e) Mixed	7	11	5
				Mixed Mineral and Agricultural	8	7	2
All exports[4/]	18	2	-9	All countries	11	10	4

1/ Group price changes are derived from indices published by the NIESR (London). Specified commodity price series relate to world market quotations for representative grades only, and thus exclude the influence of prices determined under contracts.
2/ Defined as at least one half of export earnings as classified. Excludes countries dependent on petroleum. Data relate to 71 countries.
3/ Provisional.
4/ Excluding petroleum.

However, in the earlier Fund report, "Fund Policies and Procedures in Relation to the Compensatory Financing of Commodity Fluctuations,"1/ the trend or norm was defined for purposes of illustration as the average of actual exports for the five years beginning two years previous and ending two years subsequent to the year for which the trend value was calculated. The same definition was adopted in the staff paper cited on page 10 of the report on "Compensatory Financing of Export Fluctuations,"2/ and it was on the basis of this definition of the "ideal" trend or norm that certain conclusions were drawn in that report as to the best statistical method of estimating it in the absence of complete information.3/ This is also the definition that has been adopted in all applications of the Compensatory Financing Decision to particular countries up to the present time.

In the absence of precise quantitative knowledge as to the nature of the economic forces at work in determining trends and fluctuations, a moving average seems the best and most flexible way--better, for example, than fitting a trend line of any *a priori* shape--of reflecting what is meant by trend. Moving averages of 4 years, 5 years, or 6 years, respectively, might, any one of them, serve as a reasonable definition of a "medium-term" trend. However, a 5-year period is preferable to the others in that it contains a middle year, the trend value of which can be defined as the average of the period. The trend value for any year in any time series must anticipate the figures for subsequent as well as reflect those of previous years in that series. If this is not done--e.g., if the trend values are determined solely as an average of past years--the trend line might lie persistently above, or below, the actual series to a substantial extent, which would be contrary to the normal meaning of the term "trend." Only if the moving average is centered in the manner illustrated above can one expect to find, over a reasonable period of time, a rough balancing of shortfalls and surpluses of actual exports with respect to trend.4/

Once the best possible estimate has been made of the medium-term trend, and hence of the shortfall, if any, from that trend, in accordance with Paragraph 7 of the Decision, no separate judgment is required as to whether the shortfall in question is "temporary" or of a "short-term" character.

1/ IMF *Staff Papers*, November 1960, p. 9.

2/ J. Marcus Fleming, Rudolf Rhomberg, and Lorette Boissonneault, "Export Norms and Their Role in Compensatory Financing," *Staff Papers*, Vol. X, 1963.

3/ "Compensatory Financing of Export Fluctuations," pp. 17-18.

4/ The balancing of surpluses and deficits is far from perfect, however; in any 5-year period there is likely to be either an excess of surpluses over deficits exceeding 50 per cent of gross surpluses, or an excess of shortfalls over surpluses exceeding 50 per cent of gross shortfalls. This, however, appears to be quite unavoidable. There is no way of defining a norm or trend consistently from year to year in such a way as to secure a perfect balance of surpluses and shortfalls over any given period.

The definition of the trend itself is such as to make it likely--though one can never be certain--that shortfalls with respect to it will be of short duration.1/ Any attempt to make a separate determination as to whether a given shortfall would cease to exist within, say, 2 or 3 years would involve estimating for that period ahead not only actual exports--which, as is indicated in the following section, may be involved in the estimation of the current norm--but also the export trend itself. To forecast the latter would involve estimating exports for still further years ahead. This, in the present state of forecasting techniques, would appear to be impracticable, and a determination that a shortfall of a given magnitude exists should, therefore, be taken as satisfying the requirement that the shortfall is of a short-term character.

II. Estimation of Trend and Shortfall

In paragraph 7 of the 1963 Decision it is laid down that the Fund will seek to establish reasonable estimates regarding the medium-term trend of the member's exports "on the basis of appropriate statistical data in conjunction with qualitative information about its exports prospects." This phrase appears to foreshadow a two-sided approach--"statistical" and "qualitative"--to the problem of estimation. However, while statistical estimation can be carried out without qualitative appraisal, qualitative appraisal can scarcely be applied without the aid of some statistical information, and the true alternative approaches are those of statistical automatism and the exercise of judgment, respectively.

In the three cases in which the Decision has been applied thus far, the estimation of normal exports has represented a compromise between (a) a figure or figures arrived at through the application of automatic formulae to past statistical data, and (b) an estimate based on a combination of these data with a forecast for actual exports two years ahead, these forecasts in turn being arrived at by a process of market appraisal using all available information.

The combination of the two methods in one form or another is justified by the knowledge that the result of either method is to a considerable extent uncertain. Any formula admittedly gives a precise answer; but no formula can be devised that gives a good approximation of the medium-term trend, as here defined, on the basis of past statistical data. On the other hand, any forecasting exercise must to some extent be subjective and uncertain. Given these facts it is necessary to strike a reasonable balance between these two methods, each less than satisfactory, which at the same time assures countries as much uniformity of treatment as possible from one case to the other.

1/ Calculations covering 48 countries show that almost 50 per cent of all shortfalls with respect to a norm defined as above last only 1 year, nearly 85 per cent no more than 2 years, and 96 per cent no more than 3 years.

As regards the automatic statistical approach to the estimation of the norm, the Fund has, in the past, used two types of formula, a "general" formula and a "national" formula, in both of which the norm for any given year is estimated as a weighted average of actual exports for the year in question and the two preceding years. In both cases the weights assigned to the various years are those which experience (of some ten years or more) shows to provide the best approximation to the "true" norm as defined above.1/

The "general" formula, used in calculations contained in the Fund's Report on "Compensatory Financing of Export Fluctuations," in all three applications of the Decision to date attaches a weight of .50 to the exports of the year for which the shortfall is being estimated, .25 to the preceding year, and .25 to the second preceding year. These weights were arrived at on the basis of analysis of the experience of some 48 countries over a period of nine testable years (thirteen years of data). While not absolutely the best of the formulae tested, it was chosen as a good formula with rounded weights close to those of the optimal formula.

"National" formulae have differed from country to country, the formula for each country being arrived at on the basis of experience affecting that country alone. It is intended to discontinue the use of "national" formulae on the ground that they are based on too small a number of observations, and complicate the statistical side of the exercise.

As regards the more subjective ~~or "qualitative"~~ estimate primarily based on market analysis, it is in the nature of the case more difficult to describe the method used, which varies from country to country. In all cases the procedure is first to estimate the average exports in the two years following the year for which the shortfall is being determined and then to take an average of the five years centered on the shortfall year. The forecast in question is conducted largely on the basis of commodity analysis, taking into account the prospective price movements for the commodity in question and the prospective volume movements in the country in question. For the great majority of primary exporting Fund members, 60 per cent to 90 per cent of total exports take place in a rather small number (1 to 4) of commodities, thus a large proportion of most countries' trade can be estimated on the basis of commodity market analysis. But there remains a sizeable residual for which no such analysis is possible and it may well prove desirable in particular cases to make a more or less automatic statistical estimate for this part of the exports. In this event the partial results of market analysis for major commodities would be combined with a more mechanical result for the residual to arrive at a global estimate.

1/ The "true norm" for exports, x, in any year t, i.e., $\bar{x}_t$ is defined as $\frac{x_{t-2} + x_{t-1} + x_t + x_{t+1} + x_{t+2}}{5}$. The problem is to find weights w_o, w_1, w_2, such that the estimated norm $x^*_t = w_2x_{t-2} + w_1x_{t-1} + w_ox_t$ provides the best approximation to $\bar{x}_t$ for all values of t. This is found by regression analysis for years in which the relevant export data are available.

In the past, "statistical" and "qualitative" estimates have been given approximately equal weight in determining the final estimate of the trend of exports. However, the "qualitative" estimates, involving a direct forecast of exports two years ahead, have been found in practice to yield better results than the formula. Experience has tended to bear out the judgment that a "better estimate could be made by the exercise of judgment based on an analysis of the causal factors at work than by any mathematical formula, however skillfully contrived, which is based on the mere statistical magnitude of current and previous exports."1/ In future, therefore, it would seem advisable to give a somewhat greater weight than in the past to the "qualitative" as against the "statistical" estimate.

III. Proposals Regarding the Mode of Determining the Shortfall

A. Weight to be Given to Past Years

In the Resolution on the Study of Measures Relative to the Compensatory Credit System of the International Monetary Fund, set forth at Annex A.IV.17 of its Report, the UNCTAD made the following request:

"The Conference

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2. Requests that the International Monetary Fund, in its determination of the shortfall in export receipts, consider giving greater weight to the actual experience of the three preceding years."

The issue here, though it appears to be purely technical, in fact touches on a point of principle. At present, as has been explained above, the Fund's compensatory financing facility is designed to compensate for shortfalls from the presumed current trend level of exports rather than from a previous trend level. It is designed to help countries to bring their export availabilities--export receipts plus compensatory drawings less repayments of such drawings--closer to the presumed trend level rather than to provide them with a financial buffer against reductions as compared with their previous standards. While it might be entirely appropriate to provide countries with such a buffer, it would seem preferable to supply this through the ordinary drawing facilities of the Fund, use of which could be made conditional, where necessary, on the adoption of measures to adapt the economy to new export conditions, or to improve the trend of exports, than through the compensatory financing facility, the use of which is more automatic.

1/ Compensatory Financing of Export Fluctuations, A Report of the International Monetary Fund, February 1963, page 10.

It is important, however, to give members some assurance that estimates of export trends will remain within a certain predictable range. This can be achieved by providing that, in the calculation of the trend, the average level of exports predicted for the two years following the shortfall year will not be assumed to exceed by more than ten per cent the average level experienced in the two years preceding the shortfall year and will not be assumed to be less than the level of exports experienced in the shortfall year itself.

It is because the aim of compensatory financing is conceived in the manner described above, that in the assessment of the norm with reference to which the shortfall is calculated account is taken of the expected exports of the ensuing years, that a substantial weight in the determination of the norm is given to the current year's exports, and that no weight is given, for example, to exports three or more years anterior to the year with respect to which the shortfall is being calculated. The weights assigned to the current and preceding years in the estimation of the export norm--insofar as it is estimated by formula--were arrived at on the basis of experience as to which weights gave the closest estimate of the current trend and the best implied forecast of the two years subsequent to the shortfall year.

A formula in which no weight was given to the shortfall year would, for this reason, tend to lead to a higher estimate of the trend value, and hence a larger shortfall and a larger drawing entitlement. Because of the long-term upward trend of exports, however, this effect would generally be offset to some extent by the inclusion in the weighting formula of the third year preceding the shortfall, or of still earlier years. From Table 2 it can be seen that a formula for trend estimation giving equal weights to the three years preceding the shortfall would have led, over the period 1951 to 1964, to somewhat larger drawing entitlements than the present formula. The same table, however, shows that the "performance" of the scheme (as measured by the degree to which compensatory drawings and repurchases bring export availabilities closer the true trend value, and the degree to which they tend to smooth out export availabilities) would not have been improved, but if anything, worsened by such a change in formula. It is not the object of the compensatory facility to aim at the largest possible amount of drawings, and, as will be shown below, there are ways in which it would be possible for an increase in drawings outstanding to improve the performance of the scheme significantly, or even for the scheme to be improved without a net increase in drawings outstanding.

Some further points deserve mention.

The element of forecasting involved in the determination of a current rather than a past trend value of exports, though irksome and subject to uncertainty, is a good discipline for country and Fund alike, and may help to counteract the natural tendency to delay adaptations to changing circumstances.

More important is the fact that measurement solely from a past level would frequently yield "shortfalls" which could not by any means be described as "temporary." While countries with a rising trend of exports, even when the rise was subject to serious interruption, would seldom, if ever, be deemed to have shortfalls, those with a generally falling trend of exports would experience persistent shortfalls. Such a change in formula would necessitate the introduction of a separate determination as to whether or not the shortfall was temporary--a determination which, as already indicated, would involve forecasting much further ahead and hence a higher degree of guesswork than that involved in the determination of the trend by present methods.

The other alternative would be to drop the proviso that export shortfalls--or rather declines--should be temporary. But this would scarcely be compatible with the legal requirement of temporariness in the use of Fund resources.

For these reasons it seems on balance undesirable to alter the present concept of the export norm.

Table 2. Fund Compensatory Financing Facility: Comparison of Weighting Systems over Years 1951 to 1964 1/

Limit Per Cent of Quota	Coefficients Applied to Years t	t-1	t-2	t-3	Drawing Entitlement 2/	Average Drawings Outstanding 3/	Approximation Ratio 4/	Smoothness Ratio 5/
.25	0	1/3	1/3	1/3	1.04	.31	.022	.028
.25	.50	.25	.25		.97	.29	.023	.029
.50	0	1/3	1/3	1/3	1.82	.54	.033	.046
.50	.50	.25	.25		1.61	.48	.034	.046

1/ Scheme applied to a sample of 48 countries. Drawings are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of the level of exports in those years. The quotas in per cent of which the limits are expressed are not present quotas but those obtaining at the relevant dates during the period 1951 to 1964.

2/ Cumulative total entitlements over the period in billions of U.S. dollars.

3/ Average for all years of total amounts outstanding in billions of U.S. dollars.

4/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

5/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

B. Degree of Reliance on Automatic Formulae

Governor Pugliese, of Argentina, speaking at the 1965 Annual Meeting of the Fund on behalf of 19 Latin American countries and the Philippines, mentioned as one of the fundamental aspects of the Fund's compensatory financing decision which it would be advisable to consider,

> "3. In conclusion, we would emphasize the non-automatic nature of the drawings permitted. In the decisions on individual cases submitted to the consideration of the Executive Board there has been some flexibility, although in all of them there has been no lack of a subjective assessment in the determination both of the amount to be compensated and of the circumstances in which the loss of income occurs."

This question, so far as it concerns the determination of the shortfall, has already been considered at some length above.

It has been the experience of the Fund, based not only on its own export forecasts but on those of outside bodies, that a closer estimate of the medium-term trend can be arrived at by the use of short-term forecasts based on commodity analysis than by reliance on the best statistical formula. While greater reliance on formulae might give countries a slightly higher degree of certainty as to the amount of compensation they could rely on, the proposed balance between the two methods of estimation would seem to give as much weight as is prudent to the "automatic" element in the estimation process.

C. Account to be Taken of Terms of Trade

At the 1965 Annual Meeting of the Fund, Governor Wanninayake of Ceylon made a suggestion in the following terms:

> "I was encouraged by the reference by Mr. Schweitzer to the work that the Fund is now undertaking to improve the compensatory financing facility. Several speakers have urged that compensatory assistance should be provided for a decline in the terms of trade rather than for a fall in export earnings alone. My own country's experience in recent years vividly illustrates the importance of this reform. We suffered a decline in the terms of trade by 13 per cent in two years alone, but since this was almost entirely due to an increase in import prices we were unable to avail ourselves of the compensatory financing facility. I do sincerely hope that this particular improvement in the scheme will be made effective at an early date."

The terms of trade refer to the ratio between a country's export prices and its import prices. Fluctuations in export prices are, of course, reflected, along with fluctuations in export quantities, in the flucutations in export proceeds. It might be argued that price fluctuations are more properly

compensable than quantity fluctuations in that they are less easily affected by the policies of the exporting countries. On the other hand, some of the commonest and most genuinely short-run fluctuations in export proceeds are those arising from crop failures. More harm than good would probably be done by attempting to distinguish the specific roles of price and quantity in the fluctuations in export proceeds.

The case is different where price fluctuations are concerned. There is undoubtedly a good economic case for compensating not the money value but the real value, or importing power, of exports. An estimate of the latter could be arrived at by deflating exports (for the purpose of arriving at the trend value of exports) by an import price index based on the shortfall year.

There are, however, a number of practical and other objections to this procedure. Most primary producing countries have no import price index. Of those import price indices that exist many are unrepresentative or unreliable. Moreover, such indices usually become available several months later than the data on export proceeds, so that the lag in the granting of a compensatory drawing behind the occurrence of the export shortfall would necessarily be increased. It might be thought that, where the import price indices of developing countries are unavailable, unreliable, or late in appearing, estimates could be formed on the basis of the export and import price indices of industrial countries. Such data, however, would provide extremely uncertain and disputable estimates for the imports of any individual developing country. It has to be borne in mind that the developing countries that experience the largest fluctuations in import prices do so because they are substantial importers of primary products, often from other developing countries. Apart from such cases, the import price indices of primary producing countries do not, as a rule, show very large movements within a short period of years. For all these reasons, it seems better, at this time, to continue to adhere to the principle of compensating for shortfalls in export proceeds rather than in the importing power of exports.

IV. Period for Which Shortfall is Calculated

Thus far it has been the practice of the Fund to require that any request for the use of the compensatory facility shall relate to an export shortfall over the latest twelve-month period for which, at the time of the request, a reliable estimate of actual exports can be made. There must, in any event, be some maximum lapse of time within which any claim for compensation with respect to the exports of a given period should be made, and if the compensatory facility is to fulfil its purpose of enabling countries to stabilize their external expenditures as much as possible in the face of fluctuations in receipts, it seems desirable that the time lag between shortfall and compensatory financing should be as short as possible. (As indicated below, countries need not be deterred from applying for a compensatory drawing as soon as a shortfall appears by the fact that they will thereby preclude themselves from claiming a larger compensation a little later if the shortfall has by then increased.)[1/]

1/ See page 14 below.

The present practice enables a claim for a compensatory drawing to be made at any time during the year with respect to the twelve-month period immediately preceding. The question arises whether this right should be restricted in any way. There would seem to be no advantage in a system under which such claims could be made only with respect, say, to calendar years. A more plausible case could be made for ruling that, where exports are marked by seasonality, claims for compensatory drawings should be made only with respect to twelve-month periods which include all those months over which the principal export crop is liable to be marketed abroad. Otherwise, it might be argued, countries which marketed their crops early one year and late the following season might show a shortfall over a twelve-month period that spanned two seasons, whereas no shortfall would appear from a comparison of crop years. Bearing in mind, however, that most countries have a number of export crops with different seasonalities, it is doubtful whether the variability of seasonality is sufficient to justify the introduction of a restriction which would both reduce the value of the facility to the country and complicate its administration. It would be no easy task to determine for each country with respect to which twelve-month periods applications for compensatory financing would not be entertained. It should also be borne in mind that any shortfall that appeared to be artificially induced by deliberate delay in the marketing of a crop would be unlikely to be regarded as "largely attributable to circumstances beyond the control of the member" and in this event would not qualify for a compensatory drawing.

The arrangement outlined in the first paragraph of this section can be criticized from another angle, namely that even a time lag of a few months between the shortfall and the compensatory drawing is undesirable, and that it would be better if the drawing could coincide with the shortfall. This means that the drawing would have to take place at a time when the precise amount of the shortfall was unknown. In order to meet this point and to encourage the use of the stand-by and ordinary drawing facilities for the compensation of export shortfalls, it is intended, subject to what is said below, to allow members, within a six months period of any drawing, to reclassify all or part of it as a compensatory drawing under Paragraph 5 of the Decision. The drawing, when first made, would have to satisfy the ordinary conditions for drawing in the tranche in question, or, if made under standby, the requirements appropriate to drawing under the standby. The reclassification of the drawing would have to satisfy the conditions for a compensatory drawing under Paragraph 5 of the Decision with respect to an export shortfall for the latest twelve months for which data were available prior to the reclassification. The amount reclassified could not exceed the amount of that shortfall. Such reclassification would confer on the drawings the privilege of additionality as defined in (ii) of Paragraph 6 of the 1963 Decision (with any enhancement of that privilege that may result from the separation of the compensatory facility from other drawing facilities, discussed below). It would not, however, reconstitute rights to draw under standby.

Repurchase undertakings made in connection with the original drawing would be replaced by the undertakings appropriate to a compensatory drawing. In principle, policy undertakings made in connection with the original drawing would, however, remain unaffected by the reclassification.

It is estimated that if both the compensatory facility and the privilege of reclassification had existed over the period 1959-64, and the latter had been exercised to the full--which might not in all cases have been to the country's advantage--some 20 to 25 per cent of all non-compensatory drawings could have been so reclassified.

V. Problem of Double Compensation

It would neither be equitable, nor in accordance with the intention of the Decision on Compensatory Financing, that any member should be compensated twice for the same shortfall, or more precisely, that the sum of any drawings made with respect to any given shortfall should exceed the amount of the shortfall.

Under the Decision a member can draw from the Fund with respect to a payments deficit arising out of an export shortfall either in the form of a drawing under ordinary tranche policies (referred to in Paragraph 4 of the Decision) or in the form of a drawing under the special policies outlined in Paragraph 5 of the Decision. Moreover, it is intended, as indicated in the preceding section, that a drawing originally made under ordinary tranche policies could in certain circumstances be reclassified. The problem of double compensation may arise either with respect to two drawings under Paragraph 5, or with respect to a pair of drawings, one under Paragraph 5 and another under Paragraph 4.

In the case of two drawings under Paragraph 5, it is proposed that, if the period with respect to which a second such drawing is requested to be made (or reclassified) overlaps with that for which a first such drawing has been made (or reclassified), the first drawing would be prorated over the twelve months with respect to which it was given, and such part of it as corresponded to the overlap between the two periods would be subtracted from the drawing entitlement with respect to the second period.

As regards the problem of avoiding double counting as between a Paragraph 5 drawing and an ordinary drawing which can be considered as at least partly undertaken for compensatory purposes, there is no real difficulty if the ordinary drawing follows the Paragraph 5 drawing and is not made under a standby accorded before the latter drawing. In that case, the Paragraph 5 drawing will simply be "taken into account" as one of the many factors affecting the balance of payments situation of the drawing country on the occasion of any subsequent drawing or standby.

The real difficulty arises if a Paragraph 5 drawing or reclassification is requested after ~~an ordinary drawing or standby arrangement.~~ We then have to ask whether the payments situation with respect to which the drawing or standby was given included any part of the export shortfall with respect to which the Paragraph 5 drawing or reclassification is now requested. Such a question would be hard to answer since an ordinary drawing or standby is not usually given to meet the payments deficit of any precisely defined period, still less to meet fluctuations in any specific item in the balance of payments.

a standby arrangement or an ordinary drawing--other than the drawing that is to be reclassified.

One approach would be for some specific statement to be made by the Fund at the time of the ordinary drawing or standby arrangement as to the proportion thereof, if any, that should be regarded as granted with respect to an export shortfall, and as to the period of the shortfall. In the case of standbys, however, account is more often taken of the possibility of future shortfalls than of the accomplished fact of past shortfalls, and it is impossible to be precise as regards either the amount or the timing of future shortfalls. Some conventional rules will, therefore, have to be adopted as to the period and magnitude of the export shortfall deemed to be compensated by ordinary drawings or drawings under standby made prior to the request for a drawing or reclassification under the compensatory facility.

VI. Responsibility for Shortfall and Policy Conditions

According to Paragraph 5(a) of the Compensatory Financing Decision of 1963, one of the conditions of a compensatory drawing is that this export shortfall should be "largely attributable to circumstances beyond the control of the member." Where this condition is clearly not satisfied, it would be inappropriate for a drawing to be made under the compensatory facility. However, there may be ambiguous cases where difficulties of interpretation arise. A shortfall can sometimes be attributed with equal propriety to any one of a number of causes, some of which may be under the member's control and others not. For example, suppose a combination of the following:

(a) a <u>rise</u> in foreign demand for the country's exports;

(b) a short crop due to weather;

(c) a rise in home consumption of the export product due to inflation, subsidization, or some other factor for which the government is responsible.

Given the rise in prices resulting from (a), the shortfall in export value may be no greater than could be entirely accounted for by <u>either</u> (b) or (c). Again, suppose that a shortfall takes place in the exports of a given product due to "act of God" but that an increase in the export of other products, which would otherwise have offset the shortfall, fails to occur because of the policies of the member. Again, there may be cases where the shortfall would not have occurred without certain policies of the member but these policies were reasonable in the light of all the circumstances, or cases where the shortfall could have been prevented by certain policies but abstention from these policies on the part of the member was reasonable in the light of all the circumstances.

In such ambiguous cases an interpretation favorable to the member requesting the compensatory drawing should generally be adopted, and whenever the shortfall can be largely attributed to "circumstances beyond the control of the member" it should be so attributed.

It would also eliminate certain possible inequities as between countries utilizing the facility.1/

One of the conditions for drawing under Paragraph 5 of the 1963 Decision is that "the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties."

In the application of the Decision to individual cases, the Fund, in accordance with the intention of the Decision, has not attempted to reach agreement with the member on what the nature of these solutions would have to be. This has been left to subsequent discussions, and has not stood in the way of prompt action on a request for compensatory drawings. Nevertheless, in one case in which a compensatory drawing was requested, the country concerned made, at the time of the request, a statement of the policies it intended to follow. In the two other cases of compensatory drawings, the Fund subsequently reached agreements on appropriate policies with the countries in question.

VII. Separation of the Compensatory Facility from other Drawing Facilities

One of the measures which the UNCTAD proposed for consideration by Fund member governments runs as follows:

> "(2) To place compensatory credits entirely outside the structure of the gold and successive credit tranches, so that the drawing of compensatory credits would not directly or indirectly prejudice a member's ability to make an ordinary drawing."

Presumably the measure recommended is to be interpreted in the sense that the amount drawn under the compensatory financing facility would be ignored by the Fund in computing the amount of drawing facilities still available to members under the principles applicable to the gold tranche, the first credit tranche, etc., as well as in computing the practical maximum drawing facilities open to members. In other words, the Fund would treat a drawing request by a member as if its holdings of member currency were less than its actual holdings by the amount of any drawings outstanding under the compensatory financing facility. At present the Fund is prepared to waive the 200 per cent limit to the extent that compensatory drawings are outstanding. If the UNCTAD recommendation were accepted, the limits for gold tranche and first credit tranche policies would be extended beyond 100 per cent and beyond 125 per cent of holdings, respectively, to the extent that compensatory drawings were outstanding. Most compensatory drawings are likely to occur after a country has used its gold tranche and probably also its first credit tranche. To ignore the compensatory drawings not only from the standpoint of the total drawing facilities of a member but also from the standpoint of tranche policies to be applied to the member would have the advantage of rendering the facility clearly additional in all respects. On the other hand, at any given level of holdings it would somewhat reduce the Fund's ability to secure satisfactory corrective programs in the case of ordinary drawings. It would not

1/ At present, a member that draws on its compensatory facility after having drawn its gold tranche and first credit tranche may in effect draw up to 75 per cent of quota on relatively easy policy conditions, while a member drawing on its compensatory tranche at an earlier stage could draw only up to 50 per cent on such conditions.

affect the level of charges corresponding to any given level of Fund holdings, nor would it affect the applicability to compensatory drawings of the repurchase provisions of Article V, Section 7(b). The Fund is prepared to separate the compensatory facility from other drawing facilities in the sense described above.

VIII. The Limit on Compensatory Drawings

One measure recommended by UNCTAD to Governments members of the Fund for study is:

> "(1) To increase as soon as possible the amount allocated by the Fund to compensatory financing over and above its current transactions, from 25 per cent to 50 per cent of a member country's quota."

It should be noted that the limit of 25 per cent of quota on outstanding compensatory drawings under Paragraph 5 of the Decision is not an absolute one, but applies only "normally." However, it would clearly be undesirable for compensatory drawings to be accorded frequently or as a general rule in excess of the "normal" maximum. This would raise issues of discrimination, both with respect to the compensatory drawing facility and total drawing facilities accorded to different countries. It would also defeat one purpose of the compensatory facility, namely that a country can, to a large extent, rely on obtaining compensatory financing in the circumstances for which it is designed, and should, therefore, not have to rely on "rallonges" of this facility.

It is also important to bear in mind that the limit on drawings under the facility is not the limit on the amount a country may draw as a result of a payments difficulty arising out of an export shortfall. It is always open to the country to request an additional drawing under the ordinary drawing policies applicable to its tranche position with the Fund. Admittedly, this would reduce the amount of drawing facilities available for other purposes.

If one disregards the foregoing considerations, there can be little doubt but that over any extended period of years an expansion of the 25 per cent limit on outstanding compensatory drawings would add significantly to the value of the assistance provided. Calculations as to how the Fund's compensatory facility might have worked if it had been applied, on a pure formula basis,1/ to the export earnings of primary producing

1/ It is, of course, impossible to establish in retrospect precisely what compensation would have been payable over the period 1951 to 1964 under the present scheme and with a higher limit respectively, inasmuch as estimates of trend and shortfall would have been affected by qualitative appraisal as well as by formula.

countries over the period from 1951 to 1964, and if it had been used to the full, indicate that an extension of the limit on outstanding drawings from 25 to 50 per cent of quota would have increased the effectiveness of assistance provided under the facility in a proportion roughly commensurate with the increased "cost" involved. The extent to which export availabilities are brought closer to the trend value of exports would have been increased by almost 50 per cent, the extent to which availabilities are smoothed out would have risen by some 60 per cent, while the average drawings outstanding would have risen by some 65 per cent. The data are set forth at Table 3.

In the rather favorable circumstances which have prevailed since the compensatory financing decision, only three compensatory drawings have taken place. It is noteworthy, however, that in one of them (the case of Sudan), the amount of compensation which would *prima facie* have been paid under the facility was restricted by the existence of the 25 per cent maximum. In the other two cases the amount of compensation paid was not so restricted but in each case a single compensatory drawing absorbed, respectively, 86 per cent and 71 per cent of a quota tranche.

Table 3. Compensatory Financing: Fund Scheme with Varied Limits Applied to Data for Years 1951-64 1/

Limit	Approximation Ratio 2/	Smoothness Ratio 3/	Average Drawings Outstanding 4/
.25 of Quota	.023	.029	.29
.50 of Quota			
(a) Unqualified	.034	.046	.48
(b) Qualified as to rate of use 5/	.035	.047	.45
None	.100	.121	1.36

1/ Scheme applied to a sample of 48 countries. Coefficients of .5, .25 and .25 applied to years t, t-1, and t-2, respectively, to compute shortfalls. Drawings are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of the level of exports in those years. The quotas in per cent of which the limits are expressed are not present quotas but those obtaining at the relevant dates during the period 1951 to 1964.

2/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

3/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

4/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

5/ Drawings outstanding may not increase in any year by more than 25 per cent of quota.

From a compensatory financing standpoint there is much to be said for extending the limit of the facility from 25 to 50 per cent. Since, however, it would involve an addition to the amount of liquidity which the Fund provides on liberal conditions, it might tend to reduce countries' willingness to have recourse to facilities of a more strictly conditional character. This ~~weakening of conditionality~~ increase of automaticity, which will be somewhat intensified by the separation of the compensatory facility from other drawing facilities which has been recommended in the preceding section, is ~~perhaps the~~ a most important ~~disadvantage~~ feature of the proposal under consideration.

Account should also be taken of the possible effect on the Fund's own liquidity, i.e., its effect on the probable level of drawings relative to resources provided by quotas in the Fund. ~~As shown in Table 3, if the compensatory facility had existed over the period 1951-64, and if all the~~ 48 countries covered by the table had made full use of that facility, an extension of the limit from 25 per cent to 50 per cent of present quotas would have increased the average amount of compensatory drawings outstanding from $290 million to $480 million. From the standpoint of Fund liquidity, however, what matters is not so much the average amount of compensatory drawings outstanding as the amount liable to be outstanding at peak periods. It is estimated that, on the assumptions set forth above, the extension of the limit from 25 per cent to 50 per cent would have raised the maximum amount of compensatory drawings outstanding within the period from $400 million to $740 million or, say, from 18 per cent to 33 per cent of the quotas of the countries concerned in the year--1955--in which these maxima occurred. On the assumption that potential peak year compensatory drawings outstanding at any given percentage limit have expanded since 1955 in proportion to quotas it may be estimated on the basis of the new quotas becoming effective in 1966, that outstanding drawings for a peak year like 1955 would now amount to somewhat more than $1,100 and $2,000 million for the 25 per cent and 50 per cent limits, respectively. Since, however, countries with adequate reserves will often not use opportunities for compensatory drawings that are open to them, or will not exercise their full entitlement to such drawings, and since any use made of the compensatory facility is likely to reduce to some extent requests for ordinary drawings, the true magnitude of the additional use of Fund resources at peak periods involved in the extension of the limit would be unlikely to exceed, say, $400 million to $500 million. Moreover, past experience ~~would suggest that while peak years for compensatory drawings outstanding~~

[making reasonable efforts to solve its balance of payments problems.]

~~would be likely to occur in years when non-compensatory outstandings were relatively high, they would not be likely to coincide precisely with the peak years for non-compensatory drawings outstanding.~~ 1/

Balancing the divergent considerations discussed in this section, it is intended that:

(i) the limit on the use of the compensatory facility under Paragraph 5 of the Compensatory Financing Decision of 1963 should be raised from 25 per cent to 50 per cent of quota; but that

(ii) the ~~new~~ 50 per cent limit should apply in all circumstances and not merely as with the present limit, "normally"; 1/

(iii) in any twelve month period the net expansion in drawings outstanding under Paragraph 5 of the Decision should not exceed 25 per cent of quota; and

(iv) any drawings the effect of which would be to raise drawings outstanding under Paragraph 5 of the Decision beyond 25 per cent of quota will be granted only if the member country, in addition to fulfilling the requirements of the Decision, is found to have been [following policies reasonably conducive to the development of its exports.]

1/ Outstanding Drawings in Relation to Fund Quotas, 1951-64
(in per cent of total Fund quotas)

	Actual Fund Drawings: All countries	Actual Fund Drawings: Less developed countries	Hypothetical compensatory drawings 1/
1951	12.1	3.5	0.1
1952	11.0	3.0	2.6
1953	10.5	3.7	5.0
1954	8.3	4.0	4.5
1955	6.0	3.3	4.0
1956	11.9	3.8	3.9
1957	21.8	7.9	3.2
1958	21.2	8.6	4.6
1959	11.0	5.8	2.3
1960	6.9	5.9	1.3
1961	18.0	8.7	1.4
1962	11.6	9.0	1.6
1963	11.6	9.6	0.9
1964	16.1	8.9	0.7

1/ Mixed Repurchase Scheme with qualified 50 per ~~cent limit.~~

1/ The relevant words of the Decision are: "The amount of drawings outstanding under this decision will not normally exceed 25 per cent of the member's quota."

The limitation suggested under (iii) above will impose a delaying effect in utilizing the compensatory facility to the full extent proposed under (i). As will be seen from Table 3, this arrangement would probably yield slightly better results with respect both to approximation to export trend and to smoothness of export availabilities than would an unqualified limit of 50 per cent of quota, and would be slightly less expensive to the Fund in terms of drawings outstanding.

In connection with the delaying effect of proposal (iii), it should be borne in mind that Consultations under Article XIV or Article VIII would provide an opportunity for testing the extent to which a member had implemented its undertakings under earlier compensatory drawings to "cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties," and also the extent to which it was complying with the conditions set forth at (iv) above.

If the resources needed by a member to deal with a particular shortfall exceeded the amount permitted under condition (iii) above and the member desired additional assistance from the Fund, it would enter into discussions with the Fund for a drawing on the terms normally applicable to the tranche in which the country found itself.1/ This would be a drawing under Paragraph 4 of the 1963 Decision, and, as such, would not be limited in magnitude to any a priori percentage of the member's quota.

IX. Repurchase of Compensatory Drawings

The third measure recommended by UNCTAD for study by Fund member governments is:

> "(3) To explore ways to secure possible refinancing of compensatory financing obligations of the developing countries in the event of a persistent shortfall in export receipts beyond the control of the country affected."

While there is no specific provision in the Compensatory Financing Decision of 1963 for refinancing of compensatory drawings, refinancing on a short- to medium-term basis would, in effect, be possible under present procedures in the circumstances that appear to be envisaged in the recommendation, viz., in the case where at the time when the repurchase falls due there is a shortfall in export receipts beyond the control of the affected country. The repurchase would, of course, restore the compensatory financing facility pro tanto, and if at that time an export shortfall of the type described persisted, the member would be in a position to apply for a new drawing under this facility. It would not, however, be able to increase its outstanding compensatory drawings as much as if there had been no repurchase obligation. Moreover, a country that had

1/ In accordance with the proposal at p. 16 above, the terms in question would, of course, be determined by the Fund's holdings of the member's currency, exclusive of those arising from drawings outstanding under Paragraph 5 of the Compensatory Financing Decision.

made a compensatory drawing might suffer hardship by having to repurchase in a year in which, even though it had no shortfall, neither had it any excess of exports over the norm out of which it could afford to make repayment.

This raises the much more fundamental issue as to whether repayments for compensatory drawings should take place according to the normal 3 to 5 years rule, or whether they should take place, entirely or to a considerable extent, in years in which exports exceed the estimated trend value. As can be seen from Table 4 below, schemes in which (a) repurchases were made exclusively out of export excesses, and (b) the full amount of such excesses was directed to repurchases would probably, over the years 1951 to 1964, have enhanced the degree of approximation to the export trend by over 20 per cent, and the smoothing effect of the facility on export availabilities by over 50 per cent as compared to schemes involving repurchase under the 3 to 5 year rule. This holds true whether the limit on outstanding drawings is 25 per cent or 50 per cent of quota. For schemes without limits the superiority of compensatory repurchase would have been still greater.

Contrary to what might perhaps at first sight be assumed, the change in the timing of repurchases would also, save in the "no limit" case, have reduced the average length of time for which compensatory drawings remained outstanding and hence have reduced the average amount of compensatory drawings outstanding at any one time. It seems probable, therefore, that a system whereby compensatory drawings are repaid out of export excesses rather than under the 3 to 5 year rule would do much to improve the performance of the facility without any additional "cost"--indeed with a reduction in cost--in terms of drawings outstanding.

In order to apply this method of repayment for compensatory drawings, calculations would have to be made at twelve-monthly intervals to see whether or not export excesses had occurred. These calculations might be made with respect to calendar years or Fund financial years, beginning with the first complete year following the drawing. Alternatively, and preferably, they might be made for each twelve-months period, beginning with the twelve months immediately following that with respect to which the drawing had been granted. Since it would be a matter not of a drawing facility, but of a repayment obligation, it would be inappropriate to rely to any extent on qualitative estimation of a necessarily subjective kind in calculating the export excess. This ~~should be done~~ calculation should be made on the basis of the statistical formula adopted as an element in the calculation of shortfalls.

~~[The following passage, to the end of the section on "Compensatory~~ Facility and Fund Liquidity," diverges substantially from the corresponding passage from the foot of p. 22 to p. 26 inclusive in SM/65/101, and proposes a type of mixed repayment system for compensatory drawings different from that proposed in SM/65/101. These changes were made to meet the point made by a number of Executive Directors that repurchases out of export excesses, though avoiding the difficulties that would arise from repurchase requirements occurring at a time of poor or mediocre exports, might have difficulties of their own in that the amount of the repurchase obligation would not be known in advance. The system now proposed attempts to avoid or mitigate both sets of difficulties, in a manner ~~not unduly expensive to the Fund.]~~

Two difficulties arise with respect to this fully compensatory system of repurchases out of export excesses. The first concerns the predictability of repurchase obligations. Countries might occasionally find it difficult to repurchase compensatory drawings to the full extent of any excess of actual over trend value of exports, partly because an expansion in exports would probably entail some increase in import requirements, and partly because the obligation to repay would not be known with certainty until after the event. This difficulty should not be exaggerated. Owing to the manner in which export excesses are calculated, only one half of any increase in exports over the average level in the two years preceding the excess year could give rise to a repurchase, and if serious problems on repurchase should nevertheless arise owing to circumstances affecting other items in the balance of payments, it would always be possible for the Fund, under appropriate conditions, to agree to an ordinary drawing at the time of the compensatory repurchase. Nevertheless, it is possible that countries might prefer to have their repurchase obligations expressed in a more predictable form.

The second difficulty arises from the fact that under the system of repurchase out of export excesses a proportion of the repurchases of compensatory drawings would probably remain outstanding for longer periods than has hitherto been deemed compatible with the temporary character of Fund assistance. This does not mean that repayment would normally be more delayed than under the 3 to 5 year rule. Indeed, if, as indicated in Table 4, the amount of compensatory drawings outstanding is generally likely to be less when repayments are geared to exports than when they are made under the 3 to 5 year rule, the average length of time for which a drawing remains outstanding will probably be less in the former than in the latter case. More direct measurements of probable periods for which compensatory drawings would remain outstanding if repayments were also on a compensatory basis are given in Table 5, which is based on the experience of the years 1951-64. From this it can be seen that, even with an unqualified limit of 50 per cent of quota, some two thirds of all compensatory drawings would be repaid within 3 years, and more than four fifths within 5 years. The residue remaining outstanding beyond 8 years might be about 1 per cent. In considering these results, it should be borne in mind that the repurchase obligations under Article V, Section 7, would, of course, continue to apply--a fact which could not be taken into account in the calculations set forth at Table 5.

Table 4. Compensatory Financing: Fund Scheme with Varied Forms of Repayment, 1951-64[1/]

Repayments System	Fixed Term[2/]	Compensatory[3/]	Mixed[4/]
	25 Per Cent of Quota Limit		
Approximation Ratio[5/]	.023	.028	~~.026~~ .026
Smoothness Ratio[6/]	.029	.045	~~.036~~ .037
Average Drawings Outstanding[7/]	.29	.17	~~.26~~ .25
	50 Per Cent of Quota Limit (Unqualified)		
Approximation Ratio	.034	.042	~~.041~~ .039
Smoothness Ratio	.046	.072	~~.060~~ .059
Average Drawings Outstanding	.48	.36	~~.40~~ .43
	50 Per Cent of Quota Limit (Qualified)		
Approximation Ratio	.035	.043	~~.042~~ .041
Smoothness Ratio	.047	.071	.060 .060
Average Drawings Outstanding	.45	.28	~~.42~~ .38
	No Limit		
Approximation Ratio	.100	.155	~~.160~~ .121
Smoothness Ratio	.121	.216	~~.205~~ .050
Average Drawings Outstanding	1.36	1.49	~~1.77~~ 1.17

1/ Weights of .50, .25 and .25 applied to years t, t-1, and t-2, respectively, for estimating calculated norm. 100 per cent compensation of calculated shortfall.

2/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

3/ 100 per cent of export excesses applied to repayment in all years.

4/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings are deducted from exports for the purpose of computing shortfalls.

5/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

6/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

7/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

If the requirement that the Fund assistance be "temporary" could be deemed to be adequately met by the manner in which export shortfalls and excesses are calculated, and by the statistical probability that the average period of repayment will be short, this change is one which it would be advisable to adopt. However, it is considered that this requirement calls for a fixed maximum term for every drawing, which would make it difficult to adopt the repayment system under consideration in an unmodified form.

A "mixed" system on the following lines would seem to meet both of the difficulties referred to above and to combine many of the advantages of "compensatory" and "fixed term" repurchase respectively:

(a) Compensatory drawings would be repaid in equal annual instalments over a five-year period.

(b) In estimating export shortfalls for the purpose of making compensatory drawings, the Fund would, if the member so requested, deduct from the figure for actual exports one half of any repurchases on past compensatory drawings that had been made within 12 months prior to the new compensatory drawing. Such deductions, which would not affect the computation of the export norm for the shortfall year, would be allowed only if the resulting estimate of shortfall exceeded 2 per cent of the drawing member's quota.

(c) Any request for compensatory drawings involving a deduction such as that described at (b) above would be met only if the Fund was satisfied that the member, in addition to fulfilling the requirements of Paragraph 5 of the Compensatory Financing Decision, [had been following policies reasonably conducive to the development of its exports.] [had been making reasonable efforts to solve its balance of payments problems.]

To the extent that a member took advantage of the deduction, the effect of this arrangement would be that the member would repay, with respect to any compensatory drawing, either the due instalment for the year or half that instalment plus its export excess, whichever was the less. This would be easier on the member, in respect of the predictability and possibly the amount of the repayment in certain years, than the system of full compensatory repayment out of export excesses. [It would differ from that system in two other ways: (i) Normal repurchases would be the occasion for a new compensatory drawing provided an appraisal partly on a qualitative and not entirely on a formula basis justified such a drawing, and the member declared that it was prepared to discuss its policy with the Fund. (ii)] On the other hand, the addition of paragraph (c) introduces the concept that the country whose compensatory drawing was enhanced on account of a repurchase would have to satisfy the Fund that it had been pursuing reasonable [export] [balance of payments] policies even where the drawing [insofar as it was occasioned by a repurchase] would fall within the first compensatory tranche. This [latter] feature, together with the 2 per cent cut-off mentioned at (b) above, would eliminate one of the possible defects of the fully compensatory repurchase system, viz., that a country would never repurchase if its exports, having once declined, continued to stagnate. [insofar as the stagnation was attributable to faulty policies.]

Table 5. Duration of Drawings under Compensatory Repayments System[1/]

(Period = 1951-64)

	25% of Quota Limit		50% of Quota Limit (Qualified)		50% of Quota Limit (Unqualified)	
	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings
Total drawings	.89	100	1.24	100	1.45	100
Repaid:						
Within 3 years	.74	83	.97	78	.97	67
Outstanding after:						
Fifth year	.09	10	.15	12	.27	18
Eighth year	.01	about 1[2/]		about 1[2/]		about 1[2/]

1/ Coefficients of .5, .25 and .25 applied to years t, t-1, and t-2, respectively, to compute shortfalls. Full compensation of shortfalls is assumed. One hundred per cent of excesses applied to repayment.
2/ Since some of the drawings in question were still outstanding at the end of the period but had not yet reached their eighth year, this figure is an estimate.

As will be seen from Table 4, the performance of this "mixed" system of repurchase, over the years 1951-64, as measured by the approximation ratio and the smoothness ratio, would probably have been better than that of the "fixed term" (3 to 5 years) system of repurchase, ~~and only slightly~~ though somewhat inferior ~~--except where there are no limits to outstanding drawings--~~ to that of a fully compensatory system of repurchase out of export earnings.

The "cost" in terms of drawings outstanding is higher for the "mixed" system than for a fully compensatory system of repurchase. This is the price that has to be paid for increasing the predictability of repurchase obligations. The cost is, however, no greater--so long as the outstanding drawings of individual countries are limited to 25 per cent or 50 per cent of quota--than under the present system of repurchase within 3 to 5 years.

X. Changes in the Compensatory Facility and Fund Liquidity

~~On page 19 above an estimate was made of the possible charge on Fund liquidity that might arise~~ from additional drawings ~~associated~~ with an extension of individual country ~~limits on outstanding~~ compensatory drawings from 25 per cent to 50 ~~per cent of~~ quota. At this ~~point, a similar calculation is in order as to the charge on Fund liquidity that might result from adopting both of the~~ principal measures suggested above, viz., (a) the

It may be appropriate, at this point, to estimate the possible charge on Fund liquidity that might result from additional drawings with the adoption of the two extension of the limit from 25 per cent to 50 per cent with the qualification that the increase in outstandings in any year should not normally exceed 25 per cent, and (b) the adoption of the "mixed" system of repurchase discussed above in place of the fixed-term system of repurchase which applies at present. Some additional claims on Fund resources might also arise from the proposed separation of the compensatory facility from the other drawing facilities of the Fund, but this cannot be quantified and is unlikely to be large.

As can be seen from Table 4, if the compensatory facility had existed over the period 1951-64, and if all the 48 countries covered by the Table had made full use of the facility, the transition from "fixed term" repurchase with a 25 per cent of quota limit, to a "mixed" system of repurchase with a qualified 50 per cent of quota limit would [over the 1951-64 period] have involved an increase in the average level of [potential] compensatory drawings outstanding over the period from $290 million to[$420] $380 million, i.e., an increase of [$130] $90 million. From the standpoint of Fund liquidity, however, what matters is not so much the average amount of compensatory drawings outstanding as the amount liable to be outstanding at peak periods. It is estimated that, on the assumptions set forth above, the maximum level of [potential] compensatory drawings outstanding would likewise have risen from $400 million (in 1955) to[$560] $520 million (in 1958), i.e., by[$160] $120 million. On the assumption that peak year potential compensatory drawings outstanding have expanded since 1955-8 in proportion to quotas, the proposed changes in limits and repurchase systems might, under present conditions, raise maximum potential compensatory drawings from $1,100 million to [$1,500] $1,400 million, i.e., by [$400] $300 million. [Allowing for failure to use the full entitlement to compensatory drawings and other factors] Since, however, countries with adequate reserves will often not use opportunities for compensatory drawings that are open to them, and since any use made of the compensatory facility is likely to reduce to some extent requests for ordinary drawings, it seems unlikely that the increase in peak year drawings occasioned by the proposed changes would in practice exceed [$200 million] half the amount mentioned above, viz., $150.

XI. Conclusions for Action

More than three years have now elapsed since the creation of the compensatory financing facility, and though it has not been extensively used the Fund has had sufficient experience with it to review and reappraise its application and scope. As a result it has been deemed desirable both to clarify the circumstances under which the facility can be used and to introduce into it certain modifications designed to increase the effectiveness of the assistance which the Fund provides to members.

In determining the medium-term export trend for the purpose of calculating the export shortfall the practice hitherto has been to give approximately equal weight to statistical and qualitative estimates, respectively. Experience suggests that qualitative estimates based on commodity analysis gives a closer estimate of the trend; consequently qualitative estimates will receive a greater weight in the future.

At present, the Fund is prepared to waive the requirement that total outstanding drawings may not exceed the Fund holdings of a member's currency beyond 200 per cent of quota either to accommodate compensatory drawings or, to the extent that compensatory drawings are outstanding, to accommodate other drawings. However, drawings under the compensatory facility are included in Fund holdings of the member's currency in applying the tranche policies of the Fund to subsequent drawings. Full recognition of the special circumstances which give rise to compensatory drawings would make it desirable to separate this facility from normal drawing facilities of the Fund so that additions to the amount of compensatory drawings outstanding would not in any way affect the tranche policies applicable to other drawings.

While the use of the compensatory facility is most needed when a shortfall appears, members may be precluded or deterred from requesting use of the facility at that time since the full amount of shortfall can be known only after the interval of several months. To meet this problem it is proposed that within six months of any drawing, members should be enabled to reclassify all or part of it as a compensatory drawing and thus to restore to that extent their normal drawing rights for future contingencies.

Under the 1963 Decision outstanding drawings under the compensatory facility are limited normally to 25 per cent of quota. It is believed that an extension of the limit on outstanding drawings from 25 to 50 per cent of quota would add substantially to the value of the assistance provided. At the same time it is important to avoid such changes as would tend to weaken the ability of the Fund to exert its influence with members toward early adoption of sound corrective policies. It is, therefore, proposed that compensatory drawings outstanding may amount to a maximum of 50 per cent of quota, but that during any twelve-month period the amount of such drawings outstanding may not increase by more than 25 per cent of quota and that requests which would increase outstanding compensatory drawings beyond 25 per cent of quota should be met only if the Fund is satisfied that the member has been [following reasonably sound export policies.] [making reasonable efforts to solve its balance of payments problems.]

The question of repurchases of compensatory drawings has also been reconsidered in light of the possibility that the course of export receipts may make it difficult for a member to repurchase drawings fully within 3 to 5 years. On the other hand, repurchase terms should not be so changed as to undermine the revolving nature of Fund resources. Balancing these considerations, it is proposed that compensatory drawings should be repayable in equal annual instalments over a five-year period but that the member should be able to offset[1] one half of such repurchases against actual export receipts for the purpose of determining the amount of any new compensatory drawings if it is able to satisfy the Fund that it has been [pursuing reasonably sound export policies.] [making reasonable efforts to solve its problems.]

XII. Decision

In the light of the foregoing considerations, Decision No. 1477-(63/8) of February 27, 1963, on Compensatory Financing of Export Fluctuations is hereby amended by the deletion of paragraphs (5) through (8) and the substitution of the following paragraphs:

"(5) The Fund has reviewed its policies to determine how it could more readily assist members, particularly primary exporters, encountering payments difficulties produced by temporary export shortfalls, and has decided that such members can expect that their requests for drawings will be met where the Fund is satisfied that

(a) the shortfall is of a short-term character and is largely attributable to circumstances beyond the control of the member; and

(b) the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

Drawings outstanding under this paragraph may amount to 50 per cent of the member's quota provided that: (i) such drawings will not be increased by a net amount of more than 25 per cent of the member's quota in any 12-month period, and (ii) requests for drawings which would increase the drawings outstanding under this paragraph beyond 25 per cent of the member's quota will be met only if the Fund is satisfied that the member has been[following policies reasonably conducive to the development of its exports.] [making reasonable efforts to solve its balance of payments problems.]

(6) A member requesting a drawing under paragraph (5) will be expected to represent that it will make a repurchase corresponding to the drawing in equal annual instalments to commence one year after the drawing and to be completed not later than five years after the drawing. However, in estimating export shortfalls for the purpose of drawings under paragraph (5), the Fund will, if the member so requests, deduct from the figures for actual one half of exports an amount equivalent to any repurchases made with respect to past drawings under paragraph (5) within 12 months of the request for the new drawing. A request for a drawing with respect to a shortfall which results in whole or in part from such deductions will be met by the Fund if it is satisfied that the member, in addition to fulfilling the requirements of paragraph (5), has been[following policies reasonably conducive to the development of its exports.] [making reasonable efforts to solve its balance of payments problems.]

(7) Whenever the Fund's holdings of a member's currency resulting from an outstanding compensatory drawing under paragraph (5) are reduced, by the member's repurchase or otherwise, this will restore *pro tanto* the member's facility to make a further compensatory drawing under that paragraph, should the need arise.

(8) When drawings are made under paragraph (5), the Fund will so indicate in an appropriate manner. Within six months from the date of any drawing which is not under paragraph (5) and to the extent that it is still outstanding, a member may request that all or part of the drawing be reclassified and treated, for all purposes of this decision, as a drawing made under paragraph (5). The Fund will agree to such a request if at the time of the request the member meets the requirements for a drawing of an equal amount under paragraph (5) and makes the representation as to repurchase appropriate to such drawings, which representation will then be substituted for the original repurchase representation.

provided that the resulting shortfall exceeds 2 per cent of the member's quota.

(9) In order to implement the Fund's policies in connection with compensatory financing of export shortfalls, the Fund will be prepared to waive the limit on Fund holdings of 200 per cent of quota, where appropriate. In particular, the Fund will be prepared to waive this limit (i) where a waiver is necessary to permit compensatory drawings to be made under paragraphs (4) and (5) above, or (ii) to the extent that drawings in accordance with paragraph (5) are still outstanding.

Moreover, the Fund will apply its tranche policies to drawing requests by a member as if the Fund's holdings of the member's currency were less than its actual holdings of that currency by the amount of any drawings outstanding under paragraph (5).

(10) In order to identify more clearly what are to be regarded as export shortfalls of a short-term character, the Fund, in conjunction with the member concerned, will seek to establish reasonable estimates regarding the medium-term trend of the member's exports ~~on the basis of appropriate statistical data in conjunction with qualitative information about its export prospects.~~ based partly on statistical calculation and partly on appraisal of export prospects.

(11) The provision of credit to deal with the balance of payments effects of export fluctuations provides immediate relief for a country's short-term difficulties. In many cases, however, it will also be necessary to introduce measures of a policy character in order to attain a satisfactory and lasting solution to a country's balance of payments problems. Members generally have actively cooperated with the Fund to find and adopt the measures necessary to this end. Beyond immediate balance of payments difficulties, the primary exporting countries are, in many instances, facing unfavorable long-term export trends, and all are trying to meet the challenge of achieving more rapid and sustained development through a strengthening and broadening of their economies. The last mentioned problem will require action in many fields and over many years by both the primary exporting countries and the industrial countries, separately and in concert, including readier access to the markets of the developed countries for the products of the developing countries and an appropriate and sustained flow of technical and financial assistance to the developing countries. The Fund considers that its activities can provide valuable assistance in helping to establish a climate within which longer-term measures can be more effectively pursued."

(12) The Fund will review this decision in the light of experience and developing circumstances.

APPENDIX "A"

United Nations Conference on Trade and Development
Final Act and Report

Annex A.IV.17

Study of Measures Related to the Compensatory Credit System of the International Monetary Fund

The Conference,

Considering that the compensatory credit system put into operation by the International Monetary Fund since February 1963 constitutes a definite step towards the solution of short-term financing problems,

Considering that, in view of the short-term needs of developing countries derived from fluctuations in their export receipts, this system should be reviewed,

1. Recommends that Governments members of the International Monetary Fund study the following measures:

> (1) To increase, as soon as possible, the amount allocated by the Fund to compensatory financing, over and above its current transactions, from 25 per cent to 50 per cent of a member country's quota;
>
> (2) To place compensatory credits entirely outside the structure of the gold and successive credit tranches, so that the drawing of compensatory credits would not directly or indirectly prejudice a member's ability to make an ordinary drawing;
>
> (3) To explore ways to secure possible refinancing of compensatory financing obligations of the developing countries in the event of a persistent shortfall in export receipts beyond the control of the country affected.

2. Requests that the International Monetary Fund, in its determination of the shortfall in export receipts, consider giving greater weight to the actual experience of the three preceding years.

APPENDIX "B"

Excerpts from Speeches of Governors at the 1965 Annual Meetings

AFGHANISTAN (Governor Achaczai)

The recent fall in basic commodity prices and difficulties in marketing total available supplies will necessitate compensatory financing in the coming months. To meet these needs, the facilities of the Fund need improvement.

ARGENTINA (Governor Pugliese, on behalf of 19 Latin American countries and the Philippines)

We should like to reiterate our opinion once more regarding the decision adopted in 1963 by the Executive Board of the Fund on the compensatory financing of losses in the export proceeds of primary-producing countries. We recognize that this represents a contribution toward the partial solution of this very important problem. However, it would be advisable to consider three fundamental aspects:

1) The need for considering the compensatory tranche in addition to the normal credit facilities of the Monetary Fund. The decision of February 1963, indeed, permits the drawing without taking into consideration the position of the requesting country with regard to the credit tranches. Nevertheless, the drawing has been added to those already made and thus may affect the country's position in respect of future transactions with the Fund. In our opinion it is of the greatest importance that the compensatory drawing be allotted quite separately from the others and invested with the supplementary nature that the different schemes favored by our countries have always upheld.

2) The amount available under this type of loan, limited to 25 per cent of each member's quota, is of insufficient size even in the case of very moderate depressions. If this ceiling were raised from 25 to 50 per cent, more significant resources would be made available to the countries exporting primary products, without this entailing a very heavy burden on the resources of the institution.

3) In conclusion, we would emphasize the non-automatic nature of the drawings permitted. In the decisions on individual cases submitted to the consideration of the Executive Board there has been some flexibility, although in all of them there has been no lack of a subjective assessment in the determination both of the amount to be compensated and of the circumstances in which the loss of income occurs.

CEYLON (Governor Wanninayake)

I was encouraged by the reference by Mr. Schweitzer to the work that the Fund is now undertaking to improve the compensatory financing facility. Several speakers have urged that compensatory assistance should be provided for a decline in the terms of trade rather than for a fall in export earnings alone. My own country's experience in recent years vividly illustrates the importance of this reform. We suffered a decline in the terms of trade by 13 per cent in two years alone, but since this was almost entirely due to an increase in import prices we were unable to avail ourselves of the compensatory financing facility. I do sincerely hope that this particular improvement in the scheme will be made effective at an early date.

CHINA (Governor Lee)

However, the scanty application that developing countries have made of the compensatory financing facility of the Fund would seem to indicate that the economic problems of developing countries cannot readily be solved through temporary accessibility to credit.

GREECE (Governor Zolotas)

. . . improved facilities for compensatory financing and more flexible conditions for drawings and repurchases should also be envisaged to provide for a direct contribution to the liquidity position of developing countries.

IRAQ (Governor Haseeb)

May I point out in this connection that the compensatory financing scheme of the Fund, though admirable in itself, suffers from one drawback. The borrowing facility under this scheme is available to primary producing countries when the shortfall in their exports is due to factors beyond their control. Since the decline in exports in such cases would be temporary and self-correcting, the Fund should not make the facility conditional on the pursuit by the country concerned of particular policies about its general balance of payments position.

SUDAN (Governor El Hindi)

Appreciative as we are of the Fund's efforts in this respect, we strongly feel that the terms and conditions under which the Fund provides such compensatory assistance (and, indeed, any other assistance) should be reconsidered with the view of softening them. It is no secret that a very limited number of members have so far made use of these arrangements, in spite of the pressing need of many for such assistance.

UGANDA (Governor Kalule-Settala)

While the Fund's operations are properly concerned with short-term balance of payments aspects, it may not be possible under conditions of fluctuating export earnings to differentiate between the short- and the long-term aspects. Such conditions tend to make public debt burdens unduly onerous on developing countries which base the servicing of their public debt burden on the expectation of a steady and reasonable growth in export earnings. It is therefore important in my view that both the Bank and the Fund should continue their efforts to find solutions to these problems. The Fund, on the one hand, should review the present compensatory financing arrangements to take account of the problems of fluctuating export earnings. The Bank, on the other hand, should continue to play a prominent role in evolving price stabilization machinery for primary products in association with UNCTAD.

UNITED ARAB REPUBLIC (Governor Kaissouni of the Bank)

Thus, the compensatory financing facility could be increased from one tranche to two tranches and the criteria for using this facility could be improved to take into account results to date and discussions in UNCTAD.

VIET-NAM (Governor Truong Thai Ton)

In particular, the nonliberal trade policy adopted by developed countries has obstructed the entry into these countries of primary manufactured products from the underdeveloped countries. To be sure, the action of the Bank and Fund in the form of compensatory financing granted to countries exporting primary products or in the form of assistance for the development and expansion of trade has been highly effective. However, the action necessary for the removal of discriminatory trade practices or other obstacles to the development of international trade should be hastened. This action should be supplemented by a complete revision of the present system of international payments. We also have high hopes that with the general increase in Fund quotas, the Fund will be able not only to grant compensatory financing facilities on a broader basis, for example, by increasing the percentage of this financing, but also to consider ways to aid countries which have experienced a temporary export shortfall as a result of crop losses caused by war, floods or other natural calamities.

FOR AGENDA

Mr. J. J. Polak

Room 504 F

#3

SM/66/97

August 5, 1966

To: Members of the Executive Board

From: The Secretary

Subject: Compensatory Financing: More Systems of Repurchase

The attached memorandum has been prepared for consideration by the Executive Directors in connection with the Board's resumed discussion of compensatory financing, presently scheduled for Monday, August 15.

Att: (1)

Other Distribution:
Department Heads
Division Chiefs

INTERNATIONAL MONETARY FUND

Compensatory Financing: More Systems of Repurchase

Prepared by the Research and Statistics Department

August 4, 1966

The discussion, which took place at Executive Board Meeting No. 66/62 of July 20, of the various alternative systems of repurchase set forth in SM/66/86 gave rise to a number of suggestions for new or modified systems. These are discussed below and their performance evaluated in the light of tables and charts.

On page 1 of SM/66/86 five systems were listed and described. In the present paper three additional systems are considered, as follows:

(6) A variant of system (5) of SM/66/86. Repurchase would take place in five annual instalments. However, a member, in applying for a drawing under the compensatory facility could, if it so desired, request that half of any repurchases of compensatory drawings taking place over the preceding year should be subtracted from exports for the purpose of calculating the export shortfall. Such a request would be granted only where condition (c) described at page 25 of SM/66/77 (or Mr. Lieftinck's alternative condition described below) was met, and only where the resulting shortfall exceeded 2 per cent of the member's quota. (The lastmentioned feature is referred to in what follows as "the 2 per cent cut-off.")

(7) A combination of systems (2) and (5) of SM/66/86, as suggested by Mr. O'Donnell. As in the "mixed system" of SM/65/101 (system 2), any export excesses occurring in the first three years after a shortfall for which a compensatory drawing had been made would be used to repay the drawing; any amount remaining unpaid three years after the drawing would be repaid in equal instalments in the fourth and fifth years. However, in applying for any new compensatory drawing, the member could, if it wished, request that any instalment repayments occurring in the year preceding the drawing be subtracted from exports in computing the shortfall, subject to the same 2 per cent cut-off and the same conditions as under system (6).

(8) A modification of system (2) that has been suggested, under which half of any export excess occurring in the first three years following a shortfall for which a drawing had been made would be used for repurchase, while in the fourth year either half the amount still outstanding or half the excess, whichever is the greater, would be used for repurchase, the remainder being paid in the fifth year.

The tables and graphs appended to this paper are based either on the actual export experience of 48 countries over the period 1951 to 1964, or else on the hypothetical export experience of two notional countries A and B, introduced in SM/66/86. In country A, exports are assumed to fall suddenly from a plateau of 1,000 per annum to a plateau of 900 per annum. In country B, exports are assumed to develop, over a 29 year period, with the sort of fluctuations and growth trends typically found to exist in the actual experience of primary producing countries (though probably with fewer periods of relative calm than in the average country.)

In Table 1, the performance of repurchase systems (1), (6), (7) and (8), as measured by the usual statistical tests, is considered in relation to (a) the export experience of the 48 countries over the period 1951-64 and (b) that of notional country B.

In Table 2, the same sort of data relating to notional countries A and B that was given in Table 2 of SM/66/86 for systems (1) to (5) are given for systems (6) to (8).

In Table 3, data on drawings outstanding for country B are given for systems (1) to (8).

In Charts 1 to 3, data relating to systems (6) to (8) are given for notional countries A and B. Chart 1 illustrates systems (6) and (7) for country A; system (8) is not shown for country A since the chart would be identical to the top panel of Chart 1 in SM/66/86. Charts 2 and 3 show data relating to systems (7) and (8), respectively, for country B; system (6) is not shown for country B, since export availabilities differ only minutely from those for system (5), given in Chart 7 of SM/66/86.

Re System (6)

The introduction of the 2 per cent cut-off, while it makes no perceptible difference to the approximation ratio or the smoothness ratio for the 48 countries, shortens the period of continuously outstanding drawings substantially in the case of country A and slightly also in the case of country B.

At the Executive Board meeting of July 20 the point was made, on the basis of Table 2 of SM/66/86, that system (5) had the disadvantage, illustrated in the case of country B, of leaving drawings outstanding for a long period. From Table 3 of the present paper it can be seen that in system (6), (i.e., system (5) with the 2 per cent cut-off) the period of continuous use is not significantly longer than in system (1) (the present 3 to 5 years repurchase system), while the amounts outstanding are in most years significantly lower. From Table 1 it can be seen that the approximation and smoothness ratios are somewhat lower for system (6) than for systems (7) or (8) (though higher than for system (1)) when these systems are applied to the 48 countries, but that the contrary is true when the systems are applied to the case of country B. Though country B is only a notional country, this result is not without significance since the length of the period covered (29 years) allows the effects of repurchase systems to work themselves out more fully than the period of 14 years for which the data for 48 countries are available.

Re System (7)

This system, as already indicated, gives relatively good results on the statistical criteria for the 48 countries. However, the staff consider it should be rejected partly because it involves superimposing the complications of the refinancing procedure on an already somewhat complicated system of repurchase, and partly because it does nothing to meet the objection to fully compensatory repurchases that was mentioned on page 23 of SM/66/77. There it was stated that "Countries might occasionally find it difficult to repurchase compensatory drawings to the full extent of any excess of actual over trend value of exports, partly because an expansion in exports would probably entail some increase in import requirements, and partly because the obligation to repay would not be known with certainty until after the event."

Re System (8)

This system also gives relatively good statistical results for the 48 countries--slightly better results, indeed, than the mixed system of SM/65/101, of which it is a modification, as can be seen by comparing Table 1 of the present paper and Table 1 of SM/66/86. It also does something to meet the objection to fully compensatory repurchase set forth above. On the other hand, it gives less predictability than system (6) and does nothing to meet the considerations underlying the UNCTAD resolution mentioned at page 21 of SM/66/77.

Taking into account a wide variety of considerations, both those mentioned in SM/66/77 and those which have arisen in discussions at Executive Board meetings, the staff would recommend system (6) as on the whole most suitable for adoption, with system (8) as a second choice. Either would actually be preferable to the present system (system (1)). The compensatory facility is intended to assist countries to maintain their economies on an even keel, and this objective is promoted by bringing the principle of compensation into the treatment of export excesses as well as shortfalls. While the existence of a three years period of grace for repurchase undertakings has its justification in relation to payments deficits that arise from maladjustments that take time to correct, it has little justification in relation to short-term export fluctuations. Yet the temptation to withhold repurchase till it becomes inevitable may often be too strong to be resisted.

The last-mentioned consideration is of importance also in considering the suggestion made at the Executive Board Meetings of July 6 and July 20 that members making use of the compensatory drawing facility should be allowed to choose whether they should make repurchases in accordance with a system chosen especially for compensatory drawings or under the 3 to 5 year system applicable to ordinary drawings. This obviously cannot mean that a member would be allowed to switch from one repurchase system to another according to its current advantage during the lifetime of a compensatory drawing. For example, it cannot mean that a member, though it had export excesses, could refrain from making repurchases during the first three years after such a drawing under system (1), and then in the fourth and fifth year move over to system (6) so as to take advantage of its smaller instalments or its refinancing privileges. If the proposal is understood in the sense that, at the moment of the drawing the member could choose irrevocably which repurchase system it would apply, then it is doubtless feasible in a technical sense. It is, however, open to the objection that just those members that experience the greatest difficulty in keeping their economies on an even keel would be most tempted to postpone repurchases as long as possible by adopting system (1). The proposals now under consideration for reforming the compensatory facility are best regarded as a package. The additional scope for drawings afforded by the extension of the limit to 50 per cent of quota strengthens the case for a system of repurchase that ensures that part at least of export excesses are devoted to repurchase.

At the Executive Board Meeting of July 20, it was suggested that the phrase "is found to have been following policies reasonably conducive to the development of its exports" in sub-paragraph (iv) of page 20 of SM/66/77, which deals with the conditions for making compensatory drawings in the second 25 per cent of quota, should be replaced by some phrase referring to the balance of payments as a whole and closer to the present terms of drawing in the first credit tranche. If this were done, analogous substitutions would presumably be made in sub-paragraph (c) of page 25 and in paragraph 6 on page 29 of that paper, and would be applicable to repurchase systems (3), (5) and (6).

It is important in both contexts that in any rephrasing the condition should remain one with respect to <u>past</u> rather than to <u>prospective</u> policies, so that requests for compensatory drawings could be handled without the delays involved in special consultations or missions. If, therefore, it is decided to adopt a phrase relating to the balance of payments as a whole rather than to exports alone, it might run as follows: "is found to have been making reasonable efforts to solve its balance of payments problems."

Table 1. Compensatory Financing: Effect of Various Repurchase Systems, 48 Countries (1951-64) and Hypothetical Country B 1/

(Qualified 50 Per Cent of Quota Limit)

	48 Countries			Hypothetical Country B		
	Approximation ratio 2/	Smoothness ratio 3/	Average drawings outstanding 4/	Approximation ratio 2/	Smoothness ratio 3/	Average drawings outstanding 5/
System 1 6/	.035	.047	.45	.123	.148	6.2
System 6 7/	.041	.060	.38	.135	.160	4.5
System 7 8/	.042	.068	.28	.120	.137	2.5
System 8 9/	.043	.071	.32	.120	.141	3.1

1/ Weights of .50, .25 and .25 applied to years t, t-1, and t-2, respectively, for estimating calculated norm. 100 per cent compensation of calculated shortfall.

2/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

3/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

4/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

5/ Average for all years of total amounts outstanding, in units. (Exports of country B vary between 100 and 238 units, and its quota is assumed to rise in quinquennial steps from 20 to 40 units.)

6/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

7/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

8/ 100 per cent of export excesses applied to repayment in the first three years; remaining amounts to be repaid in two equal instalments in the fourth and fifth years. One half of any fourth-year or fifth-year repayment is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

9/ 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

Table 2. Compensatory Financing: Effect of Various Repurchase Systems for Two Hypothetical Countries

Year	Exports	Standard Norm[1/]	System 6[2/] Drawings	System 6 Repurchases	System 6 Availabilities	System 7[3/] Drawings	System 7 Repurchases	System 7 Availabilities	System 8[4/] Drawings	System 8 Repurchases	System 8 Availabilities
					Hypothetical Country A						
1	1,000	1,000	-	-	1,000.0	-	-	1,000.0	-	-	1,000.0
2	1,000	1,000	-	-	1,000.0	-	-	1,000.0	-	-	1,000.0
3	1,000	1,000	-	-	1,000.0	-	-	1,000.0	-	-	1,000.0
4	900	950	50.0	-	950.0	50.0	-	950.0	50.0	-	950.0
5	900	925	30.0	10.0	920.0	25.0	-	925.0	25.0	-	925.0
6	900	900	8.0	16.0	892.0	-	-	900.0	-	-	900.0
7	900	900	8.8	17.6	891.2	-	-	900.0	-	-	900.0
8	900	900	9.7	19.4	890.3	12.5	25.0	887.5	-	25.0	875.0
9	900	900	10.6	21.3	889.4	18.7	37.5	881.2	-	37.5	862.5
10	900	900	6.7	13.4	893.3	6.2	12.5	893.7	-	12.5	887.5
11	900	900	4.4	8.8	895.6	-	-	900.0	-	-	900.0
12	900	900	4.0	8.0	896.0	-	6.2	893.7	-	-	900.0
13	900	900	-	7.1	892.9	7.8	15.6	892.2	-	-	900.0
14	900	900	-	5.2	894.8	6.2	12.5	893.7	-	-	900.0
15	900	900	-	3.0	897.0	-	3.1	896.9	-	-	900.0
16	900	900	-	1.7	898.3	-	-	900.0	-	-	900.0
17	900	900	-	0.8	899.2	-	3.9	896.1	-	-	900.0
18	900	900	-	-	900.0	-	7.0	893.0	-	-	900.0
19	900	900	-	-	900.0	-	3.1	896.9	-	-	900.0
					Hypothetical Country B						
1	105	101.2	-	-	105.0	-	-	105.0	-	-	105.0
2	109	105.7	-	-	109.0	-	-	109.0	-	-	109.0
3	100	103.5	3.5	-	103.5	3.5	-	103.5	3.5	-	103.5
4	101	102.7	2.1	0.7	102.4	1.7	-	102.7	1.7	-	102.7
5	115	107.7	-	1.1	113.9	-	5.2	109.7	-	3.6	111.4
6	120	114.0	-	1.1	118.9	-	-	120.0	-	1.6	118.4
7	135	126.2	-	1.1	133.9	-	-	135.0	-	-	135.0
8	100	113.7	6.9	1.1	105.7	5.7	-	105.7	5.7	-	105.7
9	135	126.2	-	1.8	133.2	-	5.7	129.2	-	4.4	130.6
10	125	121.2	-	1.4	123.6	-	-	125.0	-	1.4	123.6
11	120	125.0	5.7	1.4	124.3	5.0	-	125.0	5.0	-	125.0
12	140	131.2	-	2.5	137.5	-	5.0	135.0	-	4.4	135.6
13	160	145.0	-	2.5	157.5	-	-	160.0	-	0.6	159.4
14	170	160.0	-	1.1	168.9	-	-	170.0	-	-	170.0
15	100	132.5	8.6	1.1	107.5	7.5	-	107.5	7.5	-	107.5
16	130	132.5	3.9	2.9	131.1	2.5	-	132.5	2.5	-	132.5
17	115	115.0	1.3	2.5	113.7	-	-	115.0	-	-	115.0
18	125	123.7	-	2.8	122.2	-	1.2	123.7	-	0.6	124.4
19	130	125.0	-	2.8	127.2	-	5.6	124.4	-	3.4	126.6
20	130	128.7	-	2.8	127.2	0.3	3.1	127.2	-	4.7	125.3
21	144	137.0	-	1.0	143.0	-	0.3	143.7	-	1.2	142.7
22	160	148.5	-	0.3	159.7	-	-	160.0	-	-	160.0
23	192	172.0	-	-	192.0	-	-	192.0	-	-	192.0
24	218	197.0	-	-	218.0	-	-	218.0	-	-	218.0
25	218	211.5	-	-	218.0	-	-	218.0	-	-	218.0
26	200	209.0	9.0	-	209.0	9.0	-	209.0	9.0	-	209.0
27	232	220.5	-	1.8	230.2	-	9.0	223.0	-	5.7	226.2
28	208	212.0	4.9	1.8	211.1	4.0	-	212.0	4.0	-	212.0
29	238	229.0	-	2.8	235.2	-	4.0	234.0	-	4.5	233.5

1/ Weights of 0.50, 0.25, and 0.25 applied to years t, t-1, and t-2, respectively.

2/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

3/ 100 per cent of export excesses applied to repayment in the first three years; remaining amounts to be repaid in two equal instalments in the fourth and fifth years. One half of any fourth-year or fifth-year repayment is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

4/ 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

Table 3. Hypothetical Country B: Amounts Outstanding Under Various Repurchase Systems

Year	System 1/	System 2/	System 3/	System 4/	System 5/	System 6/	System 7/	System 8/
1	-	-	-	-	-	-	-	-
2	-	-	-	-	-	-	-	-
3	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
4	5.2	5.2	5.3	4.8	4.9	4.9	5.2	5.2
5	5.2	-	4.1	3.7	3.8	3.8	-	1.6
6	5.2	-	2.9	2.6	2.7	2.7	-	-
7	3.5	-	1.7	1.5	1.5	1.5	-	-
8	9.2	5.7	7.4	7.3	7.3	7.3	5.7	5.7
9	8.4	-	5.6	5.5	5.5	5.5	-	1.4
10	8.4	-	4.1	4.1	4.1	4.1	-	-
11	13.0	5.0	9.2	7.7	8.4	8.4	5.0	5.0
12	8.8	-	6.5	5.3	5.9	5.9	-	0.6
13	4.6	-	3.8	2.9	3.4	3.4	-	-
14	4.6	-	2.6	1.9	2.3	2.3	-	-
15	12.1	7.5	10.1	9.4	9.8	9.8	7.5	7.5
16	12.3	10.0	12.6	10.3	10.8	10.8	10.0	10.0
17	12.3	10.0	12.6	8.5	9.6	9.6	10.0	10.0
18	12.3	8.7	11.3	6.0	7.0	6.8	8.7	9.4
19	7.4	3.7	7.4	3.5	4.2	4.1	3.1	5.9
20	1.2	1.2	6.2	1.0	1.5	1.3	0.3	1.2
21	-	-	3.5	.2	0.4	0.3	-	-
22	-	-	2.0	.1	0.1	-	-	-
23	-	-	1.0	-	0.1	-	-	-
24	-	-	0.5	-	-	-	-	-
25	-	-	-	-	-	-	-	-
26	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0
27	9.0	-	7.2	7.2	7.2	7.2	-	3.2
28	13.0	4.0	11.2	9.8	10.3	10.3	4.0	7.2
29	13.0	-	8.2	7.4	7.5	7.5	-	2.7

1/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

2/ 100 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at end of the third year or the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

Table 3 (concluded). Hypothetical Country B: Amounts Outstanding Under Various Repurchase Systems

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3/ Repayment in five equal instalments, beginning in the year following the shortfall year: repayments on past drawings are deducted from exports for the purpose of computing shortfalls.

4/ Repayment in five equal instalments, beginning in the year following the shortfall year: for purposes of computing shortfalls, repayments on past drawings are deducted from exports, and average repayments (over the five-year period on which the norm is based) arising from these past drawings are deducted from the practical norm.

5/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls.

6/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

7/ 100 per cent of export excesses applied to repayment in the first three years; remaining amounts to be repaid in two equal instalments in the fourth and fifth years. One half of any fourth-year or fifth-year repayment is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

8/ 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

CHART 1

HYPOTHETICAL COUNTRY A

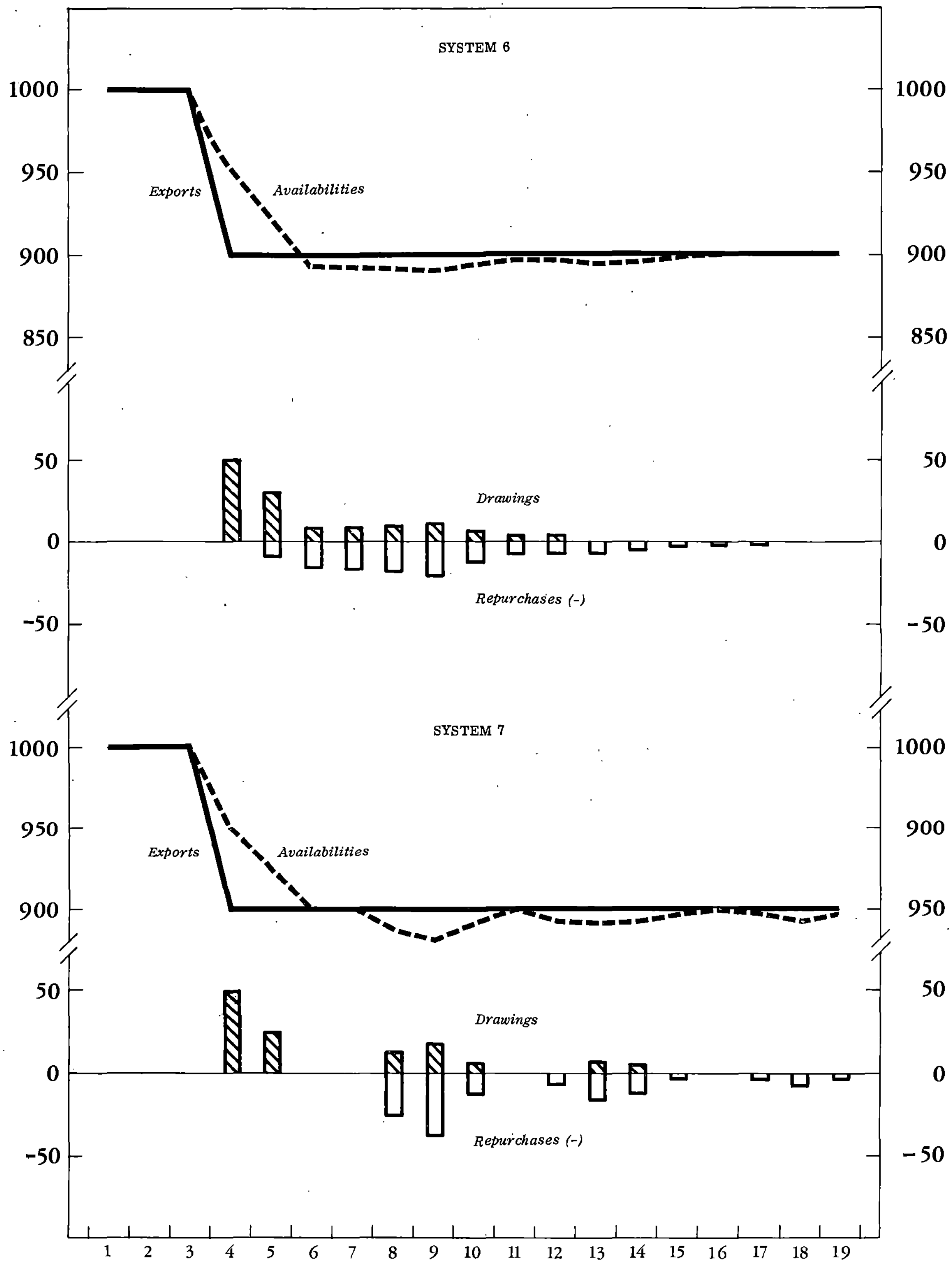


CHART 2

HYPOTHETICAL COUNTRY B

SYSTEM 7

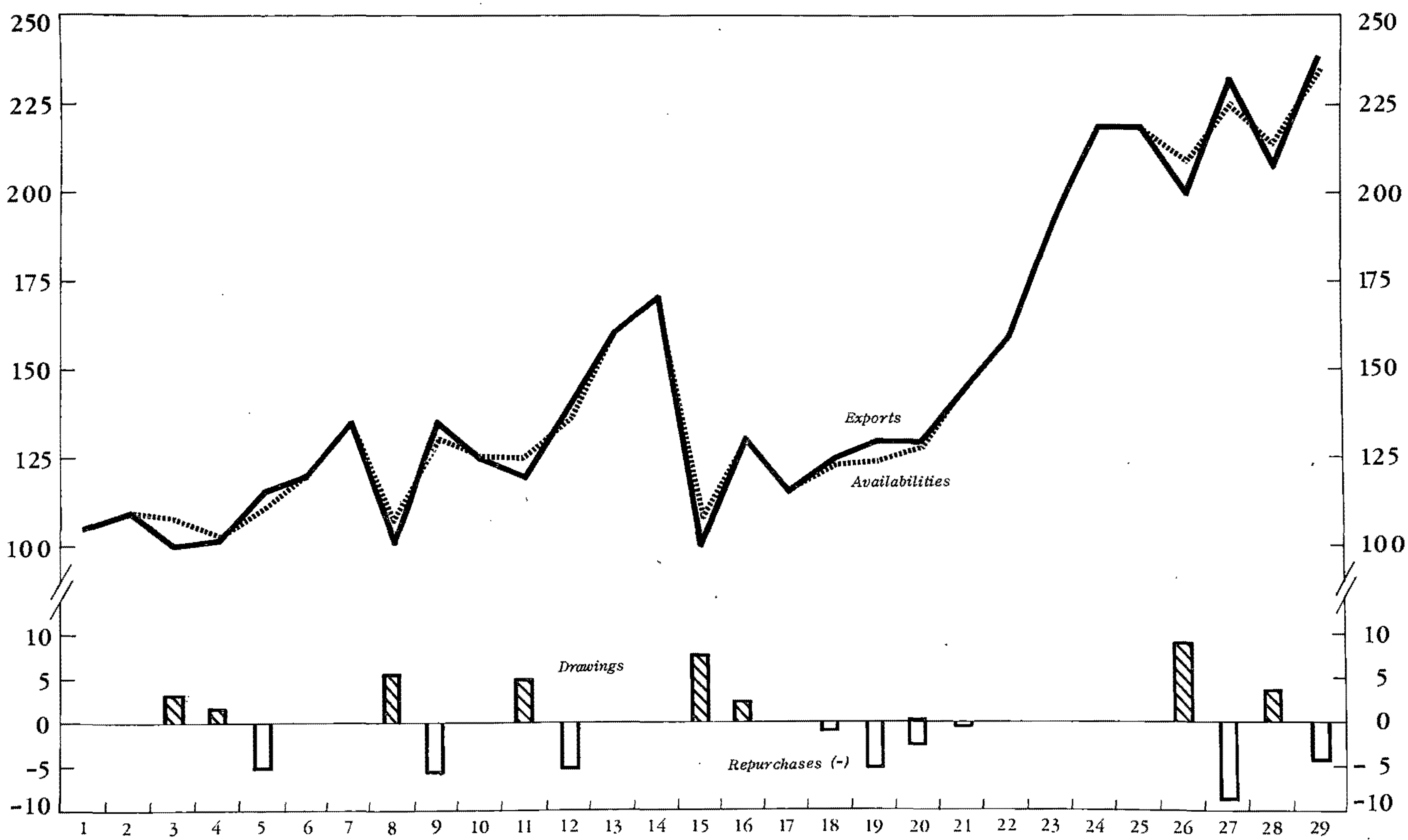
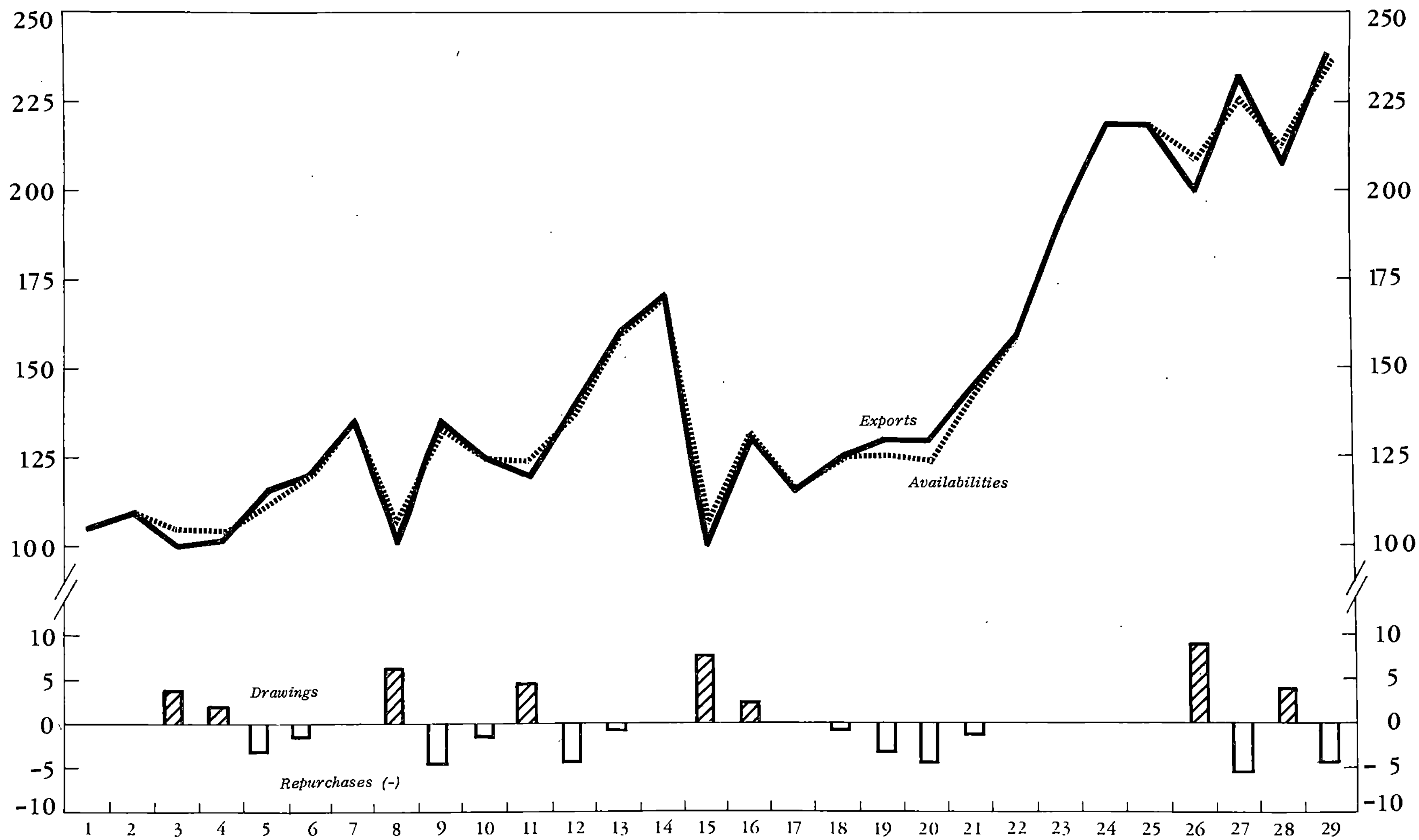


CHART 3

HYPOTHETICAL COUNTRY B

SYSTEM 8



Mr. Polak

BANQUE NATIONALE DE BELGIQUE

The Governor

Brussels, September 1, 1966

Mr. Pierre-Paul Schweitzer
Managing Director
International Monetary Fund
19th and H streets
Washington D.C. 20431

My Dear Friend:

I feel that I must tell you of the misgivings I have about the discussions now taking place in the Executive Board of the Fund on the subject of Compensatory Financing.

I am completely in agreement with the principle that the Fund should intervene to enable its members to meet deficits caused by extraordinary events beyond their control, but it is essential that these interventions should retain the temporary nature which is essential to the 'monetary' function of the Fund.

We must avoid the Fund gradually turning into a life-time or long-term aid institution. That is not its purpose, and if it were to undertake too large a number of operations without adequate attention to their temporary nature, it would be endangering its monetary function and would be unable to play its own vital role.

Some countries believe, wrongly in my opinion, that the Fund has already made too many concessions to the tendency which I view with anxiety, and it is mainly for this reason that some people wish to entrust to institutions other than the Fund the new international monetary tasks which are being discussed during these days. I have personally always opposed this view and supported the principle that international monetary functions ought to be entrusted to the Fund. It is precisely for this reason that I would be so alarmed to see it depart from its monetary role.

What give me most cause for anxiety in the present discussions on compensatory financing are those proposals which, in dealing with the separation of drawing tranches, the reclassification of drawings, the accumulation of drawings and repurchases, tend to extend automaticity, while reducing the conditions imposed in connection with drawings and weakening the control exercised by the Fund over the use of its resources.

I am fully aware of the enormous difficulties which the developing countries may experience in reestablishing a balance of payments equilibrium which has been disturbed by circumstances beyond their control; but in my view these same difficulties demand that the countries' situation and the efforts they are making should be watched and followed very closely by the Fund. The Fund should thus assure itself that its resources are being put to good use and that they will be restored within a reasonable period of time.

The Belgian representative on the Executive Board has been instructed to defend this view point. He will be unable to associate himself with the adoption of decisions or methods which do not sufficiently protect the Fund's powers of control, and so risk jeopardizing its character as a monetary institution.

Sincerely yours,

/s/
H ANSIAUX

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/66/86 C. 1

July 15, 1966

To: Members of the Executive Board

From: The Secretary

Subject: Compensatory Financing: Systems of Repurchase

The attached memorandum has been prepared by the Research and Statistics Department in reply to requests made at Meetings 66/52 and 66/53 on July 6, 1966.

The subject of compensatory financing is scheduled for further consideration by the Executive Directors at Meeting 66/61, Monday, July 18, 1966.

Att: (1)

Other Distribution:
Department Heads
Division Chiefs

INTERNATIONAL MONETARY FUND

Compensatory Financing: Systems of Repurchase

Prepared by the Research and Statistics Department

July 14, 1966

In accordance with requests made at Executive Board Meetings Nos. 66/52 and 66/53 held on July 6, 1966, a number of tables and charts have been prepared bearing on the performance of a number of alternative systems for repurchases of drawings under the compensatory facility. All of these are based on the assumption of a 50 per cent of quota limit on drawings outstanding qualified by a 25 per cent of quota limit on annual net drawings in the manner suggested in SM/66/77, page 20. In Table 1, the various repurchase systems are considered in relation to the export experience of 48 countries over the period 1951-64. In Table 2 and Charts 1-7, the repurchase systems are considered in relation to the assumed export experience of two notional countries. In country A (Mr. Dale's assumption), exports are assumed to fall suddenly from a plateau of 1000 per annum to a plateau of 900 per annum. For the purpose of determining the limits this country's quota is assumed to be 200. (Part A of Table 2, and Charts 1 and 2.) In country B, exports are assumed to develop with the sort of fluctuations and growth trends as have been typically found to exist in actual experience of primary producing countries. The quota is assumed initially to be 20 per cent of exports and to be adjusted quinquennially so as to maintain this relation approximately. (Part B of Table 2, and Charts 3 to 7.)

The types of repurchase systems considered are five: (1) the existing system of 3-5 year repurchase; (2) the "mixed" system described at p. 25 of SM/65/101; (3) the "mixed" system described at p. 25 of SM/66/77, on the assumption that all requests for refinancing drawings are in fact granted; (4) the modification of system (3) suggested by Mr. Wass, under which if any country, in requesting a compensatory drawing, requested that repurchases from previous compensatory drawings should be deducted from computed exports, the export norm would itself be subject to deduction to allow for all repurchases scheduled in connection with these previous drawings over the five-year period on which the norm is based; and (5) another variant of system (3) in which there would be no adjustment of the norm but in which countries, in making a drawing under the compensatory facility, could not refinance more than half of any repurchases on previous compensatory drawings made within the previous year.

In considering the relative merits of these and other possible repurchase arrangements the following considerations should be borne in mind.

Retention of the present 3-5 year repurchase arrangements is in a sense inconsistent with the purpose of the compensatory facility. The purpose of the facility is to smooth out export availabilities and the effect of the repurchases--which are after all an inevitable consequence of the drawings--may be to render these export availabilities more irregular than any other of the repurchase systems that have been suggested, and much more irregular than they would have been under a fully compensatory system of repurchase out of export excesses. The possibility that repurchase might have to be made at a time of poor export performance has given rise to the UNCTAD request mentioned at page 21 of SM/66/77, and adherence to the present system would mean that a somewhat negative response would have to be given to this request.

A fully compensatory system of repurchase out of export excesses discussed on pages 22 and 23 of SM/66/77, though likely in the average case to lead to a shortening of the repurchase period, is open to the objection that it does not strictly ensure the short-term character of individual drawings, that in certain imaginable, though extremely unlikely, cases such as that brought forward by Mr. Dale, repurchase might be postponed indefinitely, and moreover that the countries would not know in advance the maximum amount of their repurchase obligation in any year.

The mixed system of repurchase suggested in SM/65/101, though it would improve the performance of the scheme in smoothing out export availabilities and reduce the disturbing effect of bunched repurchases in the fourth and fifth years, would in most cases speed up the repurchases as compared with the present system and in no case permit a lengthening of that period. It could, therefore, scarcely be regarded as an affirmative response to the UNCTAD request mentioned above, and is to some extent open to the objection just mentioned that countries would not know in advance the maximum amount of their repurchase obligations in any year.

The mixed system of repurchase suggested in SM/66/77 was designed to meet several of these objections. It provides a formal limit to the repurchase period, an upper limit known in advance to the repurchase obligation, and it makes refinancing not an automatic matter but one subject to certain criteria of performance by the country concerned in the field of policies affecting exports. It remains, however, open to the objection advanced against fully compensatory repurchases that in certain special though unlikely cases an indefinite prolongation of net use of Fund resources is possible.

The fourth and fifth variants mentioned above have the purpose of meeting the last objection, though necessarily at some sacrifice to the compensatory principle of repayment out of excesses. In both of these systems the repurchasing country would know in advance the maximum amount of its repurchase obligation (i.e., 20 per cent of the original drawing). In both cases the country could, if the conditions were fulfilled, refinance after the event but within the facility a part of its repurchases on compensatory drawings. Under Mr. Wass's system, the part that could be refinanced might be approximately 50 per cent for the initial repurchase instalment but would dwindle rapidly for any transactions involving subsequent instalments as the norm was adjusted to take account of repurchases and repurchase obligations. Under the fifth system, the part that could be refinanced would remain constant. Both systems would ensure net repurchases in the long run, but Mr. Wass's system would secure such net repurchase at an earlier date. By the same token, it represents a more radical departure from the compensatory system of repurchase.

If the Board feels that the mixed system of repurchases, as suggested in SM/66/77, cannot be accepted in that it could, in some conceivable cases, result in an unduly prolonged net use of Fund resources, it is suggested that the fifth system of repurchase mentioned above is simpler to understand and (by varying the percentage of repurchases that are refinanceable) could be more easily amended later in the light of experience.

If it is felt that the mixed system suggested in SM/66/77 is objectionable in that it provides too automatic and institutionalized a system of refinancing, it would of course be possible to alter provision (c) on page 25 in such a way as to increase the discretionary character of the arrangement.

Table 1. Compensatory Financing: Effect of Various Repurchase Systems, 48 Countries, 1951-64 1/

(Qualified 50 per cent of Quota Limit)

	Approximation Ratio 2/	Smoothness Ratio 3/	Average Drawings Outstanding 4/
Fixed-term repurchases (3-5 years) 5/	.035	.047	.45
Mixed repurchase system of SM/65/101 6/	.042	.070	.27
Mixed repurchase system of SM/66/77 7/	.042	.060	.42
Mixed repurchase system of SM/66/77 with export norm adjusted for repurchases 8/	.040	.059	.36
Mixed repurchase system of SM/66/77 with refinancing limited to one half of repurchases 9/	.041	.060	.38

1/ Weights of .50, .25 and .25 applied to years t, t-1, and t-2, respectively, for estimating calculated norm. 100 per cent compensation of calculated shortfall.

2/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

3/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

4/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

5/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

6/ 100 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or the export excess (whichever is the greater) applied to repayment. In the fifth year any amount oustanding at the end of the fourth year repaid.

7/ Repayment in five equal instalments, beginning in the year following the shortfall year: repayments on past drawings are deducted from exports for the purpose of computing shortfalls.

8/ Repayment in five equal instalments, beginning in the year following the shortfall year: for purposes of computing shortfalls, repayments on past drawings are deducted from exports, and average repayments (over the five-year period on which the norm is based) arising from these past drawings are deducted from the practical norm.

9/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls.

Table 2. Compensatory Financing: Effect of Various Repurchase Systems for Two Hypothetical Countries

			Fixed Repurchases (3 - 5 years)[2]			Mixed Repurchase System of SM/65/101[3]			Mixed Repurchase System of SM/66/77[4]			Mixed Repurchase System of SM/66/77 with Export Norm Adjusted for Repurchases[5]				Mixed Repurchase System of SM/66/77 with Refinancing Limited to 1/2 of Repurchase[6]		
Year	Exports	Standard Norm[1]	Drawings	Repurchases	Availabilities	Drawings	Repurchases	Availabilities	Drawings	Repurchases	Availabilities	Adjusted Norm	Drawings	Repurchases	Availabilities	Drawings	Repurchases	Availabilities
								Hypothetical Country A										
1	1000	1000	-	-	1000.0	-	-	1000.0	-	-	1000.0	-	-	-	1000.0	-	-	1000.0
2	1000	1000	-	-	1000.0	-	-	1000.0	-	-	1000.0	-	-	-	1000.0	-	-	1000.0
3	1000	1000	-	-	1000.0	-	-	1000.0	-	-	1000.0	-	-	-	1000.0	-	-	1000.0
4	900	950	50.0	-	950.0	50.0	-	950.0	50.0	-	950.0	950.0	50.0	-	950.0	50.0	-	950.0
5	900	925	25.0	-	925.0	25.0	-	925.0	35.0	10.0	925.0	919.0	29.0	10.0	919.0	30.0	10.0	920.0
6	900	900	-	-	900.0	-	-	900.0	17.0	17.0	900.0	888.5	4.3	15.8	888.5	8.0	16.0	892.0
7	900	900	-	-	900.0	-	-	900.0	20.4	20.4	900.0	884.8	1.5	16.7	884.8	8.8	17.6	891.2
8	900	900	-	25.0	875.0	-	25.0	875.0	24.5	24.5	900.0	885.3	2.3	17.0	885.3	9.7	19.4	890.3
9	900	900	-	37.5	862.5	-	37.5	862.5	29.4	29.4	900.0	888.0	5.4	17.4	888.0	10.6	21.3	889.4
10	900	900	-	12.5	887.5	-	12.5	887.5	25.3	25.3	900.0	894.5	3.0	8.5	894.5	6.7	13.4	893.3
11	900	900	-	-	900.0	-	-	900.0	23.3	23.3	900.0	897.6	0.9	3.3	897.6	4.4	8.8	895.6
12	900	900	-	-	900.0	-	-	900.0	24.6	24.6	900.0	897.8	0.4	2.6	897.8	4.0	8.0	896.0
13	900	900	-	-	900.0	-	-	900.0	25.4	25.4	900.0	898.1	0.5	2.4	898.1	3.5	7.1	896.5
14	900	900	-	-	900.0	-	-	900.0	25.6	25.6	900.0	898.6	0.6	2.0	898.6	2.9	5.9	897.1
15	900	900	-	-	900.0	-	-	900.0	24.8	24.8	900.0	899.3	0.3	1.1	899.3	2.2	4.3	897.8
16	900	900	-	-	900.0	-	-	900.0	24.7	24.7	900.0	899.6	0.1	0.5	899.6	1.7	3.4	898.3
17	900	900	-	-	900.0	-	-	900.0	25.0	25.0	900.0	899.7	0.1	0.4	899.7	1.4	2.9	898.6
18	900	900	-	-	900.0	-	-	900.0	25.1	25.1	900.0	899.8	0.1	0.3	899.8	1.2	2.4	898.8
19	900	900	-	-	900.0	-	-	900.0	25.0	25.0	900.0	899.9	0.1	0.2	899.9	0.9	1.9	899.1
								Hypothetical Country B										
1	105	101.2	182 -	-	105.0	-	-	105.0	-	-	105.0	101.2	-	-	105.0	-	-	105.0
2	109	105.7	-	-	109.0	-	-	109.0	-	-	109.0	105.7	-	-	109.0	-	-	109.0
3	100	103.5	3.5	-	103.5	3.5	-	103.5	3.5	-	103.5	103.5	3.5	-	103.5	3.5	-	103.5
4	101	102.7	1.7	- 136	102.7	1.7	-	102.7	2.5	0.7	102.7	102.3	2.0	0.7	102.3	2.1	0.7	102.4
5	115	107.7	-	-	115.0	-	5.2	109.7	-	1.2	113.8	106.9	-	1.1	113.9	-	1.1	113.9
6	120	114.0	-	-	120.0	-	-	120.0	-	1.2	118.8	113.0	-	1.1	118.9	-	1.1	118.9
7	135	126.2	-	1.7	133.2	-	-	135.0	-	1.2	133.8	125.2	-	1.1	133.9	-	1.1	133.9
8	100	113.7	8.4[7]	2.6	105.7	5.7[7]	-	105.7	6.9[7]	1.2	105.7	113.0	6.9[7]	1.1	105.7	6.9[7]	1.1	105.7
9	135	126.2	-	0.9	134.1	-	5.7	129.2	-	1.9	133.1	125.1	-	1.8	133.2	-	1.8	133.2
10	125	121.2	-	-	125.0	-	-	125.0	-	1.4	123.6	120.1	-	1.4	123.6	-	1.4	123.6
11	120	125.0	4.6[7]	-	124.6	5.0	-	125.0	6.4	1.4	125.0	123.6	5.0	1.4	123.6	5.7	1.4	124.3
12	140	131.2	-	4.2	135.8	-	5.0	135.0	-	2.7	137.3	129.5	-	2.4	137.6	-	2.5	137.5
13	160	145.0	-	4.2	155.8	-	-	160.0	-	2.7	157.3	143.4	-	2.4	157.6	-	2.5	157.5
14	170	160.0	-	-	170.0	-	-	170.0	-	1.3	168.7	159.0	-	1.0	169.0	-	1.1	168.9
15	100	132.5	9.8[7]	2.3	107.5	7.5[7]	-	107.5	8.8[7]	1.3	107.5	131.7	8.5[7]	1.0	107.5	8.6[7]	1.1	107.5
16	130	132.5	2.5	2.3	130.2	2.5	-	132.5	5.5	3.0	132.5	130.9	3.6	2.7	130.9	3.9	2.9	131.1
17	115	115.0	-	-	115.0	-	-	115.0	2.9	2.9	115.0	113.2	0.6	2.4	113.2	1.3	2.5	113.7
18	125	123.7	-	-	125.0	-	1.2	123.7	2.2	3.4	123.7	121.4	-	2.5	122.5	0.1	2.8	122.4
19	130	125.0	-	4.9	125.1	-	5.0	125.0	-	3.9	126.1	122.9	-	2.5	127.5	-	2.8	127.2
20	130	128.7	-	6.2	123.8	-	2.5	127.5	2.6	3.9	128.7	127.0	-	2.5	127.5	0.1	2.8	127.4
21	144	137.0	-	1.2	142.7	-	1.2	142.7	-	2.6	141.4	136.5	-	0.8	143.2	-	1.1	142.9
22	160	148.5	-	-	160.0	-	-	160.0	-	1.5	158.5	148.4	-	0.1	159.9	-	0.3	159.7
23	192	172.0	-	-	192.0	-	-	192.0	-	1.0	191.0	172.0	-	-	192.0	-	0.1	191.9
24	218	197.0	-	-	218.0	-	-	218.0	-	0.5	217.5	197.0	-	-	218.0	-	-	218.0
25	218	211.5	-	-	218.0	-	-	218.0	-	0.5	217.5	211.5	-	-	218.0	-	-	218.0
26	200	209.0	9.0	-	209.0	9.0	-	209.0	9.0	-	209.0	209.0	9.0	-	209.0	9.0	-	209.0
27	232	220.5	-	-	232.0	-	9.0	223.0	-	1.8	230.2	219.4	-	1.8	230.2	-	1.8	230.2
28	208	212.0	4.0	-	212.0	4.0	-	212.0	5.8	1.8	212.0	210.6	4.4	1.8	210.6	4.9	1.8	211.1
29	238	229.0	-	-	238.0	-	4.0	234.0	-	3.0	235.0	226.7	-	2.7	235.3	-	2.8	235.2

1/ Weights of 0.50, 0.25, and 0.25 applied to years t, t-1, and t-2, respectively.

2/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

3/ 100 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year is repaid.

4/ Repayment in five equal instalments, beginning in the year following the shortfall year: repayments on past drawings are deducted from exports for the purpose of computing shortfalls.

5/ Repayment in five equal instalments, beginning in the year following the shortfall year: for purposes of computing shortfalls, repayments on past drawings are deducted from exports, and average repayments (over the five-year period on which the norm is based) arising from these past drawings are deducted from the practical norm.

6/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls.

7/ Drawing determined by the assumed quota limit (qualified 50 per cent limit). Country B's quota is assumed to be 20 at the outset and to be raised in year 5 to 23, in year 10 to 26, in year 15 to 30, in year 20 to 34.5, and in year 25 to 40.

CHART 1

HYPOTHETICAL COUNTRY A

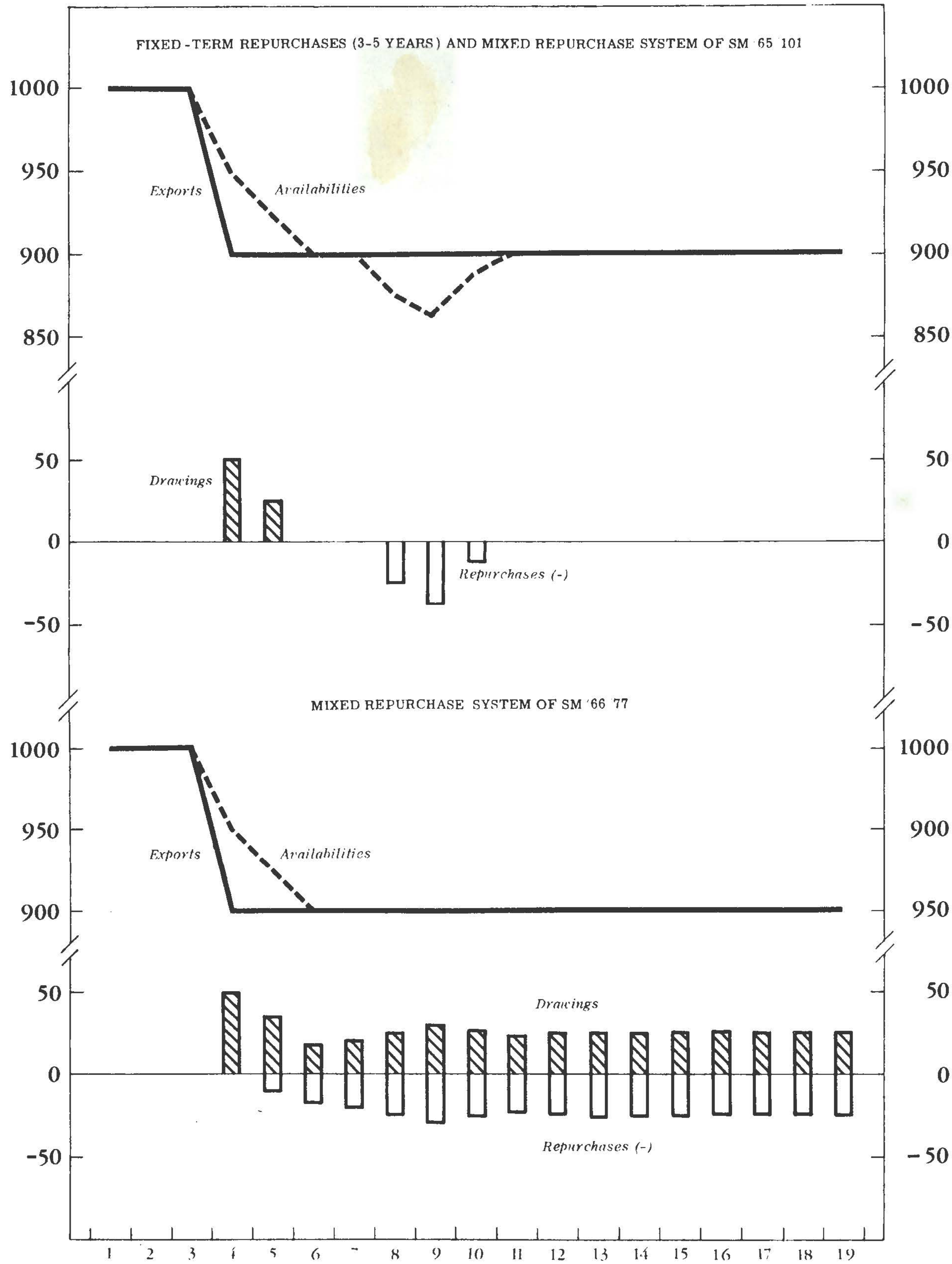


CHART 2

HYPOTHETICAL COUNTRY A

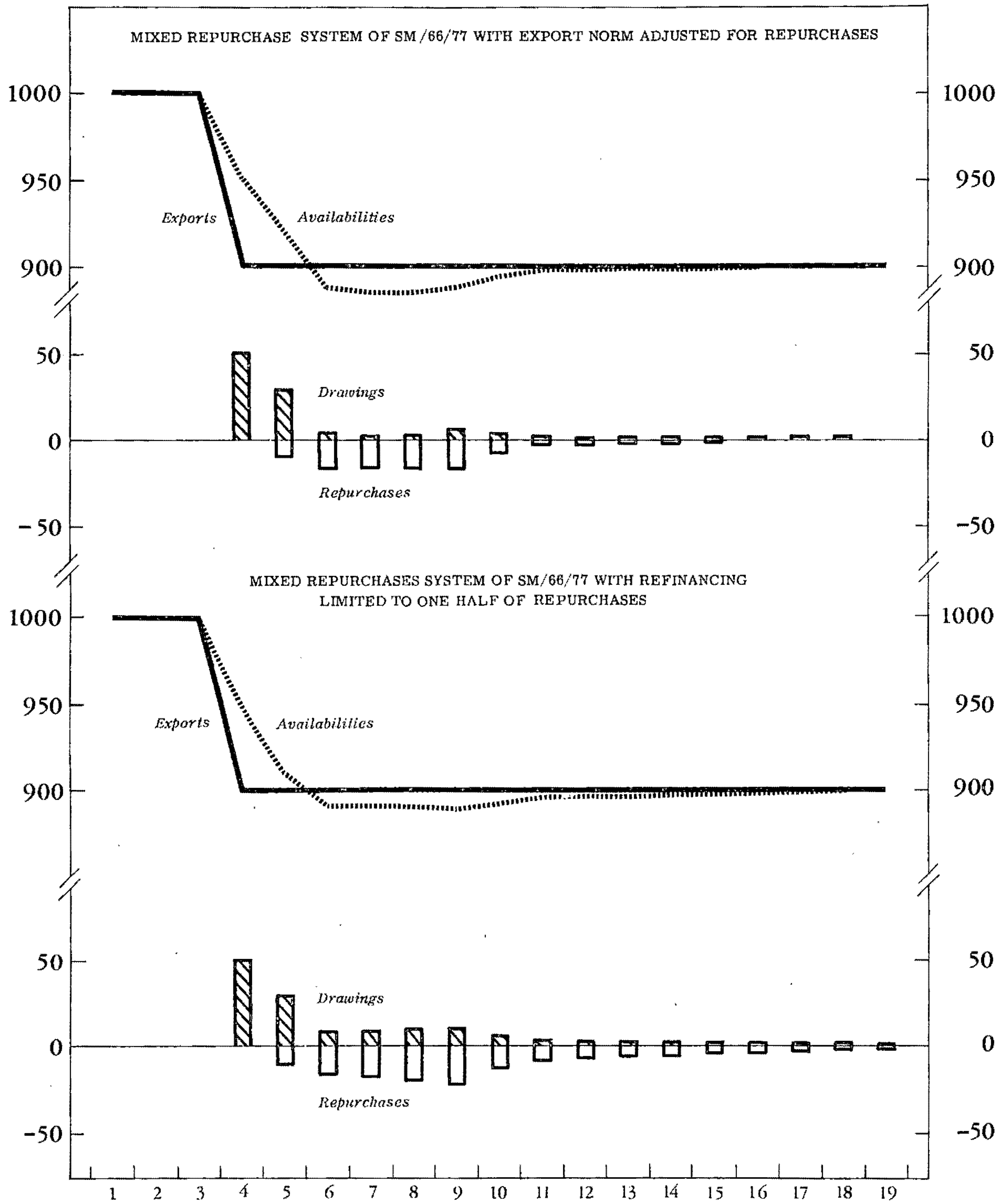


CHART 3

HYPOTHETICAL COUNTRY B

FIXED-TERM REPURCHASES (3-5 YEARS)

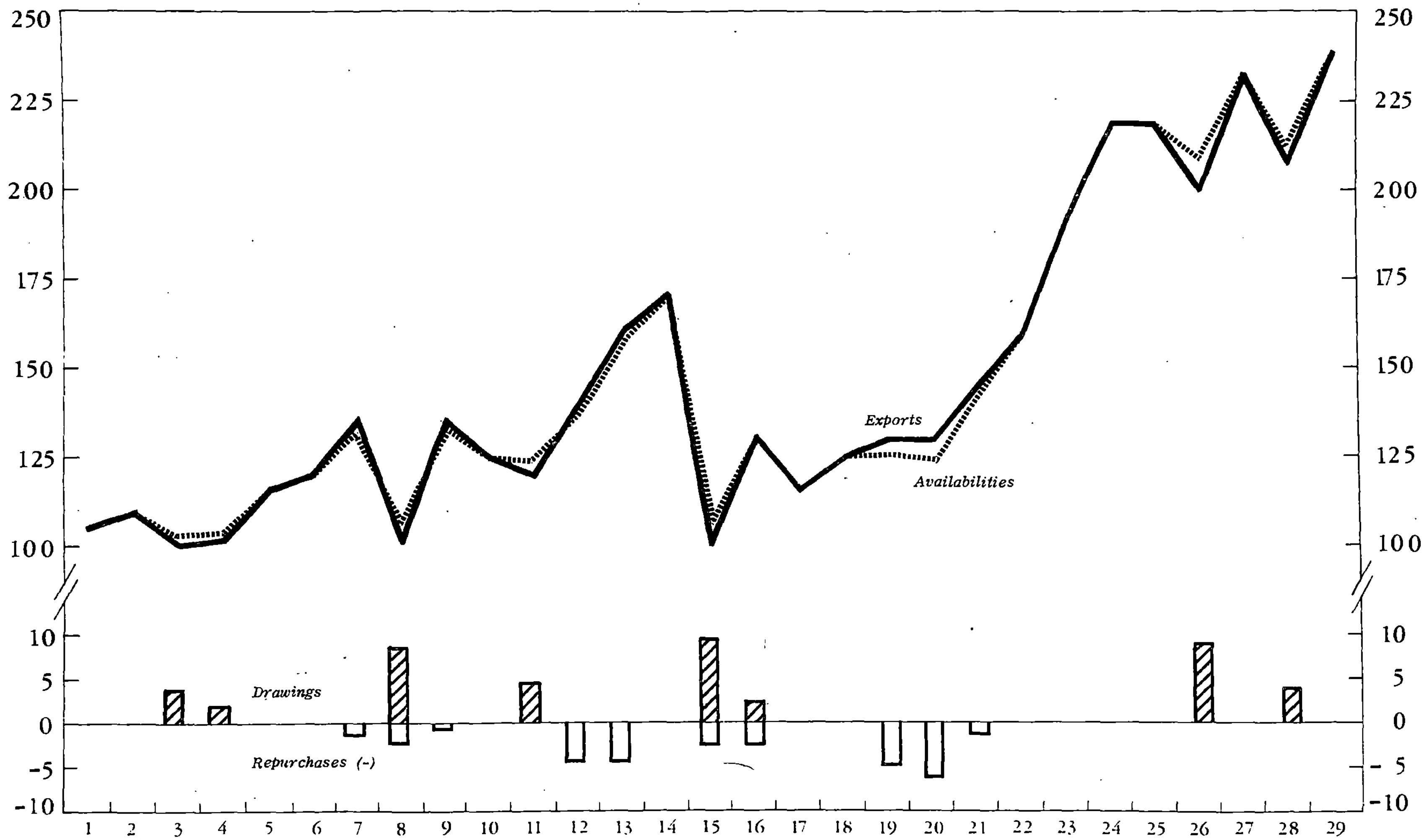


CHART 4

HYPOTHETICAL COUNTRY B

MIXED REPURCHASE SYSTEM OF SM/65/101

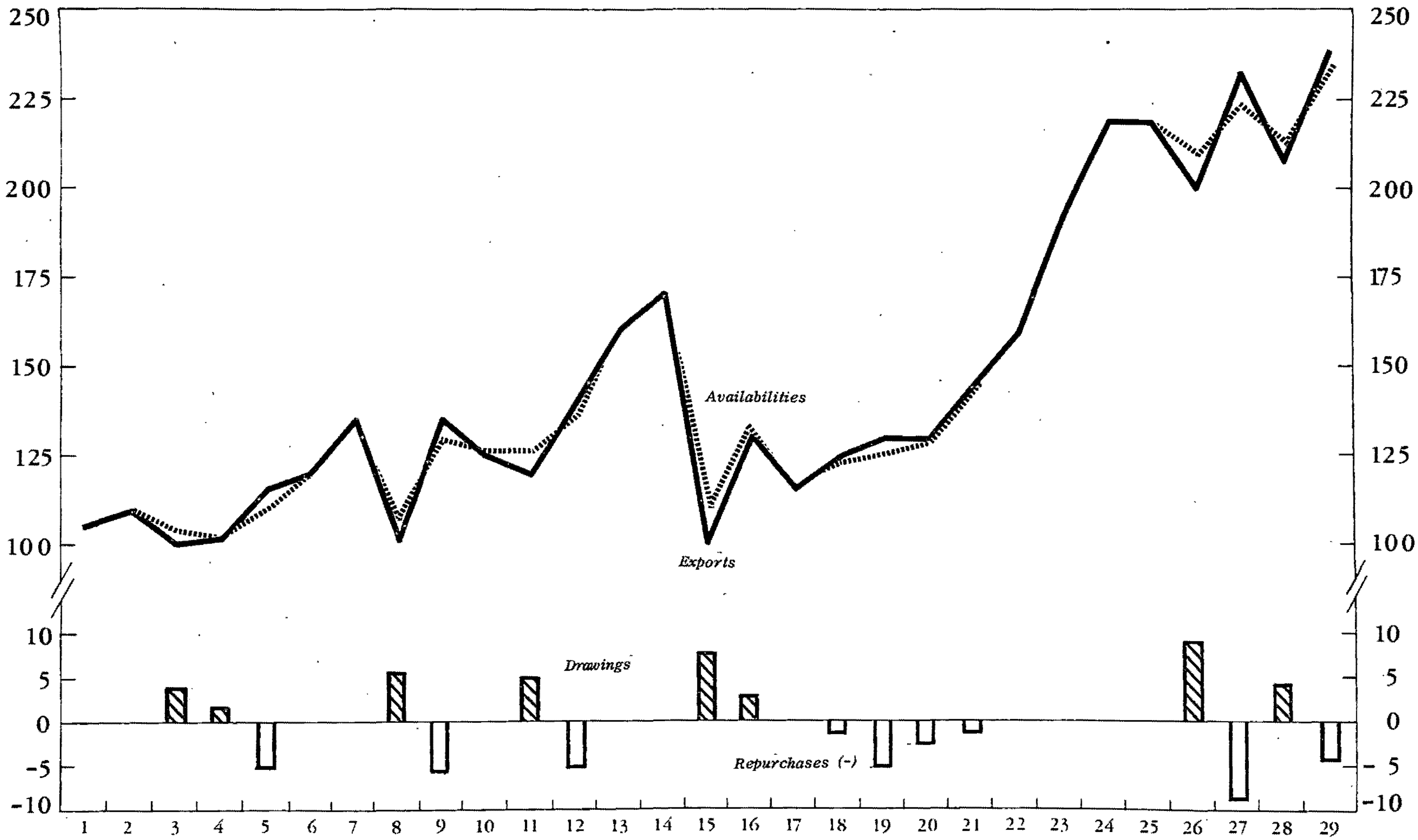


CHART 5

HYPOTHETICAL COUNTRY B

MIXED REPURCHASE SYSTEM OF SM/66/77

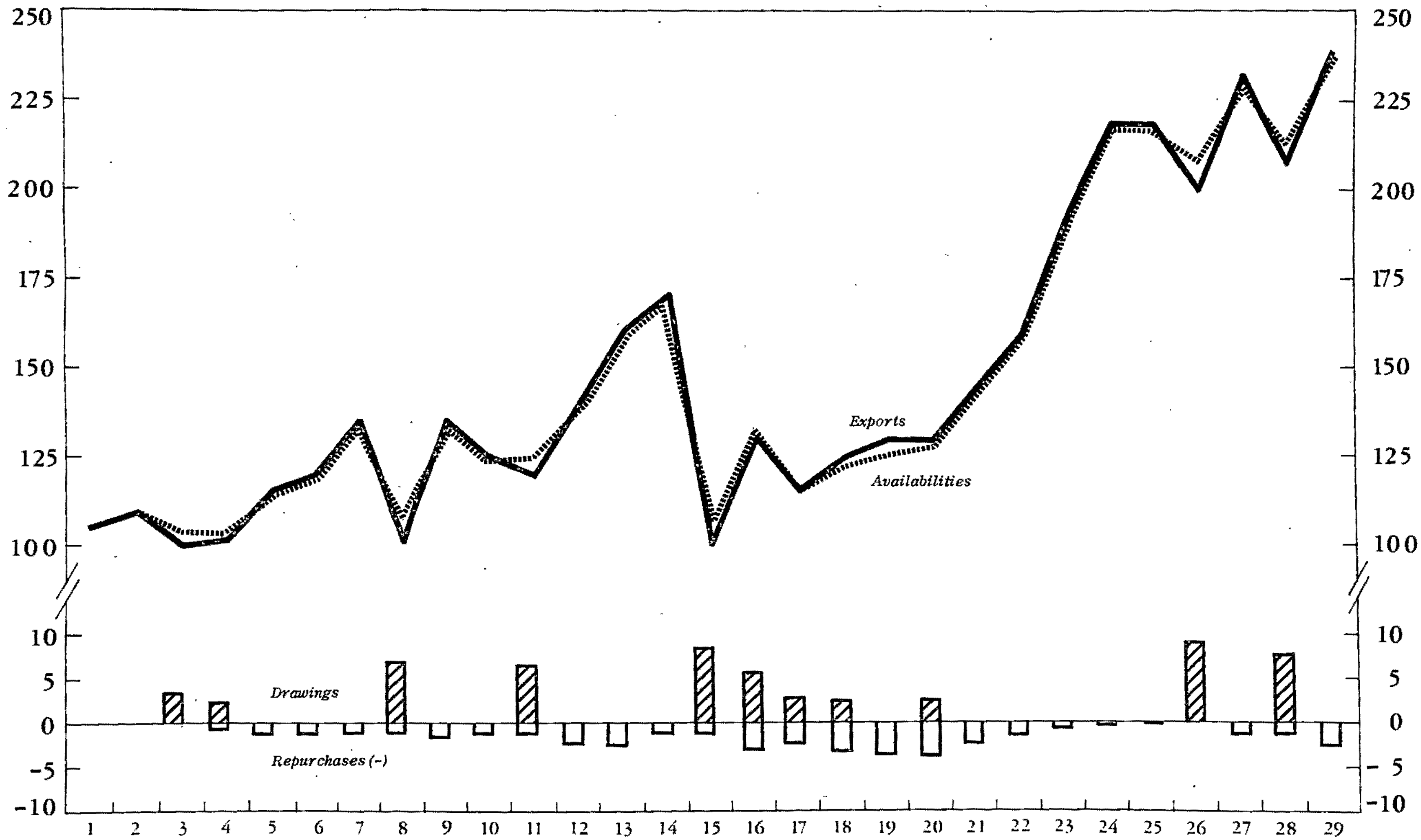


CHART 6

HYPOTETICAL COUNTRY B

MIXED REPURCHASE SYSTEM OF SM/66/77 WITH EXPORT NORM ADJUSTED FOR REPURCHASES

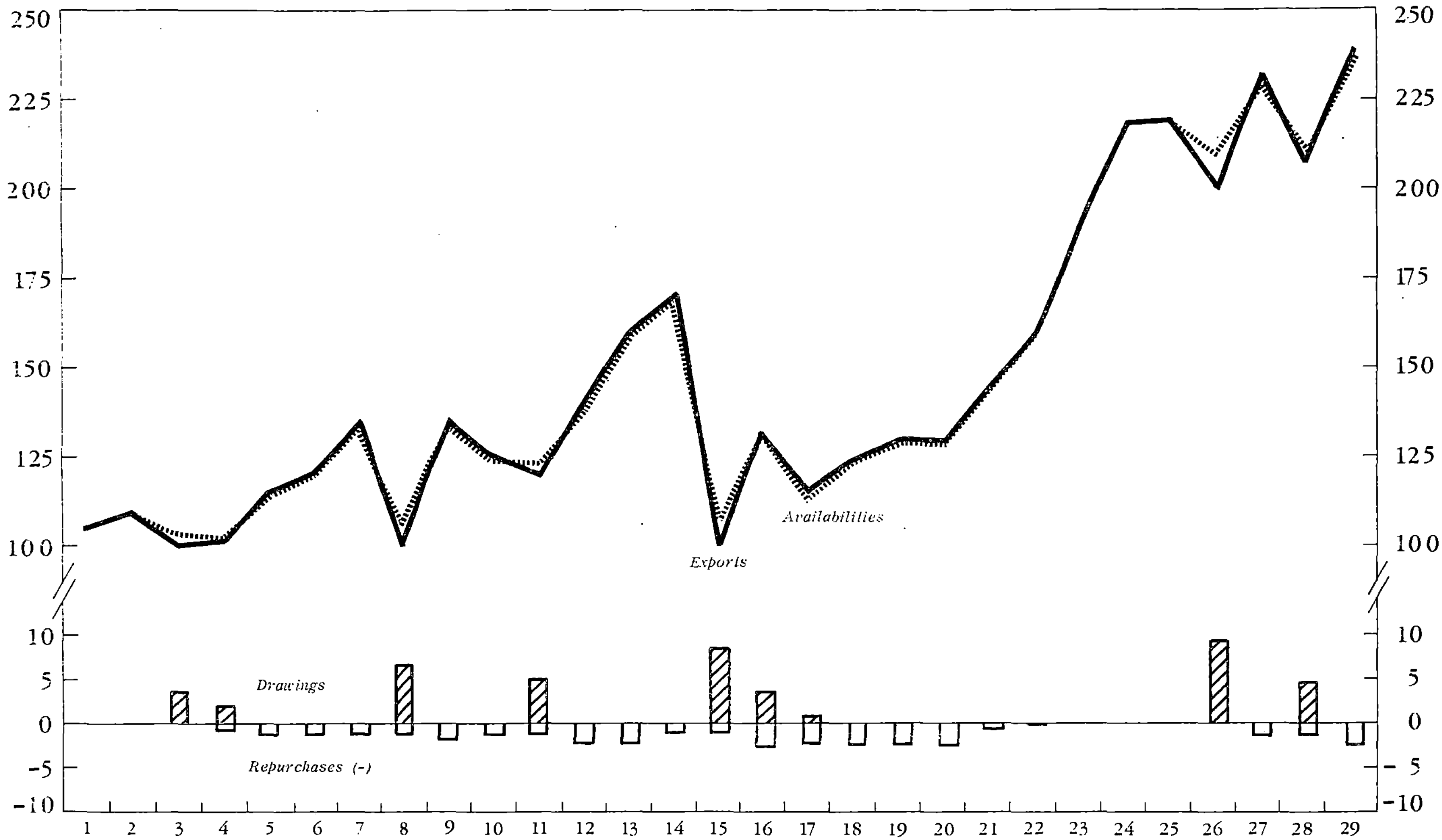
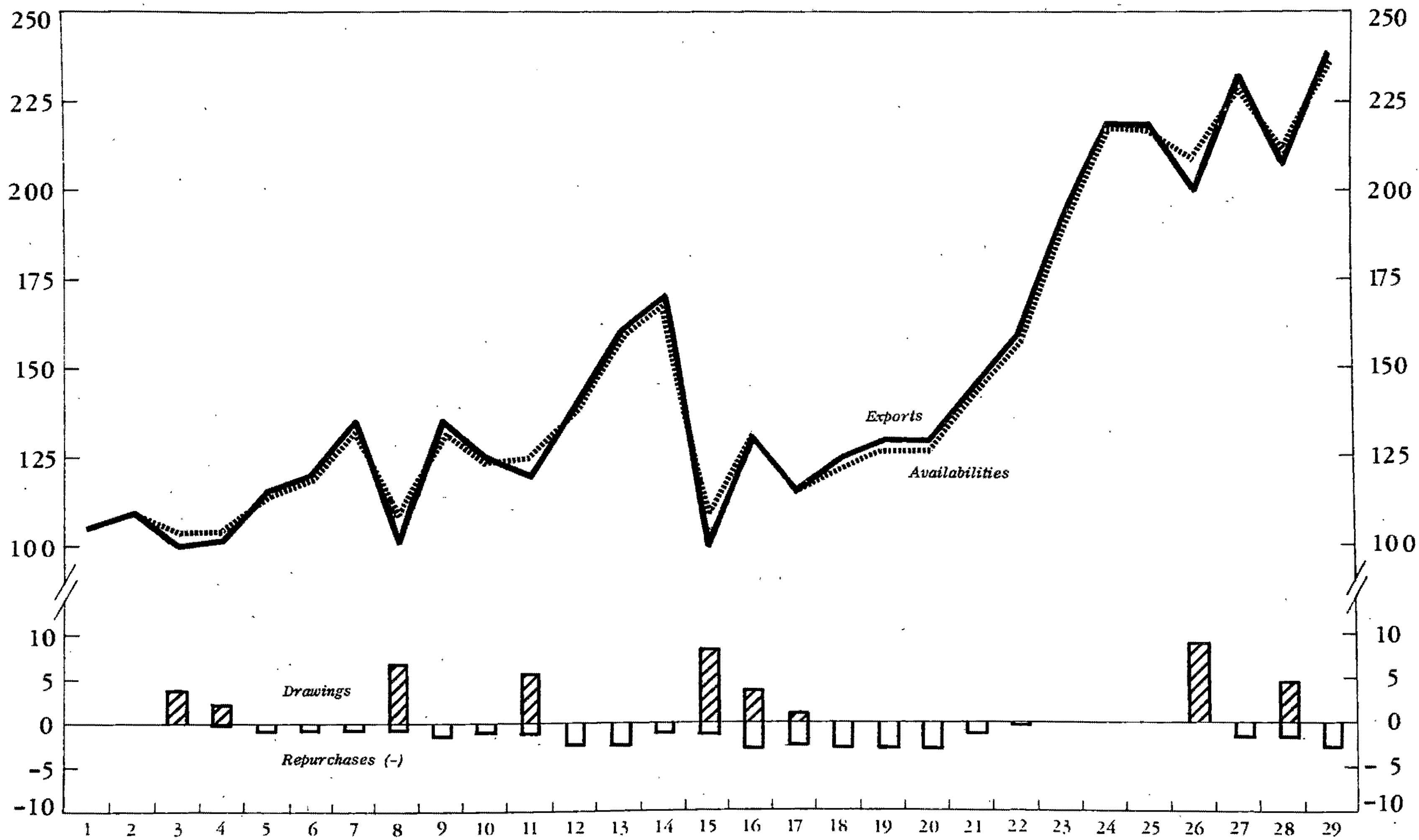


CHART 7

HYPOTHETICAL COUNTRY B

MIXED REPURCHASE SYSTEM OF SM/66/77 WITH REFINANCING LIMITED TO ONE HALF OF REPURCHASES



FOR AGENDA

Mr. J. J. Polak

Room 504 F

#1

Mr Fleming

SM/66/77

June 13, 1966

To: Members of the Executive Board

From: The Secretary

Subject: Compensatory Financing of Export Fluctuations: Developments in the Fund's Facility

The attached paper "Compensatory Financing of Export Fluctuations: Developments in the Fund's Facility" prepared by the staff is circulated for consideration by the Executive Directors at a meeting tentatively scheduled for Wednesday, June 29, 1966.

Some suggestions for drafting on

p.13, p.15
p 19

Att: (1)

Other Distribution:
Department Heads
Division Chiefs

INTERNATIONAL MONETARY FUND

Compensatory Financing of Export Fluctuations: Developments in the Fund's Facility

Prepared by the Research and Statistics Department
in consultation with the Legal Department, Exchange and
Trade Relations Department, and the Area Departments

June 13, 1966

The attached paper has been prepared on the basis of SM/65/101 ("The Fund's Compensatory Financing Facility Reconsidered") of December 10, 1965, revised in the light of the discussion at the Executive Board seminar of December 17, 1965, and recast in the form of a draft report by the Fund announcing changes in its compensatory financing facility.

It is suggested that the Executive Board should consider this paper with a view to revising its 1963 Decision on Compensatory Financing before this year's Annual Meeting.

The Decision on Compensatory Financing has now been in existence for over three years and is ripe for review and revision as part of the normal operations of the Fund. The revisions proposed, whether their scope is measured in terms of potential cost of Fund resources or of potential use by members, are not comparable in character or in order of magnitude with those involved in any schemes to create international reserves, whether through the Fund or otherwise, and it would seem unnecessary and inappropriate to defer consideration of them until decision has been taken on the other and larger matter.

The Fund's compensatory financing facility might well be affected if any scheme for supplementary financing of the type now under consideration under UNCTAD auspices were brought into existence. However, it would be possible, and seems desirable for the Fund to go ahead with the revision of its compensatory facility without reference to this possibility, while at the same time considering what further amendments to the Fund facility might be desirable if and when arrangements for supplementary financing were brought into existence.

Compensatory Financing of Export Fluctuations: Developments in the Fund's Facility

Introduction: the 1963 Decision

In February 1963, in response to an invitation extended by the United Nations Commission on International Commodity Trade at its tenth session in May, 1962, the Fund issued a report entitled "Compensatory Financing of Export Fluctuations." This report, after reviewing the problems involved in Fund financing of fluctuations in exports of primary exporting countries, set forth in its concluding chapter an Executive Board Decision[1/] covering two points: (a) quotas and (b) drawing policies.

With respect to quotas, the Fund declared its willingness to give sympathetic consideration to requests for the adjustment of the quotas of certain primary exporting countries, particularly those with relatively small quotas, to make them more adequate in the light of fluctuations in export proceeds and other relevant criteria.

As regards drawing policies, the Fund introduced a new facility, of which the principal features are as follows:

(1) It is open to all member countries, but designed in particular for primary producing countries.

(2) It is designed to compensate for temporary shortfalls in export receipts, rather than in export prices or in the terms of trade, or in the importing power of exports.

(3) By temporary shortfalls are meant deviations from a medium-term trend in export receipts.

(4) Compensation is paid in the form of a drawing subject to the normal conditions of repayments for Fund drawings, including an outside limit of 3 to 5 years.

(5) Compensation has been paid to the full extent of the calculated shortfall, subject to the proviso that the total of compensatory drawings outstanding should not normally exceed 25 per cent of quota.

(6) The policies of members drawing under the facility do not have to meet the tests that the Fund would apply in the case of a non-compensatory drawing in the same tranche. However, members do have to satisfy the Fund that they are encountering payments difficulties, that the shortfall is of a short-term character, and is largely attributable to circumstances beyond the member's control, and that the member will cooperate with the Fund in an effort to find solutions, where required, for its payments difficulties.

1/ Decision No. 1477 (63/8) of February 27, 1963, Selected Decisions, Third Issue, p. 40.

Subsequent Developments

I. Quota Adjustments and Export Fluctuations

The Decision on Compensatory Financing has now been in operation for over three years, and the time has arrived when certain of its aspects can appropriately be reviewed.

In Paragraph 3 of that Decision, the Fund recognized that some quota adjustments might be required or desirable, as follows: "The quotas of many primary exporting countries, taken in conjunction with a reasonable use of their own reserves, are at present adequate for dealing with export fluctuations such as have occurred during the past decade. In those instances, however, where adjustment of the quotas of certain primary exporting countries, and in particular of countries with relatively small quotas, would be appropriate to make them more adequate in the light of fluctuations in export proceeds and other relevant criteria, the Fund is willing to give sympathetic consideration to requests for such adjustment."

Since February 1963 the Fund has taken steps--apart from the general quota increase which came into effect on February 23, 1966--to implement this paragraph in several ways.

In the first place, it has approved more than 22 quota increases under a special policy applied to developing countries with relatively small quotas; 15 other countries appear to be eligible for such quota increases under that policy.

Secondly, the Fund facilitates drawings by such countries to enable them to purchase the amount of gold that must be paid in connection with the quota increases referred to above. This gives them the benefit of a quota increase immediately, and makes it possible to spread the reserve cost of the increase over a number of years.

Finally, in considering applications for individual quota increases, even from countries other than the above, the Fund has modified the formula which is taken into account in calculating quotas in such a way as to improve the position of developing countries. Variability of trade, which was a component of the so-called Bretton Woods formula, has now been defined in terms of standard deviation around a five-year moving average. This new definition provides a more accurate measure of variability and is thus more favorable to quota calculations of raw materials exporting countries. The Fund has also modified the formula to give greater weight to trade and the variability to trade, and less weight to national income and international reserves.

II. The Fund's Compensatory Facility

It might have been expected that the drawing facility established by the Fund in February 1963 to provide compensatory financing for export fluctuations would by this time have been used often enough to provide

ample illustrations of the type of problems that were liable to arise in applying it, and possibly also to indicate ways in which it could be improved. In fact, however, few countries have had even a prima facie case for using it, and three countries have actually drawn: (1) Brazil in June 1963 for the sum of $60 million (21 per cent of quota); (2) the United Arab Republic in October 1963 for the sum of $16 million (18 per cent of quota); and (3) Sudan in June 1965 for the sum of $11.25 million (25 per cent of quota).1/ This infrequency of use is largely attributable to the fact, illustrated in Table 1, that price developments over the past three or four years have been such as to permit the export earnings of less developed primary producing countries to show a generally upward trend, though one that tended to flatten out in 1965. Even the substantial declines in price of tropical foodstuffs (other than coffee), which began in spring 1964 and continued through the greater part of 1965 have not reacted sufficiently on earnings to evoke many opportunities for the use of the facility.

Despite the small number of instances of use, there has been enough experience and enough reflection on the variety of situations that might present themselves to permit of a reconsideration of several of the features of the 1963 Decision. Moreover, a number of suggestions have been made both inside the Fund--notably at the recent Annual Meeting of the Board of Governors--and outside the Fund, as to ways in which the Fund's compensatory financing facility might be amended or improved.

Most of these suggestions are summed up in the three recommendations made by the United Nations Conference on Trade and Development of 1964 to Governments members of the Fund as to changes that might be made in the facility, and in the request which it addressed directly to the Fund. The UNCTAD resolution containing these recommendations and request is reproduced at Appendix A. Passages dealing with compensatory financing excerpted from speeches of Governors at the 1965 Annual Meetings are reproduced at Appendix B. It will be seen that most of the points made by the Governors are covered in the UNCTAD Resolution referred to above, except for the reference to automatism in the speech of Governor Pugliese of the Argentine, and the reference to terms of trade and import prices in the speech of Governor Wanninayake of Ceylon.

Application and Development of the Facility

I. Nature of Shortfall

Drawings under Paragraph 5 of the Compensatory Financing Decision of 1963 may be made only when the requesting member experiences payments difficulties produced by a temporary export shortfall, i.e., by an export shortfall which is "of a short-term character." Such shortfalls, according to Paragraph 7 of the Decision, are to be identified on the basis of "estimates regarding the medium-term trend of the member's exports." In the 1963 Decision itself, no definition of the medium-term trend is given.

1/ The quotas referred to in these percentages are those applicable at the time the drawing was made.

Table 1. Changes in Prices and Export Earnings for Primary Producers in 1962 to 1965

Commodity	Prices[1] Percentage increase or decrease (-) from previous year 1963	1964	1965	Export Earnings: Countries mainly dependent on specified commodities[2]	Percentage increase from previous year 1963	1964	1965[3]
Metals and minerals[4]	3	21	13	Metals and minerals	9	24	13
Agricultural products	20	-	-12	Agricultural products	12	10	4
Food	31	-	-17				
Coffee	4	30	-5	(a) Coffee	12	8	7
Sugar	185	-31	-64	(b) Mixed tropical			
Cocoa	20	-8	-26	foodstuffs	11	11	3
Wheat	1	4	-5	(c) Mainly temperate			
				products	14	12	2
Non-food	4	-	-5	(d) Fibers and rubber	10	2	9
Cotton	2	29	-6				
Wool	18	-	-13				
Rubber	-7	-5	-1	(e) Mixed	7	11	5
				Mixed Mineral and Agricultural	8	7	2
All exports[4]	18	2	-9	All countries	11	10	4

1/ Group price changes are derived from indices published by the NIESR (London). Specified commodity price series relate to world market quotations for representative grades only, and thus exclude the influence of prices determined under contracts.

2/ Defined as at least one half of export earnings as classified. Excludes countries dependent on petroleum. Data relate to 71 countries.

3/ Provisional.

4/ Excluding petroleum.

However, in the earlier Fund report, "Fund Policies and Procedures in Relation to the Compensatory Financing of Commodity Fluctuations,"[1] the trend or norm was defined for purposes of illustration as the average of actual exports for the five years beginning two years previous and ending two years subsequent to the year for which the trend value was calculated. The same definition was adopted in the staff paper cited on page 10 of the report on "Compensatory Financing of Export Fluctuations,"[2] and it was on the basis of this definition of the "ideal" trend or norm that certain conclusions were drawn in that report as to the best statistical method of estimating it in the absence of complete information.[3] This is also the definition that has been adopted in all applications of the Compensatory Financing Decision to particular countries up to the present time.

In the absence of precise quantitative knowledge as to the nature of the economic forces at work in determining trends and fluctuations, a moving average seems the best and most flexible way--better, for example, than fitting a trend line of any a priori shape--of reflecting what is meant by trend. Moving averages of 4 years, 5 years, or 6 years, respectively, might, any one of them, serve as a reasonable definition of a "medium-term" trend. However, a 5-year period is preferable to the others in that it contains a middle year, the trend value of which can be defined as the average of the period. The trend value for any year in any time series must anticipate the figures for subsequent as well as reflect those of previous years in that series. If this is not done--e.g., if the trend values are determined solely as an average of past years--the trend line might lie persistently above, or below, the actual series to a substantial extent, which would be contrary to the normal meaning of the term "trend." Only if the moving average is centered in the manner illustrated above can one expect to find, over a reasonable period of time, a rough balancing of shortfalls and surpluses of actual exports with respect to trend.[4]

Once the best possible estimate has been made of the medium-term trend, and hence of the shortfall, if any, from that trend, in accordance with Paragraph 7 of the Decision, no separate judgment is required as to whether the shortfall in question is "temporary" or of a "short-term" character.

1/ IMF Staff Papers, November 1960, p. 9.
2/ J. Marcus Fleming, Rudolf Rhomberg, and Lorette Boissonneault, "Export Norms and Their Role in Compensatory Financing," Staff Papers, Vol. X, 1963.
3/ "Compensatory Financing of Export Fluctuations," pp. 17-18.
4/ The balancing of surpluses and deficits is far from perfect, however; in any 5-year period there is likely to be either an excess of surpluses over deficits exceeding 50 per cent of gross surpluses, or an excess of shortfalls over surpluses exceeding 50 per cent of gross shortfalls. This, however, appears to be quite unavoidable. There is no way of defining a norm or trend consistently from year to year in such a way as to secure a perfect balance of surpluses and shortfalls over any given period.

The definition of the trend itself is such as to make it likely--though one can never be certain--that shortfalls with respect to it will be of short duration.[1/] Any attempt to make a separate determination as to whether a given shortfall would cease to exist within, say, 2 or 3 years would involve estimating for that period ahead not only actual exports--which, as is indicated in the following section, may be involved in the estimation of the current norm--but also the export trend itself. To forecast the latter would involve estimating exports for still further years ahead. This, in the present state of forecasting techniques, would appear to be impracticable, and a determination that a shortfall of a given magnitude exists should, therefore, be taken as satisfying the requirement that the shortfall is of a short-term character.

II. Estimation of Trend and Shortfall

In paragraph 7 of the 1963 Decision it is laid down that the Fund will seek to establish reasonable estimates regarding the medium-term trend of the member's exports "on the basis of appropriate statistical data in conjunction with qualitative information about its exports prospects." This phrase appears to foreshadow a two-sided approach--"statistical" and "qualitative"--to the problem of estimation. However, while statistical estimation can be carried out without qualitative appraisal, qualitative appraisal can scarcely be applied without the aid of some statistical information, and the true alternative approaches are those of statistical automatism and the exercise of judgment, respectively.

In the three cases in which the Decision has been applied thus far, the estimation of normal exports has represented a compromise between (a) a figure or figures arrived at through the application of automatic formulae to past statistical data, and (b) an estimate based on a combination of these data with a forecast for actual exports two years ahead, these forecasts in turn being arrived at by a process of market appraisal using all available information.

The combination of the two methods in one form or another is justified by the knowledge that the result of either method is to a considerable extent uncertain. Any formula admittedly gives a precise answer; but no formula can be devised that gives a good approximation of the medium-term trend, as here defined, on the basis of past statistical data. On the other hand, any forecasting exercise must to some extent be subjective and uncertain. Given these facts it is necessary to strike a reasonable balance between these two methods, each less than satisfactory, which at the same time assures countries as much uniformity of treatment as possible from one case to the other.

1/ Calculations covering 48 countries show that almost 50 per cent of all shortfalls with respect to a norm defined as above last only 1 year, nearly 85 per cent no more than 2 years, and 96 per cent no more than 3 years.

As regards the automatic statistical approach to the estimation of the norm, the Fund has, in the past, used two types of formula, a "general" formula and a "national" formula, in both of which the norm for any given year is estimated as a weighted average of actual exports for the year in question and the two preceding years. In both cases the weights assigned to the various years are those which experience (of some ten years or more) shows to provide the best approximation to the "true" norm as defined above.1/

The "general" formula, used in calculations contained in the Fund's Report on "Compensatory Financing of Export Fluctuations," in all three applications of the Decision to date attaches a weight of .50 to the exports of the year for which the shortfall is being estimated, .25 to the preceding year, and .25 to the second preceding year. These weights were arrived at on the basis of analysis of the experience of some 48 countries over a period of nine testable years (thirteen years of data). While not absolutely the best of the formulae tested, it was chosen as a good formula with rounded weights close to those of the optimal formula.

"National" formulae have differed from country to country, the formula for each country being arrived at on the basis of experience affecting that country alone. It is intended to discontinue the use of "national" formulae on the ground that they are based on too small a number of observations, and complicate the statistical side of the exercise.

As regards the more subjective or "qualitative" estimate primarily based on market analysis, it is in the nature of the case more difficult to describe the method used, which varies from country to country. In all cases the procedure is first to estimate the average exports in the two years following the year for which the shortfall is being determined and then to take an average of the five years centered on the shortfall year. The forecast in question is conducted largely on the basis of commodity analysis, taking into account the prospective price movements for the commodity in question and the prospective volume movements in the country in question. For the great majority of primary exporting Fund members, 60 per cent to 90 per cent of total exports take place in a rather small number (1 to 4) of commodities, thus a large proportion of most countries' trade can be estimated on the basis of commodity market analysis. But there remains a sizeable residual for which no such analysis is possible and it may well prove desirable in particular cases to make a more or less automatic statistical estimate for this part of the exports. In this event the partial results of market analysis for major commodities would be combined with a more mechanical result for the residual to arrive at a global estimate.

1/ The "true norm" for exports, x, in any year t, i.e., $\bar{x}_t$ is defined as $\frac{x_{t-2} + x_{t-1} + x_t + x_{t+1} + x_{t+2}}{5}$. The problem is to find weights w_0, w_1, w_2, such that the estimated norm $x^*_t = w_2 x_{t-2} + w_1 x_{t-1} + w_0 x_t$ provides the best approximation to $\bar{x}_t$ for all values of t. This is found by regression analysis for years in which the relevant export data are available.

In the past, "statistical" and "qualitative" estimates have been given approximately equal weight in determining the final estimate of the trend of exports. However, the "qualitative" estimates, involving a direct forecast of exports two years ahead, have been found in practice to yield better results than the formula. Experience has tended to bear out the judgment that a "better estimate could be made by the exercise of judgment based on an analysis of the causal factors at work than by any mathematical formula, however skillfully contrived, which is based on the mere statistical magnitude of current and previous exports."1/ In future, it would seem advisable to give somewhat greater weight than in the past to the "qualitative" as against the statistical estimate.

III. Proposals Regarding the Mode of Determining the Shortfall

A. Weight to be Given to Past Years

In the Resolution on the Study of Measures Relative to the Compensatory Credit System of the International Monetary Fund, set forth at Annex A.IV.17 of its Report, the UNCTAD made the following request:

"The Conference

----

2. Requests that the International Monetary Fund, in its determination of the shortfall in export receipts, consider giving greater weight to the actual experience of the three preceding years."

The issue here, though it appears to be purely technical, in fact touches on a point of principle. At present, as has been explained above, the Fund's compensatory financing facility is designed to compensate for shortfalls from the presumed current trend level of exports rather than from a previous trend level. It is designed to help countries to bring their export availabilities--export receipts plus compensatory drawings less repayments of such drawings--closer to the presumed trend level rather than to provide them with a financial buffer against reductions as compared with their previous standards. While it might be entirely appropriate to provide countries with such a buffer, it would seem preferable to supply this through the ordinary drawing facilities of the Fund, use of which could be made conditional, where necessary, on the adoption of measures to adapt the economy to new export conditions, or to improve the trend of exports, than through the compensatory financing facility, the use of which is more automatic.

1/ Compensatory Financing of Export Fluctuations, A Report of the International Monetary Fund, February 1963, page 10.

It is because the aim of compensatory financing is conceived in the manner described above, that in the assessment of the norm with reference to which the shortfall is calculated account is taken of the expected exports of the ensuing years, that a substantial weight in the determination of the norm is given to the current year's exports, and that no weight is given, for example, to exports three or more years anterior to the year with respect to which the shortfall is being calculated. The weights assigned to the current and preceding years in the estimation of the export norm--insofar as it is estimated by formula--were arrived at on the basis of experience as to which weights gave the closest estimate of the current trend and the best implied forecast of the two years subsequent to the shortfall year.

A formula in which no weight was given to the shortfall year would, for this reason, tend to lead to a higher estimate of the trend value, and hence a larger shortfall and a larger drawing entitlement. Because of the long-term upward trend of exports, however, this effect would generally be offset to some extent by the inclusion in the weighting formula of the third year preceding the shortfall, or of still earlier years. From Table 2 it can be seen that a formula for trend estimation giving equal weights to the three years preceding the shortfall would have led, over the period 1951 to 1964, to somewhat larger drawing entitlements than the present formula. The same table, however, shows that the "performance" of the scheme (as measured by the degree to which compensatory drawings and repurchases bring export availabilities closer the true trend value, and the degree to which they tend to smooth out export availabilities) would not have been improved, but if anything, worsened by such a change in formula. It is not the object of the compensatory facility to aim at the largest possible amount of drawings, and, as will be shown below, there are ways in which it would be possible for an increase in drawings outstanding to improve the performance of the scheme significantly, or even for the scheme to be improved without a net increase in drawings outstanding.

Some further points deserve mention.

The element of forecasting involved in the determination of a current rather than a past trend value of exports, though irksome and subject to uncertainty, is a good discipline for country and Fund alike, and may help to counteract the natural tendency to delay adaptations to changing circumstances.

More important is the fact that measurement solely from a past level would frequently yield "shortfalls" which could not by any means be described as "temporary." While countries with a rising trend of exports, even when the rise was subject to serious interruption, would seldom, if ever, be deemed to have shortfalls, those with a generally falling trend of exports would experience persistent shortfalls. Such a change in formula would necessitate the introduction of a separate determination as to whether or not the shortfall was temporary--a determination which, as already indicated, would involve forecasting much further ahead and hence a higher degree of guesswork than that involved in the determination of the trend by present methods.

The other alternative would be to drop the proviso that export shortfalls--or rather declines--should be temporary. But this would scarcely be compatible with the legal requirement of temporariness in the use of Fund resources.

For these reasons it seems on balance undesirable to alter the present concept of the export norm.

Table 2. Fund Compensatory Financing Facility: Comparison of Weighting Systems over Years 1951 to 1964 1/

Limit Per Cent of Quota	Coefficients Applied to Years t	t-1	t-2	t-3	Drawing Entitlement 2/	Average Drawings Outstanding 3/	Approximation Ratio 4/	Smoothness Ratio 5/
.25	0	1/3	1/3	1/3	1.04	.31	.022	.028
.25	.50	.25	.25		.97	.29	.023	.029
.50	0	1/3	1/3	1/3	1.82	.54	.033	.046
.50	.50	.25	.25		1.61	.48	.034	.046

1/ Scheme applied to a sample of 48 countries. Drawings are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of the level of exports in those years. The quotas in per cent of which the limits are expressed are not present quotas but those obtaining at the relevant dates during the period 1951 to 1964.

2/ Cumulative total entitlements over the period in billions of U.S. dollars.

3/ Average for all years of total amounts outstanding in billions of U.S. dollars.

4/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

5/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

B. Degree of Reliance on Automatic Formulae

Governor Pugliese, of Argentina, speaking at the 1965 Annual Meeting of the Fund on behalf of 19 Latin American countries and the Philippines, mentioned as one of the fundamental aspects of the Fund's compensatory financing decision which it would be advisable to consider,

> "3. In conclusion, we would emphasize the non-automatic nature of the drawings permitted. In the decisions on individual cases submitted to the consideration of the Executive Board there has been some flexibility, although in all of them there has been no lack of a subjective assessment in the determination both of the amount to be compensated and of the circumstances in which the loss of income occurs."

This question, so far as it concerns the determination of the shortfall, has already been considered at some length above.

It has been the experience of the Fund, based not only on its own export forecasts but on those of outside bodies, that a closer estimate of the medium-term trend can be arrived at by the use of short-term forecasts based on commodity analysis than by reliance on the best statistical formula. While greater reliance on formulae might give countries a slightly higher degree of certainty as to the amount of compensation they could rely on, the proposed balance between the two methods of estimation would seem to give as much weight as is prudent to the "automatic" element in the estimation process.

C. Account to be Taken of Terms of Trade

At the 1965 Annual Meeting of the Fund, Governor Wanninayake of Ceylon made a suggestion in the following terms:

> "I was encouraged by the reference by Mr. Schweitzer to the work that the Fund is now undertaking to improve the compensatory financing facility. Several speakers have urged that compensatory assistance should be provided for a decline in the terms of trade rather than for a fall in export earnings alone. My own country's experience in recent years vividly illustrates the importance of this reform. We suffered a decline in the terms of trade by 13 per cent in two years alone, but since this was almost entirely due to an increase in import prices we were unable to avail ourselves of the compensatory financing facility. I do sincerely hope that this particular improvement in the scheme will be made effective at an early date."

The terms of trade refer to the ratio between a country's export prices and its import prices. Fluctuations in export prices are, of course, reflected, along with fluctuations in export quantities, in the flucutations in export proceeds. It might be argued that price fluctuations are more properly

compensable than quantity fluctuations in that they are less easily affected by the policies of the exporting countries. On the other hand, some of the commonest and most genuinely short-run fluctuations in export proceeds are those arising from crop failures. More harm than good would probably be done by attempting to distinguish the specific roles of price and quantity in the fluctuations in export proceeds.

The case is different where price fluctuations are concerned. There is undoubtedly a good economic case for compensating not the money value but the real value, or importing power, of exports. An estimate of the latter could be arrived at by deflating exports (for the purpose of arriving at the trend value of exports) by an import price index based on the shortfall year.

There are, however, a number of practical and other objections to this procedure. Most primary producing countries have no import price index. Of those import price indices that exist many are unrepresentative or unreliable. Moreover, such indices usually become available several months later than the data on export proceeds, so that the lag in the granting of a compensatory drawing behind the occurrence of the export shortfall would necessarily be increased. It might be thought that, where the import price indices of developing countries are unavailable, unreliable, or late in appearing, estimates could be formed on the basis of the export and import price indices of industrial countries. Such data, however, would provide extremely uncertain and disputable estimates for the imports of any individual developing country. It has to be borne in mind that the developing countries that experience the largest fluctuations in import prices do so because they are substantial importers of primary products, often from other developing countries. Apart from such cases, the import price indices of primary producing countries do not, as a rule, show very large movements within a short period of years. For all these reasons, it seems better, at this time, to continue to adhere to the principle of compensating for shortfalls in export proceeds rather than in the importing power of exports.

IV. Period for Which Shortfall is Calculated

Thus far it has been the practice of the Fund to require that any request for the use of the compensatory facility shall relate to an export shortfall over the latest twelve-month period for which, at the time of the request, a reliable estimate of actual exports can be made. There must, in any event, be some maximum lapse of time within which any claim for compensation with respect to the exports of a given period should be made, and if the compensatory facility is to fulfil its purpose of enabling countries to stabilize their external expenditures as much as possible in the face of fluctuations in receipts, it seems desirable that the time lag between shortfall and compensatory financing should be as short as possible. (As indicated below, countries need not be deterred from applying for a compensatory drawing as soon as a shortfall appears by the fact that they will thereby preclude themselves from claiming a larger compensation a little later if the shortfall has by then increased.)1/

1/ See page 14 below.

The present practice enables a claim for a compensatory drawing to be made at any time during the year with respect to the twelve-month period immediately preceding. The question arises whether this right should be restricted in any way. There would seem to be no advantage in a system under which such claims could be made only with respect, say, to calendar years. A more plausible case could be made for ruling that, where exports are marked by seasonality, claims for compensatory drawings should be made only with respect to twelve-month periods which include all those months over which the principal export crop is liable to be marketed abroad. Otherwise, it might be argued, countries which marketed their crops early one year and late the following season might show a shortfall over a twelve-month period that spanned two seasons, whereas no shortfall would appear from a comparison of crop years. Bearing in mind, however, that most countries have a number of export crops with different seasonalities, it is doubtful whether the variability of seasonality is sufficient to justify the introduction of a restriction which would both reduce the value of the facility to the country and complicate its administration. It would be no easy task to determine for each country with respect to which twelve-month periods applications for compensatory financing would not be entertained. ~~It should also be borne in mind that~~ any shortfall that ~~appeared~~ was ~~to be artificially~~ induced by deliberate delay in the marketing of a crop would of course be unlikely to be regarded as "largely attributable to circumstances beyond the control of the member", ~~and in this event would not qualify for a compensatory drawing~~.

The arrangement outlined in the first paragraph of this section can be criticized from another angle, namely that even a time lag of a few months between the shortfall and the compensatory drawing is undesirable, and that it would be better if the drawing could coincide with the shortfall. This means that the drawing would have to take place at a time when the precise amount of the shortfall was unknown. In order to meet this point and to encourage the use of the stand-by and ordinary drawing facilities for the compensation of export shortfalls, it is intended, subject to what is said below, to allow members, within a six months period of any drawing, to reclassify all or part of it as a compensatory drawing under Paragraph 5 of the Decision. The drawing, when first made, would have to satisfy the ordinary conditions for drawing in the tranche in question, or, if made under standby, the requirements appropriate to drawing under the standby. The reclassification of the drawing would have to satisfy the conditions for a compensatory drawing under Paragraph 5 of the Decision with respect to an export shortfall for the latest twelve months for which data were available prior to the reclassification. The amount reclassified could not exceed the amount of that shortfall. Such reclassification would confer on the drawings the privilege of additionality as defined in (ii) of Paragraph 6 of the 1963 Decision (with any enhancement of that privilege that may result from the separation of the compensatory facility from other drawing facilities, discussed below). It would not, however, reconstitute rights to draw under standby.

It is estimated that if both the compensatory facility and the privilege of reclassification had existed over the period 1959-64, and the latter had been exercised to the full--which might not in all cases have been to the country's advantage--some 20 to 25 per cent of all non-compensatory drawings could have been so reclassified.

V. Problem of Double Compensation

It would neither be equitable, nor in accordance with the intention of the Decision on Compensatory Financing, that any member should be compensated twice for the same shortfall, or more precisely, that the sum of any drawings made with respect to any given shortfall should exceed the amount of the shortfall.

Under the Decision a member can draw from the Fund with respect to a payments deficit arising out of an export shortfall either in the form of a drawing under ordinary tranche policies (referred to in Paragraph 4 of the Decision) or in the form of a drawing under the special policies outlined in Paragraph 5 of the Decision. Moreover, it is intended, as indicated in the preceding section, that a drawing originally made under ordinary tranche policies could in certain circumstances be reclassified. The problem of double compensation may arise either with respect to two drawings under Paragraph 5, or with respect to a pair of drawings, one under Paragraph 5 and another under Paragraph 4.

In the case of two drawings under Paragraph 5, it is proposed that, if the period with respect to which a second such drawing is requested to be made (or reclassified) overlaps with that for which a first such drawing has been made (or reclassified), the first drawing would be prorated over the twelve months with respect to which it was given, and such part of it as corresponded to the overlap between the two periods would be subtracted from the drawing entitlement with respect to the second period.

As regards the problem of avoiding double counting as between a Paragraph 5 drawing and an ordinary drawing which can be considered as at least partly undertaken for compensatory purposes, there is no real difficulty if the ordinary drawing follows the Paragraph 5 drawing and is not made under a standby accorded before the latter drawing. In that case, the Paragraph 5 drawing will simply be "taken into account" as one of the many factors affecting the balance of payments situation of the drawing country on the occasion of any subsequent drawing or standby.

The real difficulty arises if a Paragraph 5 drawing or reclassification is requested after an ordinary drawing or standby arrangement. We then have to ask whether the payments situation with respect to which the drawing or standby was given included any part of the export shortfall with respect to which the Paragraph 5 drawing or reclassification is now requested. Such a question would be hard to answer since an ordinary drawing or standby is not usually given to meet the payments deficit of any precisely defined period, still less to meet fluctuations in any specific item in the balance of payments.

One approach would be for some specific statement to be made by the Fund at the time of the ordinary drawing or standby arrangement as to the proportion thereof, if any, that should be regarded as granted with respect to an export shortfall, and as to the period of the shortfall. In the case of standbys, however, account is more often taken of the possibility of future shortfalls than of the accomplished fact of past shortfalls, and it is impossible to be precise as regards either the amount or the timing of future shortfalls. Some conventional rules will, therefore, have to be adopted as to the period and magnitude of the export shortfall deemed to be compensated by ordinary drawings or drawings under standby made prior to the request for a drawing or reclassification under the compensatory facility.

VI. Responsibility for Shortfall and Policy Conditions

According to Paragraph 5(a) of the Compensatory Financing Decision of 1963, one of the conditions of a compensatory drawing is that this export shortfall should be "largely attributable to circumstances beyond the control of the member." Where this condition is clearly not satisfied, it would be inappropriate for a drawing to be made under the compensatory facility. However, there may be ambiguous cases where difficulties of interpretation arise. A shortfall can sometimes be attributed with equal propriety to any one of a number of causes, some of which may be under the member's control and others not. For example, suppose a combination of the following:

(a) a rise in foreign demand for the country's exports;

(b) a short crop due to weather;

(c) a rise in home consumption of the export product due to inflation, subsidization, or some other factor for which the government is responsible.

Given the rise in prices resulting from (a), the shortfall in export value may be no greater than could be entirely accounted for by either (b) or (c). Again, suppose that a shortfall takes place in the exports of a given product due to "act of God" but that an increase in the export of other products, which would otherwise have offset the shortfall, fails to occur because of the policies of the member. Again, there may be cases where the shortfall would not have occurred without certain policies of the member but these policies were reasonable in the light of all the circumstances, or cases where the shortfall could have been prevented by certain policies but abstention from these policies on the part of the member was reasonable in the light of all the circumstances.

In such ambiguous cases an interpretation favorable to the member requesting the compensatory drawing should generally be adopted, and whenever the shortfall can be largely attributed to "circumstances beyond the control of the member" it should be so attributed.

One of the conditions for drawing under Paragraph 5 of the 1963 Decision is that "the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties."

In the application of the Decision to individual cases, the Fund, in accordance with the intention of the Decision, has not attempted to reach agreement with the member on what the nature of these solutions would have to be. This has been left to subsequent discussions, and has not stood in the way of prompt action on a request for compensatory drawings. Nevertheless, in one case in which a compensatory drawing was requested, the country concerned made, at the time of the request, a statement of the policies it intended to follow. In the two other cases of compensatory drawings, the Fund subsequently reached agreements on appropriate policies with the countries in question.

VII. Separation of the Compensatory Facility from other Drawing Facilities

One of the measures which the UNCTAD proposed for consideration by Fund member governments runs as follows:

> "(2) To place compensatory credits entirely outside the structure of the gold and successive credit tranches, so that the drawing of compensatory credits would not directly or indirectly prejudice a member's ability to make an ordinary drawing."

Presumably the measure recommended is to be interpreted in the sense that the amount drawn under the compensatory financing facility would be ignored by the Fund in computing the amount of drawing facilities still available to members under the principles applicable to the gold tranche, the first credit tranche, etc., as well as in computing the practical maximum drawing facilities open to members. In other words, the Fund would treat a drawing request by a member as if its holdings of member currency were less than its actual holdings by the amount of any drawings outstanding under the compensatory financing facility. At present the Fund is prepared to waive the 200 per cent limit to the extent that compensatory drawings are outstanding. If the UNCTAD recommendation were accepted, the limits for gold tranche and first credit tranche policies would be extended beyond 100 per cent and beyond 125 per cent of holdings, respectively, to the extent that compensatory drawings were outstanding. Most compensatory drawings are likely to occur after a country has used its gold tranche and probably also its first credit tranche. To ignore the compensatory drawings not only from the standpoint of the total drawing facilities of a member but also from the standpoint of tranche policies to be applied to the member would have the advantage of rendering the facility clearly additional in all respects. On the other hand, at any given level of holdings it would somewhat reduce the Fund's ability to secure satisfactory corrective programs in the case of ordinary drawings. It would not affect the level of charges corresponding to any given level of Fund holdings, nor would it affect the applicability to compensatory drawings of the repurchase provisions of Article V, Section 7(b). The Fund is prepared to separate the compensatory facility from other drawing facilities in the sense described above.

VIII. The Limit on Compensatory Drawings

One measure recommended by UNCTAD to Governments members of the Fund for study is:

> "(1) To increase as soon as possible the amount allocated by the Fund to compensatory financing over and above its current transactions, from 25 per cent to 50 per cent of a member country's quota."

It should be noted that the limit of 25 per cent of quota on outstanding compensatory drawings under Paragraph 5 of the Decision is not an absolute one, but applies only "normally." However, it would clearly be undesirable for compensatory drawings to be accorded frequently or as a general rule in excess of the "normal" maximum. This would raise issues of discrimination, both with respect to the compensatory drawing facility and total drawing facilities accorded to different countries. It would also defeat one purpose of the compensatory facility, namely that a country can, to a large extent, rely on obtaining compensatory financing in the circumstances for which it is designed, and should, therefore, not have to rely on "rallonges" of this facility.

It is also important to bear in mind that the limit on drawings under the facility is not the limit on the amount a country may draw as a result of a payments difficulty arising out of an export shortfall. It is always open to the country to request an additional drawing under the ordinary drawing policies applicable to its tranche position with the Fund. Admittedly, this would reduce the amount of drawing facilities available for other purposes.

If one disregards the foregoing considerations, there can be little doubt but that over any extended period of years an expansion of the 25 per cent limit on outstanding compensatory drawings would add significantly to the value of the assistance provided. Calculations as to how the Fund's compensatory facility might have worked if it had been applied, on a pure formula basis,[1/] to the export earnings of primary producing

1/ It is, of course, impossible to establish in retrospect precisely what compensation would have been payable over the period 1951 to 1964 under the present scheme and with a higher limit respectively, inasmuch as estimates of trend and shortfall would have been affected by qualitative appraisal as well as by formula.

countries over the period from 1951 to 1964, and if it had been used to the full, indicate that an extension of the limit on outstanding drawings from 25 to 50 per cent of quota would have increased the effectiveness of assistance provided under the facility in a proportion roughly commensurate with the increased "cost" involved. The extent to which export availabilities are brought closer to the trend value of exports would have been increased by almost 50 per cent, the extent to which availabilities are smoothed out would have risen by some 60 per cent, while the average drawings outstanding would have risen by some 65 per cent. The data are set forth at Table 3.

In the rather favorable circumstances which have prevailed since the compensatory financing decision, only three compensatory drawings have taken place. It is noteworthy, however, that in one of them (the case of Sudan), the amount of compensation which would <u>prima facie</u> have been paid under the facility was restricted by the existence of the 25 per cent maximum. In the other two cases the amount of compensation paid was not so restricted but in each case a single compensatory drawing absorbed, respectively, 86 per cent and 71 per cent of a quota tranche.

Table 3. Compensatory Financing: Fund Scheme with Varied Limits Applied to Data for Years 1951-64 1/

Limit	Approximation Ratio 2/	Smoothness Ratio 3/	Average Drawings Outstanding 4/
.25 of Quota	.023	.029	.29
.50 of Quota			
(a) Unqualified	.034	.046	.48
(b) Qualified as to rate of use 5/	.035	.047	.45
None	.100	.121	1.36

1/ Scheme applied to a sample of 48 countries. Coefficients of .5, .25 and .25 applied to years t, t-1, and t-2, respectively, to compute shortfalls. Drawings are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of the level of exports in those years. The quotas in per cent of which the limits are expressed are not present quotas but those obtaining at the relevant dates during the period 1951 to 1964.

2/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

3/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

4/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

5/ Drawings outstanding may not increase in any year by more than 25 per cent of quota.

some $2.0 billion of the limit were 50 per cent of quota, as against about $1.1 billion if the limit were 25 per cent of quota — or an increase of some $900 million

From a compensatory financing standpoint there is much to be said for extending the limit of the facility from 25 to 50 per cent. Since, however, it would involve an addition to the amount of liquidity which the Fund provides on liberal conditions, it might tend to reduce countries' willingness to have recourse to facilities of a more strictly conditional character. This weakening of conditionality, which will be somewhat intensified by the separation of the compensatory facility from other drawing facilities which has been recommended in the preceding section, ~~is perhaps the most important disadvantage of the proposal under consideration~~.

Account should also be taken of the possible effect on the Fund's own liquidity, i.e., its effect on the probable level of drawings relative to resources provided by quotas in the Fund. As shown in Table 3, if the compensatory facility had existed over the period 1951-64, and if all the 48 countries covered by the table had made full use of that facility, an extension of the limit from 25 per cent to 50 per cent of present quotas would have increased the average amount of compensatory drawings outstanding from $290 million to $480 million. From the standpoint of Fund liquidity, however, what matters is not so much the average amount of compensatory drawings outstanding as the amount liable to be outstanding at peak periods. It is estimated that, on the assumptions set forth above, the extension of the limit from 25 per cent to 50 per cent would have raised the maximum amount of compensatory drawings outstanding within the period from $400 million to $740 million or, say, from 18 per cent to 33 per cent of the quotas of the countries concerned in the year--1955--in which these maxima occurred. On the assumption that potential peak year compensatory drawings outstanding at any given percentage limit have expanded since 1955 in proportion to quotas it may be estimated on the basis of the new quotas that have become ~~becoming~~ effective in 1966, that outstanding drawings for a peak year like 1955 would ~~now~~ amount to ~~somewhat more than $1,100 and $2,000 million for the 25 per cent and 50 per cent limits, respectively.~~ Since, however, countries with adequate reserves will often not use opportunities for compensatory drawings that are open to them, or will not exercise their full entitlement to such drawings, and since any use made of the compensatory facility is likely to reduce to some extent requests for ordinary drawings, the true magnitude of the additional use of Fund resources at peak periods involved in the extension of the limit would be unlikely to exceed, say, $400 million to $500 million. Moreover, past experience would suggest that while peak years for compensatory drawings outstanding

half the amount mentioned —

~~and~~ could have as its effect that corrective measures would be delayed in circumstances where such measures would be appropriate, irrespective of the course of the export shortfall would be likely to occur in years when non-compensatory outstandings were relatively high, they would not be likely to coincide precisely with the peak years for non-compensatory drawings outstanding.1/

Balancing the divergent considerations discussed in this section, it is intended that:

(i) the limit on the use of the compensatory facility under Paragraph 5 of the Compensatory Financing Decision of 1963 should be raised from 25 per cent to 50 per cent of quota; but that

(ii) the new limit should apply in all circumstances and not merely as with the present limit, "normally";2/

(iii) in any twelve month period the net expansion in drawings outstanding under Paragraph 5 of the Decision should not exceed 25 per cent of quota; and

(iv) any drawings the effect of which would be to raise drawings outstanding under Paragraph 5 of the Decision beyond 25 per cent of quota will be granted only if the member country, in addition to fulfilling the requirements of the Decision, is found to have been following policies reasonably conducive to the development of its exports.

?

This is one of these

1/ Outstanding Drawings in Relation to Fund Quotas, 1951-64
(in per cent of total Fund quotas)

	Actual Fund Drawings		
	All countries	Less developed countries	Hypothetical compensatory drawings1/
1951	12.1	3.5	0.1
1952	11.0	3.0	2.6
1953	10.5	3.7	5.0
1954	8.3	4.0	4.5
1955	6.0	3.3	4.0
1956	11.9	3.8	3.9
1957	21.8	7.9	3.2
1958	21.2	8.6	4.6
1959	11.0	5.8	2.3
1960	6.9	5.9	1.3
1961	18.0	8.7	1.4
1962	11.6	9.0	1.6
1963	11.6	9.6	0.9
1964	16.1	8.9	0.7

1/ Mixed Repurchase Scheme with qualified 50 per cent limit.

2/ The relevant words of the Decision are: "The amount of drawings outstanding under this decision will not normally exceed 25 per cent of the member's quota."

The limitation suggested under (iii) above will impose a delaying effect in utilizing the compensatory facility to the full extent proposed under (i). As will be seen from Table 3, this arrangement would probably yield slightly better results with respect both to approximation to export trend and to smoothness of export availabilities than would an unqualified limit of 50 per cent of quota, and would be slightly less expensive to the Fund in terms of drawings outstanding.

In connection with the delaying effect of proposal (iii), it should be borne in mind that Consultations under Article XIV or Article VIII would provide an opportunity for testing the extent to which a member had implemented its undertakings under earlier compensatory drawings to "cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties," and also the extent to which it was complying with the conditions set forth at (iv) above.

If the resources needed by a member to deal with a particular shortfall exceeded the amount permitted under condition (iii) above and the member desired additional assistance from the Fund, it would enter into discussions with the Fund for a drawing on the terms normally applicable to the tranche in which the country found itself.1/ This would be a drawing under Paragraph 4 of the 1963 Decision, and, as such, would not be limited in magnitude to any a priori percentage of the member's quota.

IX. Repurchase of Compensatory Drawings

The third measure recommended by UNCTAD for study by Fund member governments is:

> "(3) To explore ways to secure possible refinancing of compensatory financing obligations of the developing countries in the event of a persistent shortfall in export receipts beyond the control of the country affected."

While there is no specific provision in the Compensatory Financing Decision of 1963 for refinancing of compensatory drawings, refinancing on a short- to medium-term basis would, in effect, be possible under present procedures in the circumstances that appear to be envisaged in the recommendation, viz., in the case where at the time when the repurchase falls due there is a shortfall in export receipts beyond the control of the affected country. The repurchase would, of course, restore the compensatory financing facility pro tanto, and if at that time an export shortfall of the type described persisted, the member would be in a position to apply for a new drawing under this facility. It would not, however, be able to increase its outstanding compensatory drawings as much as if there had been no repurchase obligation. Moreover, a country that had

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1/ In accordance with the proposal at p. 16 above, the terms in question would, of course, be determined by the Fund's holdings of the member's currency, exclusive of those arising from drawings outstanding under Paragraph 5 of the Compensatory Financing Decision.

made a compensatory drawing might suffer hardship by having to repurchase in a year in which, even though it had no shortfall, neither had it any excess of exports over the norm out of which it could afford to make repayment.

This raises the much more fundamental issue as to whether repayments for compensatory drawings should take place according to the normal 3 to 5 years rule, or whether they should take place, entirely or to a considerable extent, in years in which exports exceed the estimated trend value. As can be seen from Table 4 below, schemes in which (a) repurchases were made exclusively out of export excesses, and (b) the full amount of such excesses was directed to repurchases would probably, over the years 1951 to 1964, have enhanced the degree of approximation to the export trend by over 20 per cent, and the smoothing effect of the facility on export availabilities by over 50 per cent as compared to schemes involving repurchase under the 3 to 5 year rule. This holds true whether the limit on outstanding drawings is 25 per cent or 50 per cent of quota. For schemes without limits the superiority of compensatory repurchase would have been still greater.

Contrary to what might perhaps at first sight be assumed, the change in the timing of repurchases would also, save in the "no limit" case, have reduced the average length of time for which compensatory drawings remained outstanding and hence have reduced the average amount of compensatory drawings outstanding at any one time. It seems probable, therefore, that a system whereby compensatory drawings are repaid out of export excesses rather than under the 3 to 5 year rule would do much to improve the performance of the facility without any additional "cost"--indeed with a reduction in cost--in terms of drawings outstanding.

In order to apply this method of repayment for compensatory drawings, calculations would have to be made at twelve-monthly intervals to see whether or not export excesses had occurred. These calculations might be made with respect to calendar years or Fund financial years, beginning with the first complete year following the drawing. Alternatively, and preferably, they might be made for each twelve-months period, beginning with the twelve months immediately following that with respect to which the drawing had been granted. Since it would be a matter not of a drawing facility, but of a repayment obligation, it would be inappropriate to rely to any extent on qualitative estimation of a necessarily subjective kind in calculating the export excess. This should be done on the basis of the statistical formula adopted as an element in the calculation of shortfalls.

[The following passage, to the end of the section on "Compensatory Facility and Fund Liquidity," diverges substantially from the corresponding passage from the foot of p. 22 to p. 26 inclusive in SM/65/101, and proposes a type of mixed repayment system for compensatory drawings different from that proposed in SM/65/101. These changes were made to meet the point made by a number of Executive Directors that repurchases out of export excesses, though avoiding the difficulties that would arise from repurchase requirements occurring at a time of poor or mediocre exports, might have difficulties of their own in that the amount of the repurchase obligation would not be known in advance. The system now proposed attempts to avoid or mitigate both sets of difficulties, in a manner not unduly expensive to the Fund.]

Two difficulties arise with respect to this fully compensatory system of repurchases out of export excesses. The first concerns the predictability of repurchase obligations. Countries might occasionally find it difficult to repurchase compensatory drawings to the full extent of any excess of actual over trend value of exports, partly because an expansion in exports would probably entail some increase in import requirements, and partly because the obligation to repay would not be known with certainty until after the event. This difficulty should not be exaggerated. Owing to the manner in which export excesses are calculated, only one half of any <u>increase</u> in exports over the average level in the two years preceding the excess year could give rise to a repurchase, and if serious problems on repurchase should nevertheless arise owing to circumstances affecting other items in the balance of payments, it would always be possible for the Fund, under appropriate conditions, to agree to an ordinary drawing at the time of the compensatory repurchase. Nevertheless, it is possible that countries might prefer to have their repurchase obligations expressed in a more predictable form.

The second difficulty arises from the fact that under the system of repurchase out of export excesses a proportion of the repurchases of compensatory drawings would probably remain outstanding for longer periods than has hitherto been deemed compatible with the temporary character of Fund assistance. This does not mean that repayment would normally be more delayed than under the 3 to 5 year rule. Indeed, if, as indicated in Table 4, the amount of compensatory drawings outstanding is generally likely to be less when repayments are geared to exports than when they are made under the 3 to 5 year rule, the average length of time for which a drawing remains outstanding will probably be less in the former than in the latter case. More direct measurements of probable periods for which compensatory drawings would remain outstanding if repayments were also on a compensatory basis are given in Table 5, which is based on the experience of the years 1951-64. From this it can be seen that, even with an unqualified limit of 50 per cent of quota, some two thirds of all compensatory drawings would be repaid within 3 years, and more than four fifths within 5 years. The residue remaining outstanding beyond 8 years might be about 1 per cent. In considering these results, it should be borne in mind that the repurchase obligations under Article V, Section 7, would, of course, continue to apply--a fact which could not be taken into account in the calculations set forth at Table 5.

Table 4. Compensatory Financing: Fund Scheme with Varied Forms of Repayment, 1951-64 1/

Repayments System	Fixed Term 2/	Compensatory 3/	Mixed 4/
	25 Per Cent of Quota Limit		
Approximation Ratio 5/	.023	.028	.026
Smoothness Ratio 6/	.029	.045	.036
Average Drawings Outstanding 7/	.29	.17	.26
	50 Per Cent of Quota Limit (Unqualified)		
Approximation Ratio	.034	.042	.041
Smoothness Ratio	.046	.072	.060
Average Drawings Outstanding	.48	.36	.48
	50 Per Cent of Quota Limit (Qualified)		
Approximation Ratio	.035	.043	.042
Smoothness Ratio	.047	.071	.060
Average Drawings Outstanding	.45	.28	.42
	No Limit		
Approximation Ratio	.100	.155	.160
Smoothness Ratio	.121	.216	.205
Average Drawings Outstanding	1.36	1.49	1.77

1/ Weights of .50, .25 and .25 applied to years t, t-1, and t-2, respectively, for estimating calculated norm. 100 per cent compensation of calculated shortfall.

2/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

3/ 100 per cent of export excesses applied to repayment in all years.

4/ Repayment in five equal instalments, beginning in the year following the shortfall year: repayments on past drawings are deducted from exports for the purpose of computing shortfalls.

5/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

6/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

7/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

If the requirement that the Fund assistance be "temporary" could be deemed to be adequately met by the manner in which export shortfalls and excesses are calculated, and by the statistical probability that the average period of repayment will be short, this change is one which it would be advisable to adopt. However, it is considered that this requirement calls for a fixed maximum term for every drawing, which would make it difficult to adopt the repayment system under consideration in an unmodified form.

A "mixed" system on the following lines would seem to meet both of the difficulties referred to above and to combine many of the advantages of "compensatory" and "fixed term" repurchase respectively:

(a) Compensatory drawings would be repaid in equal annual instalments over a five-year period.

(b) In estimating export shortfalls for the purpose of making compensatory drawings, the Fund would, if the member so requested, deduct from the figure for actual exports any repurchases on past compensatory drawings that had been made within 12 months prior to the new compensatory drawing. Such deductions would not affect the computation of the export norm for the shortfall year.

(c) Any request for compensatory drawings involving a deduction such as that described at (b) above would be met only if the Fund was satisfied that the member, in addition to fulfilling the requirements of Paragraph 5 of the Compensatory Financing Decision, had been following policies reasonably conducive to the development of its exports.

To the extent that a member took advantage of the deduction, the effect of this arrangement would be that the member would repay, with respect to any compensatory drawing, either the due instalment for the year or its export excess, whichever was the less. This would be easier on the member, in respect of the predictability and possibly the amount of the repayment in certain years, than the system of full compensatory repayment out of export excesses. It would differ from that system in two other ways: (i) Normal repurchases would be the occasion for a new compensatory drawing provided an appraisal partly on a qualitative and not entirely on a formula basis justified such a drawing, and the member declared that it was prepared to discuss its policy with the Fund. (ii) The addition of paragraph (c) introduces the concept that the country would have to satisfy the Fund that it had been pursuing reasonable export policies even where the drawing, insofar as it was occasioned by a repurchase, would fall within the first compensatory tranche. The latter feature would eliminate one of the possible defects of the fully compensatory repurchase system, viz., that a country will never repurchase if its exports, having once declined, continued to stagnate--insofar as the stagnation was attributable to faulty policies.

Table 5. Duration of Drawings under Compensatory Repayments System 1/

(Period = 1951-64)

	25% of Quota Limit		50% of Quota Limit (Qualified)		50% of Quota Limit (Unqualified)	
	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings
Total drawings	.89	100	1.24	100	1.45	100
Repaid:						
Within 3 years	.74	83	.97	78	.97	67
Outstanding after:						
Fifth year	.09	10	.15	12	.27	18
Eighth year	.01	about 1 2/		about 1 2/		about 1 2/

1/ Coefficients of .5, .25 and .25 applied to years t, t-1, and t-2, respectively, to compute shortfalls. Full compensation of shortfalls is assumed. One hundred per cent of excesses applied to repayment.

2/ Since some of the drawings in question were still outstanding at the end of the period but had not yet reached their eighth year, this figure is an estimate.

As will be seen from Table 4, the performance of this "mixed" system of repurchase, over the years 1951-64, as measured by the approximation ratio and the smoothness ratio, would probably have been better than that of the "fixed term" (3 to 5 years) system of repurchase, and only slightly inferior--except where there are no limits to outstanding drawings--to that of a fully compensatory system of repurchase out of export earnings.

The "cost" in terms of drawings outstanding is higher for the "mixed" system than for a fully compensatory system of repurchase. This is the price that has to be paid for increasing the predictability of repurchase obligations. The cost is, however, no greater--so long as the outstanding drawings of individual countries are limited to 25 per cent or 50 per cent of quota--than under the present system of repurchase within 3 to 5 years.

X. Changes in the Compensatory Facility and Fund Liquidity

On page 19 above an estimate was made of the possible charge on Fund liquidity that might arise from additional drawings associated with an extension of individual country limits on outstanding compensatory drawings from 25 per cent to 50 per cent of quota. At this point, a similar calculation is in order as to the charge on Fund liquidity that might result from adopting both of the principal measures suggested above, viz., (a) the extension of the limit from 25 per cent to 50 per cent with the qualification that the increase in outstandings in any year should not exceed 25 per cent, and (b) the adoption of the "mixed" system of repurchase discussed above in place of the fixed-term system of repurchase which applies at present. Some additional claims on Fund resources might also arise from the proposed separation of the compensatory facility from the other drawing facilities of the Fund, but this cannot be quantified and is unlikely to be large.

As can be seen from Table 4, the transition from "fixed term" repurchase with a 25 per cent of quota limit, to a "mixed" system of repurchase with a qualified 50 per cent of quota limit would, over the 1951-64 period, have involved an increase in the average level of potential compensatory drawings outstanding from $290 million to $420 million, i.e., an increase of $130 million. The maximum level of potential compensatory drawings outstanding would likewise have risen from $400 million (in 1955) to $560 million (in 1958), i.e., by $160 million. On the assumption that peak year potential compensatory drawings outstanding have expanded since 1955-8 in proportion to quotas, the proposed changes in limits and repurchase systems might, under present conditions, raise maximum potential compensatory drawings from $1,100 million to $1,500 million, i.e., by $400 million. Allowing for failure to use the full entitlement to compensatory drawings and other factors, it seems unlikely that the increase in peak year drawings occasioned by the proposed changes would in practice exceed $200 million.

XI. Conclusions for Action

More than three years have now elapsed since the creation of the compensatory financing facility, and though it has not been extensively used the Fund has had sufficient experience with it to review and reappraise its application and scope. As a result it has been deemed desirable both to clarify the circumstances under which the facility can be used and to introduce into it certain modifications designed to increase the effectiveness of the assistance which the Fund provides to members.

In determining the medium-term export trend for the purpose of calculating the export shortfall the practice hitherto has been to give approximately equal weight to statistical and qualitative estimates, respectively. Experience suggests that qualitative estimates based on commodity analysis gives a closer estimate of the trend; consequently qualitative estimates will receive a greater weight in the future.

At present, the Fund is prepared to waive the requirement that total outstanding drawings may not exceed the Fund holdings of a member's currency beyond 200 per cent of quota either to accommodate compensatory drawings or, to the extent that compensatory drawings are outstanding, to accommodate other drawings. However, drawings under the compensatory facility are included in Fund holdings of the member's currency in applying the tranche policies of the Fund to subsequent drawings. Full recognition of the special circumstances which give rise to compensatory drawings would make it desirable to separate this facility from normal drawing facilities of the Fund so that additions to the amount of compensatory drawings outstanding would not in any way affect the tranche policies applicable to other drawings.

While the use of the compensatory facility is most needed when a shortfall appears, members may be precluded or deterred from requesting use of the facility at that time since the full amount of shortfall can be known only after the interval of several months. To meet this problem it is proposed that within six months of any drawing, members should be enabled to reclassify all or part of it as a compensatory drawing and thus to restore to that extent their normal drawing rights for future contingencies.

Under the 1963 Decision outstanding drawings under the compensatory facility are limited normally to 25 per cent of quota. It is believed that an extension of the limit on outstanding drawings from 25 to 50 per cent of quota would add substantially to the value of the assistance provided. At the same time it is important to avoid such changes as would tend to weaken the ability of the Fund to exert its influence with members toward early adoption of sound corrective policies. It is, therefore, proposed that compensatory drawings outstanding may amount to a maximum of 50 per cent of quota, but that during any twelve-month period the amount of such drawings outstanding may not increase by more than 25 per cent of quota and that requests which would increase outstanding compensatory drawings beyond 25 per cent of quota should be met only if the Fund is satisfied that the member has been following reasonably sound export policies.

The question of repurchases of compensatory drawings has also been reconsidered in light of the possibility that the course of export receipts may make it difficult for a member to repurchase drawings fully within 3 to 5 years. On the other hand, repurchase terms should not be so changed as to undermine the revolving nature of Fund resources. Balancing these considerations, it is proposed that compensatory drawings should be repayable in equal annual instalments over a five-year period but that the member should be able to offset such repurchases against actual export receipts for the purpose of determining the amount of any new compensatory drawings if it is able to satisfy the Fund that it has been pursuing reasonably sound export policies.

XII. Decision

In the light of the foregoing considerations, Decision No. 1477-(63/8) of February 27, 1963, on Compensatory Financing of Export Fluctuations is hereby amended by the deletion of paragraphs (5) through (8) and the substitution of the following paragraphs:

"(5) The Fund has reviewed its policies to determine how it could more readily assist members, particularly primary exporters, encountering payments difficulties produced by temporary export shortfalls, and has decided that such members can expect that their requests for drawings will be met where the Fund is satisfied that

(a) the shortfall is of a short-term character and is largely attributable to circumstances beyond the control of the member; and

(b) the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

Drawings outstanding under this paragraph may amount to 50 per cent of the member's quota provided that: (i) such drawings will not be increased by a net amount of more than 25 per cent of the member's quota in any 12-month period, and (ii) requests for drawings which would increase the drawings outstanding under this paragraph beyond 25 per cent of the member's quota will be met only if the Fund is satisfied that the member has been following policies reasonably conducive to the development of its exports.

(6) A member requesting a drawing under paragraph (5) will be expected to represent that it will make a repurchase corresponding to the drawing in equal annual instalments to commence one year after the drawing and to be completed not later than five years after the drawing. However, in estimating export shortfalls for the purpose of drawings under paragraph (5), the Fund will, if the member so requests, deduct from the figures for actual exports an amount equivalent to any repurchases made with respect to past drawings under paragraph (5) within 12 months of the request for the new drawing. A request for a drawing with respect to a shortfall which results in whole or in part from such deductions will be met by the Fund if it is satisfied that the member, in addition to fulfilling the requirements of paragraph (5), has been following policies reasonably conducive to the development of its exports.

(7) Whenever the Fund's holdings of a member's currency resulting from an outstanding compensatory drawing under paragraph (5) are reduced, by the member's repurchase or otherwise, this will restore <u>pro tanto</u> the member's facility to make a further compensatory drawing under that paragraph, should the need arise.

(8) When drawings are made under paragraph (5), the Fund will so indicate in an appropriate manner. Within six months from the date of any drawing which is not under paragraph (5) and to the extent that it is still outstanding, a member may request that all or part of the drawing be reclassified and treated, for all purposes of this decision, as a drawing made under paragraph (5). The Fund will agree to such a request if at the time of the request the member meets the requirements for a drawing of an equal amount under paragraph (5) and makes the representation as to repurchase appropriate to such drawings, which representation will then be substituted for the original repurchase representation.

(9) In order to implement the Fund's policies in connection with compensatory financing of export shortfalls, the Fund will be prepared to waive the limit on Fund holdings of 200 per cent of quota, where appropriate. In particular, the Fund will be prepared to waive this limit (i) where a waiver is necessary to permit compensatory drawings to be made under paragraphs (4) and (5) above, or (ii) to the extent that drawings in accordance with paragraph (5) are still outstanding.

Moreover, the Fund will apply its tranche policies to drawing requests by a member as if the Fund's holdings of the member's currency were less than its actual holdings of that currency by the amount of any drawings outstanding under paragraph (5).

(10) In order to identify more clearly what are to be regarded as export shortfalls of a short-term character, the Fund, in conjunction with the member concerned, will seek to establish reasonable estimates regarding the medium-term trend of the member's exports on the basis of appropriate statistical data in conjunction with qualitative information about its export prospects.

(11) The provision of credit to deal with the balance of payments effects of export fluctuations provides immediate relief for a country's short-term difficulties. In many cases, however, it will also be necessary to introduce measures of a policy character in order to attain a satisfactory and lasting solution to a country's balance of payments problems. Members generally have actively cooperated with the Fund to find and adopt the measures necessary to this end. Beyond immediate balance of payments difficulties, the primary exporting countries are, in many instances, facing unfavorable long-term export trends, and all are trying to meet the challenge of achieving more rapid and sustained development through a strengthening and broadening of their economies. The last mentioned problem will require action in many fields and over many years by both the primary exporting countries and the industrial countries, separately and in concert, including readier access to the markets of the developed countries for the products of the developing countries and an appropriate and sustained flow of technical and financial assistance to the developing countries. The Fund considers that its activities can provide valuable assistance in helping to establish a climate within which longer-term measures can be more effectively pursued."

APPENDIX "A"

United Nations Conference on Trade and Development
Final Act and Report

Annex A.IV.17

Study of Measures Related to the Compensatory Credit System of the International Monetary Fund

The Conference,

Considering that the compensatory credit system put into operation by the International Monetary Fund since February 1963 constitutes a definite step towards the solution of short-term financing problems,

Considering that, in view of the short-term needs of developing countries derived from fluctuations in their export receipts, this system should be reviewed,

1. Recommends that Governments members of the International Monetary Fund study the following measures:

(1) To increase, as soon as possible, the amount allocated by the Fund to compensatory financing, over and above its current transactions, from 25 per cent to 50 per cent of a member country's quota;

(2) To place compensatory credits entirely outside the structure of the gold and successive credit tranches, so that the drawing of compensatory credits would not directly or indirectly prejudice a member's ability to make an ordinary drawing;

(3) To explore ways to secure possible refinancing of compensatory financing obligations of the developing countries in the event of a persistent shortfall in export receipts beyond the control of the country affected.

2. Requests that the International Monetary Fund, in its determination of the shortfall in export receipts, consider giving greater weight to the actual experience of the three preceding years.

APPENDIX "B"

Excerpts from Speeches of Governors at the 1965 Annual Meetings

AFGHANISTAN (Governor Achaczai)

The recent fall in basic commodity prices and difficulties in marketing total available supplies will necessitate compensatory financing in the coming months. To meet these needs, the facilities of the Fund need improvement.

ARGENTINA (Governor Pugliese, on behalf of 19 Latin American countries and the Philippines)

We should like to reiterate our opinion once more regarding the decision adopted in 1963 by the Executive Board of the Fund on the compensatory financing of losses in the export proceeds of primary-producing countries. We recognize that this represents a contribution toward the partial solution of this very important problem. However, it would be advisable to consider three fundamental aspects:

1) The need for considering the compensatory tranche in addition to the normal credit facilities of the Monetary Fund. The decision of February 1963, indeed, permits the drawing without taking into consideration the position of the requesting country with regard to the credit tranches. Nevertheless, the drawing has been added to those already made and thus may affect the country's position in respect of future transactions with the Fund. In our opinion it is of the greatest importance that the compensatory drawing be allotted quite separately from the others and invested with the supplementary nature that the different schemes favored by our countries have always upheld.

2) The amount available under this type of loan, limited to 25 per cent of each member's quota, is of insufficient size even in the case of very moderate depressions. If this ceiling were raised from 25 to 50 per cent, more significant resources would be made available to the countries exporting primary products, without this entailing a very heavy burden on the resources of the institution.

3) In conclusion, we would emphasize the non-automatic nature of the drawings permitted. In the decisions on individual cases submitted to the consideration of the Executive Board there has been some flexibility, although in all of them there has been no lack of a subjective assessment in the determination both of the amount to be compensated and of the circumstances in which the loss of income occurs.

CEYLON (Governor Wanninayake)

I was encouraged by the reference by Mr. Schweitzer to the work that the Fund is now undertaking to improve the compensatory financing facility. Several speakers have urged that compensatory assistance should be provided for a decline in the terms of trade rather than for a fall in export earnings alone. My own country's experience in recent years vividly illustrates the importance of this reform. We suffered a decline in the terms of trade by 13 per cent in two years alone, but since this was almost entirely due to an increase in import prices we were unable to avail ourselves of the compensatory financing facility. I do sincerely hope that this particular improvement in the scheme will be made effective at an early date.

CHINA (Governor Lee)

However, the scanty application that developing countries have made of the compensatory financing facility of the Fund would seem to indicate that the economic problems of developing countries cannot readily be solved through temporary accessibility to credit.

GREECE (Governor Zolotas)

. . . improved facilities for compensatory financing and more flexible conditions for drawings and repurchases should also be envisaged to provide for a direct contribution to the liquidity position of developing countries.

IRAQ (Governor Haseeb)

May I point out in this connection that the compensatory financing scheme of the Fund, though admirable in itself, suffers from one drawback. The borrowing facility under this scheme is available to primary producing countries when the shortfall in their exports is due to factors beyond their control. Since the decline in exports in such cases would be temporary and self-correcting, the Fund should not make the facility conditional on the pursuit by the country concerned of particular policies about its general balance of payments position.

SUDAN (Governor El Hindi)

Appreciative as we are of the Fund's efforts in this respect, we strongly feel that the terms and conditions under which the Fund provides such compensatory assistance (and, indeed, any other assistance) should be reconsidered with the view of softening them. It is no secret that a very limited number of members have so far made use of these arrangements, in spite of the pressing need of many for such assistance.

UGANDA (Governor Kalule-Settala)

While the Fund's operations are properly concerned with short-term balance of payments aspects, it may not be possible under conditions of fluctuating export earnings to differentiate between the short- and the long-term aspects. Such conditions tend to make public debt burdens unduly onerous on developing countries which base the servicing of their public debt burden on the expectation of a steady and reasonable growth in export earnings. It is therefore important in my view that both the Bank and the Fund should continue their efforts to find solutions to these problems. The Fund, on the one hand, should review the present compensatory financing arrangements to take account of the problems of fluctuating export earnings. The Bank, on the other hand, should continue to play a prominent role in evolving price stabilization machinery for primary products in association with UNCTAD.

UNITED ARAB REPUBLIC (Governor Kaissouni of the Bank)

Thus, the compensatory financing facility could be increased from one tranche to two tranches and the criteria for using this facility could be improved to take into account results to date and discussions in UNCTAD.

VIET-NAM (Governor Truong Thai Ton)

In particular, the nonliberal trade policy adopted by developed countries has obstructed the entry into these countries of primary manufactured products from the underdeveloped countries. To be sure, the action of the Bank and Fund in the form of compensatory financing granted to countries exporting primary products or in the form of assistance for the development and expansion of trade has been highly effective. However, the action necessary for the removal of discriminatory trade practices or other obstacles to the development of international trade should be hastened. This action should be supplemented by a complete revision of the present system of international payments. We also have high hopes that with the general increase in Fund quotas, the Fund will be able not only to grant compensatory financing facilities on a broader basis, for example, by increasing the percentage of this financing, but also to consider ways to aid countries which have experienced a temporary export shortfall as a result of crop losses caused by war, floods or other natural calamities.

July 15, 1966

This is in answer to your letter of July 8th on compensatory financing.

I hope you will be able to delay completion of your study until the end of September. It seems likely namely that the Fund will take a new decision on compensatory financing by that time, which would take into account the various points made by the 1964 UNCTAD meeting. On that occasion we would also issue, probably, a pretty extensive report indicating how we approach the more technical questions such as the measurement of shortfalls. I cannot, however, let you have any preview of this material.

For the time being, the best information on how compensatory financing works is contained in an original Fund report on this subject (enclosed) and in the statement that Mr. Fleming recently gave to an UNCTAD Committee (also enclosed).

It is perhaps worth recalling that Fund compensatory financing is based on a country's total exports, which may make it less relevant to the study of an individual commodity where that commodity is only a relatively small proportion of a country's exports.

You will find all necessary information on a country's position in the Fund in *International Financial Statistics*. The position at any moment of time is in the general table I. Table II gives transactions with all members in each year since 1956. In the sections on individual countries, you will find, under "International Liquidity" the more detailed history of a country's transactions with the Fund and the total amount it could still draw within the 200 per cent limitation ("gross Fund position"). Compensatory financing drawings can, however, bring a country beyond this limit up to a maximum of 225 per cent of quota and in the case of one of our compensatory financing drawings, that of the UAR, the 200 per cent limit was in fact exceeded.

As to the most recent balance of payments information, the best source of published information is still *International Financial Statistics*. In any event, I presume that your study is not concerned with the very short-run balance of payments position of countries.

I hope the above goes somewhere towards meeting your need; if I can do anything more please let me know.

Sincerely yours,

Jacques J. Polak

Mevr. R.'tHooft
Corellistraat 6
Amsterdam, Z., Netherlands

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REF. Nº :

8 July, 1966

Dr. J. J. Polak
Director Research and Statistics Department
International Monetary Fund
19th and H. Streets
WASHINGTON, D.C.

Dear Koos,

I have been asked by the International Rubber Study Group to do a paper for them on compensatory or supplementary finance in the framework of the studies of their Working Party on the future of natural rubber.

My general ideas on this subject were first published in an UNCTAD paper I sent you, entitled : The International Organisation of Commodity Trade : Case Study of Natural Rubber. (The old reference number TD/B/AC.2/4 has in the meantime been changed into TD/B/C.1/PSC/3.)

It will be clear to you from the paper that the kind of compensation I am thinking of has nothing to do with the Fund; if I had my way - which I will not get - it would come closer to deficiency payments.

My new paper however will have to go into compensation in a more technical way, first exploring the existing mechanisms to see if they answer my problems, even partly. I think I have a fair notion of how IMF compfin. works, but I would like to be able to quote some official text, if necessary. Moreover, I hear that at present the Fund is engaged in changing the rules, which I will have to take into account.

Apart from this I wonder if you could help me with some statistics. I will be able to find the more important balance of payments items in IFS, and the national accounts in UN National Accounts publications. But it would also be of interest to know how far the countries concerned have been into the Fund during recent years and what their quotas and therefore their drawing rights are at present, in order to compare this with possible shortfalls of rubber earnings. The countries concerned are : Malaysia, Indonesia, Thailand, Vietnam, Ceylon, Liberia, Nigeria, Brazil, Cambodia and a few others. I know you have nothing on Indonesia; of the others only Malaysia, Thailand, Vietnam and Ceylon are of real importance, possibly with the addition of Liberia and Nigeria.

I would therefore be very happy if you would send me a copy of the most recent rules and regulations regarding IMF compensatory finance, and the present quotas and drawing rights of the countries mentioned above together with their recent balance of payments behaviour. Of course anything else which you think may help is very welcome.

I will be in Geneva only till July 13th, so any stuff you send had better go to my home address, Corellistraat 6, Amsterdam, Z.

Sorry for writing to you in English, because of the typing.

Het is hier onbeschrijfelijk vervelend, het gemis aan leiding in UNCTAD conferences gaat alle perken te buiten. Overigens gebeurt er niets, maar dat hebben we geloof ik gemeen met de groep van Tin[illegible].

Hart. groeten,

je [illegible]

Mr. Polak

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

Mr. Domenech's Statement on Compensatory Financing
Executive Board Meeting 66/52
July 6, 1966

Mr. Chairman:

The document which is being analized (SM/66/77) has been drawn up in response to various requests for reconsideration, submitted in different ways and on various occasions, in order to modify the actual 1963 system.

The new document, in general, is very interesting as are the specific conclusions for action; obviously, there are some nuances and aspects which one would surely deal with in a different manner or with different emphasis; however, it must be acknowledged that this document covers, for example, a good part of the recommendations formulated at the last Annual Meeting by the Governors for Latin America and the Philippines, about which I wish to express my satisfaction in principle.

In this matter of the compensatory financing of exports, perhaps more so than on other occasions, the different positions of the industrialized countries and of the exporters of raw materials are highlighted. Therefore, it is a challenge to our imagination, as well as to our technical and political capabilities to find a point of coincidence which will make possible an organic and realistic decision fulfilling the objectives pursued, to be offered to the member countries of the International Monetary Fund. Furthermore, the experience of the 1963 Decision allows us - while also committing us - to be more precise than on that occasion.

As I have already said, the Fund staff has made available some very interesting information in the document under consideration, which allows the member countries, particularly those countries which export raw materials, to formulate criticisms and suggestions to the document as a means to help attain the objectives of this Institution, in order that financial assistance be made available to the member countries at the appropriate time and in an appropriate manner. This is to say that the analysis which is presently being formulated, for reasons of time, concentrates on the principal aspects which do not directly reflect a consensus of opinions and, for the time being, no specific mention will be made regarding the many aspects where agreement exists, on which subject the staff could have condensed the observations and preoccupations put forward, on various occasions, by the countries exporting raw materials.

Under the conditions described, I have allowed myself to express herein my main comments in order that the Executive Directors and the staff should have time to reflect upon them prior to tomorrow's meeting.

Considering the document from a general point of view, it would appear that the staff has a preconception regarding the inability of member countries of the International Monetary Fund to administrate their foreign payments situation, which seems hard to expect member countries to accept. (For example, page 13: "It should also be borne in mind that any shortfall that appeared to be artificially induced by deliberate delay in the marketing of a crop would be unlikely to be regarded as "largely attributable to circumstances beyond the control of the member" and in this event would not qualify for a compensatory drawing.")

In the second place, the proposed modifications could be considered as forming part of a complicated and a long-drawn-out mechanism, which projects some discretionary behavior on the part of the Fund in relation to the trade and payments policies of the member countries; as well as a means of the estimation of the exporting potential of the countries; and of the economic policy conditions which the countries have to adopt in order to fulfill the estimates established in the document under review.

Furthermore, the introduction of a complicated mechanism for estimating future exports and other studies leading to a discretional evaluation of drawing facilities, presents administrative complications both for the member countries as well as for the International Monetary Fund which, as a result, would find itself committed to increase the size of its staff.

It should be noted that the proposal in Section I is deemed to be most suitable, whereby drawing facilities should only be utilized when the reduction occurs in the export earnings, independent of the variations which may result in international prices or in the buying capacity of the exports. In this way, the variations of the terms of trade (which is a long-term and not a short-term matter) is out of the question, and the system thereby tends to be utilized in situations in which the shortfall of exports results from contingent events not related to changes in economic policy conducive to same. The compensatory credit would operate correctly in order to meet contingent situations equivalent to those on which the existence of international reserves is partially based.

In another vein, it can be pointed out that in the statistical mechanism proposed on page 5 it would appear that no provision has been taken into consideration regarding the corrections in the purchasing power of the unit of account which is adopted in the calculation of the index figures of the export values. (For example, if the U.S. dollar were taken to be a unit of account, and if the value of same tended to decrease annually an historic series of values would have to be corrected, based on these variations. Perhaps a solution would be to consider the export values in 1960 dollars, as is the practice of the Department of Commerce of the United States, with its own statistical series of values.)

In Section II, on the other hand, there appears to be a logical contradiction in the presentation of the method of "moving averages" by which the consequent calculations would be carried out. A mean is a representative indicator of the statistical series to which it corresponds, as also its "standard deviation". To uphold, therefore, on pages 6 and 7, a method based on these characteristics and then to doubt that they are representative, unless judgments of value are introduced, implies a contradiction.

The proposed combination of taking the average of the last three years from statistical data and of the next two years from estimates presupposes the introduction of discretionary elements in the operation of the system. This implies the creation of complicated bureaucratic and significantly costly mechanisms - which have already been commented upon - in order to administrate the system. Finally, to base the system on judgments of value could presume the possibility of unequal treatment for the different members of the Fund.

The key point of the method given in Section III (page 8) is found in the proposal concerning the expansion of the faculties of the International Monetary Fund with regard to the economic and trade policies of member countries. In order to qualify for the use of these credit facilities, the countries would have to fulfill a number of requirements and conditions, in respect of their economic policy, of the same nature as those corresponding to credit tranche operations, however, with particular reference to export policies. This cannot be operational in this context.

It is clear that the spirit of the provisions concerning the use of credit in the case of a temporary shortfall in export earnings, refers to cases in which such a fall would be the result of contingent events. For this reason, it is necessary to avoid overshadowing the true spirit of the proposal, i.e., that the temporary shortfall in exports should not be due <u>to changes</u> in the economic policy of the Fund's member countries directed toward that end.

It might perhaps be relevant to clarify what is meant by the affirmation that a shortfall in exports is determined as an "Act of God", that is to say that it is not due to changes in the economic policy of the exporting country, avoiding any ambiguity in defining such situations as those arising from causes which are beyond the control of the member countries. Likewise, the Fund's financial assistance could not be subject to a <u>prior modification</u> of the country's economic policy, since the later repayment to the Monetary Fund could well be based on the gradual disappearance of the same contingent causes which originally were the cause of the financing. All that could be required is that the country involved should not have modified its economic policy in a manner conducive to the shortfall in exports, the financing of which is requested.

(Bing)

In this way, for example, the paragraph on page 20 which states: "... is found to have been following policies reasonably conducive to the development of its exports", could be changed to read: "... is not found to have been following consciously designed policies directed toward a restriction of the development of its exports".

Reverting to the subject of automatism, it is also considered that: (1) countries exporting raw materials would like to know, in advance, what is their theoretical drawing capacity in the event of a shortfall in their exports, and not a posteriori after long and complicated studies and negotiations; (2) if those countries cannot avail themselves of the drawings relatively quickly, they would have to enforce corrective internal measures in order to avoid a deterioration in their balance of payments (import restrictions, etc.) which, logically, would hardly come under the philosophy of the Articles of Agreement, and would finally render the financing tardy and relatively sterile.

One small formal matter, on page 30, point 11, the following sentence appears: "Members generally have actively cooperated with the Fund ...". Should not the reverse be said: "The Fund generally has actively cooperated with members..."?

It is consequently my hope that these remarks, as also those made by other Executive Directors, will give the staff of the International Monatery Fund the opportunity of drawing up a new automatic proposal and which will be of a more flexible nature. I am absolutely certain that on this future occasion, which I trust will be in the very near future, the well-versed and recognized imagination of the staff of the International Monetary Fund will provide us with a new document that will satisfy all the member countries with respect to this subject, which is of such great importance for the countries exporting raw materials and also for the remaining countries, as it is a part of the theme of international liquidity on which, as our main obligation, we work daily, always bearing in mind that liquidity is the business of the Fund.

Handfield-Jones

June 22, 1966

Compensatory Financing Facility

The proposal to revise the decision of compensatory financing scheduled for discussion by the Executive Board on June 29 involves mainly an enlargement of the benefits of the facility with only relatively minor technical improvements. Since this facility was last discussed and in the light of recent experience certain unsatisfactory features of the facility have become more apparent, but the proposal does not meet these difficulties, which fall under two headings:

(1) While the language of the decision is carefully worded to avoid any appearance of discrimination, it is as a matter of fact recognized that the facility is of benefit only to certain kinds of IMF member countries and not to others. We assume that it is open only to less developed primary producing countries, and would be surprised if a request for a compensatory financing drawing were received from a relatively wealthy country. This feature does not seem to be fully consistent or compatible with the view which has emerged in the broader discussions of international liquidity that all classes of countries have similar needs for international liquidity and that discriminatory treatment should be avoided wherever possible. If certain kinds of countries receive especially favourable treatment as in the compensatory financing facility, it would be more difficult to resist pressures from other kinds of countries for special treatment in other regards.

(2) It has also become apparent that the present facility fails to cover adequately the needs of member countries for assistance from the Fund in meeting the balance of payments consequences of unfavourable events which are outside their control. To date, there have been only three drawings under the compensatory financing facility, but there have also been three drawings by countries which have suffered natural disasters which have given rise for an abnormal need for imports. These countries are Chile, Yugoslavia, and most recently India. Such cases have not fallen under the compensatory financing facility, but they have not been treated as drawings under normal Fund policies and the usual conditions have not been fully applied, in recognition of the special and extraneous nature of the need. We seem to be developing an emergency drawing facility by case law rather than by explicit decision.

One possibility would be to formulize the emergency drawing facility by adding to the compensatory financing decision an additional paragraph which would offer as an alternative to the present arrangements an option of drawing within the same quantitative limits the amount which was estimated to be the direct foreign exchange cost of flood, earthquake, crop failure, or similar natural disaster. This option could well carry with it an obligation to repurchase within a relatively short period of time, as in the case of the recent Indian drawing.

The General Counsel has indicated that this proposal would not encounter any difficulties of a legal nature. There are practical difficulties centering around the problems of defining a natural disaster and estimating its foreign exchange cost, but experience has indicated that these difficulties are not insuperable. The proposal would have the advantage of formulizing our present practices and also of rendering the compensatory financing facility more universal in its application or at least less obviously discriminatory, and this would seem to be an important advantage. It seems improbable that it would significantly increase the calls on Fund resources since the only cases where drawings might be made which will not be made now are those arising from a natural disaster affecting a country which has already used up its normal drawing rights.

This discussion is not so much designed to argue the case for a specific proposal as to point up the need for a careful review of the compensatory financing facility and for an exploration of the various ways in which it might be improved. There may well be other and better ways of improving it. To reconsider the facility and only enlarge it, without recognizing the existence of such deficiencies as those described above, would seem to be a somewhat unsatisfactory course of action.

Mr. Fleming June 7, 1966

J. J. Polak

<u>Compensatory Financing</u>

I would suggest the following as a substitute for the last paragraph on page 26. Its main merit is to eliminate the reference to "refinancing," a term which I would prefer not to use, not even in inverted commas. It also makes clear that the new thing that subparagraph (c) does is to apply the provision to the first compensatory tranche.

As a separate point, I think something ought to be done for clarity to indicate which parts of the new decision are, in fact, reprinted from the old decision.

cc: Mr. Nicoletopoulos

To the extent that a member took advantage of the deduction, the effect of this arrangement would be that the member would repay, with respect to any compensatory drawing, either the due instalment for the year or its export excess, whichever was the less. This would be easier on the member, in respect of the predictability and possibly the amount of the repayment in certain years, than the system of full compensatory repayment out of export excesses. It would differ from that system in two other ways. (i) Normal repurchases would be the occasion for a new compensatory drawing provided an appraisal partly on a qualitative and not entirely on a formula basis justified such a drawing, and the member declared that it was prepared to discuss its policy with the Fund. (ii) The addition of paragraph (c) introduces the concept that the country would have to assure the Fund that it had been pursuing reasonable export policies even where the drawing, insofar as it was occasioned by a repurchase, would fall within the first compensatory tranche.

DRAFT

Compensatory Financing of Export Fluctuations: Developments in the Fund's Facility

Prepared by the Research and Statistics Department in consultation with the Legal Department, Exchange and Trade Relations Department, and the Area Departments

June 2, 1966

The following paper has been prepared on the basis of SM/65/101 ("The Fund's Compensatory Financing Facility Reconsidered") of December 10, 1965, revised in the light of the discussion at the Executive Board seminar of December 17, 1965, and recast in the form of a draft report by the Fund announcing changes in its compensatory financing facility.

It is suggested that the Executive Board should consider this paper with a view to revising its 1963 Decision on Compensatory Financing before this year's Annual Meeting.

The Decision on Compensatory Financing has now been in existence for over three years and is ripe for review and revision as part of the normal operations of the Fund. The revisions proposed, whether their scope is measured in terms of potential cost of Fund resources or of potential use by members, are not comparable in character or in order of magnitude with those involved in any schemes to create international reserves, whether through the Fund or otherwise, and it would seem unnecessary and inappropriate to defer consideration of them until decision has been taken on the other and larger matter.

The Fund's compensatory financing facility might well be affected if any scheme for supplementary financing of the type now under consideration under UNCTAD auspices were brought into existence. However, it would be possible, and seems desirable for the Fund to go ahead with the revision of its compensatory facility without reference to this possibility, while at the same time considering what further amendments to the Fund facility might be desirable if and when arrangements for supplementary financing were brought into existence.

Introduction

In February 1963, in response to an invitation extended by the United Nations Commission on International Commodity Trade at its tenth session in May 1962, the Fund issued a report entitled "Compensatory Financing of Export Fluctuations." This report, after reviewing the problems involved in Fund financing of fluctuations in exports of primary exporting countries, set forth in its concluding chapter an Executive Board Decision[1] covering two points: (a) quotas and (b) drawing policies.

With respect to quotas, the Fund declared its willingness to give sympathetic consideration to requests for the adjustment of the quotas of certain primary exporting countries, particularly those with relatively small quotas, to make them more adequate in the light of fluctuations in export proceeds and other relevant criteria.

As regards drawing policies, the Fund introduced a new facility, of which the principal features are as follows:

(1) It is open to all member countries, but designed in particular for primary producing countries.

(2) It is designed to compensate for temporary shortfalls in export receipts, rather than in export prices or in the terms of trade, or in the importing power of exports.

(3) By temporary shortfalls are meant deviations from a medium-term trend in export receipts.

(4) Compensation is paid in the form of a drawing subject to the normal conditions of repayments for Fund drawings, including an outside limit of 3 to 5 years.

(5) Compensation has been paid to the full extent of the calculated shortfall, subject to the proviso that the total of compensatory drawings outstanding should not normally exceed 25 per cent of quota.

(6) The policies of members drawing under the facility do not have to meet the tests that the Fund would apply in the case of a non-compensatory drawing in the same tranche. However, members do have to satisfy the Fund that they are encountering payments difficulties, that the shortfall is of a short-term character, and is largely attributable to circumstances beyond the member's control, and that the member will cooperate with the Fund in an effort to find solutions, where required, for its payments difficulties.

1/ Decision No. 1477 (63/8) of February 27, 1963, Selected Decisions, Third Issue, p. 40.

Quota Adjustments and Export Fluctuations

The Executive Board Decision on Compensatory Financing has now been in operation for over three years, and the time has arrived when certain of its aspects can appropriately be reviewed.

In Paragraph 3 of that Decision, the Fund recognized that some quota adjustments might be required or desirable, as follows: "The quotas of many primary exporting countries, taken in conjunction with a reasonable use of their own reserves, are at present adequate for dealing with export fluctuations such as have occurred during the past decade. In those instances, however, where adjustment of the quotas of certain primary exporting countries, and in particular of countries with relatively small quotas, would be appropriate to make them more adequate in the light of fluctuations in export proceeds and other relevant criteria, the Fund is willing to give sympathetic consideration to requests for such adjustment."

Since February 1963 the Fund has taken steps--apart from the general quota increase which came into effect on February 23, 1966--to implement this paragraph in several ways.

In the first place, it has approved more than 22 quota increases under a special policy applied to developing countries with relatively small quotas; 15 other countries appear to be eligible for such quota increases under that policy.

Secondly, the Fund facilitates drawings by such countries to enable them to purchase the amount of gold that must be paid in connection with the quota increases referred to above. This gives them the benefit of a quota increase immediately, and makes it possible to spread the reserve cost of the increase over a number of years.

Finally, in considering applications for individual quota increases, even from countries other than the above, the Fund has modified its basis for calculating quotas in such a way as to improve the position of developing countries. Variability of trade, which was a component of the so-called Bretton Woods formula, has now been defined in terms of standard deviation around a five-year moving average. This new definition provides a more accurate measure of variability and is thus more favorable to quota calculations of raw materials exporting countries. The Fund has also modified the formula to give greater weight to trade and the variability to trade, and less weight to national income and international reserves.

The Fund's Compensatory Facility

It might have been expected that the drawing facility established by the Fund in February 1963 to provide compensatory financing for export fluctuations would by this time have been used often enough to provide

ample illustrations of the type of problems that were liable to arise in applying it, and possibly also to indicate ways in which it could be improved. In fact, however, few countries have had even a *prima facie* case for using it, and three countries have actually drawn: (1) Brazil in June 1963 for the sum of $60 million (21 per cent of quota); (2) the United Arab Republic in October 1963 for the sum of $16 million (18 per cent of quota); and (3) Sudan in June 1965 for the sum of $11.25 million (25 per cent of quota).1/ This infrequency of use is largely attributable to the fact, illustrated in Table 1, that price developments over the past three or four years have been such as to permit the export earnings of less developed primary producing countries to show a generally upward trend, though one that tended to flatten out in 1965. Even the substantial declines in price of tropical foodstuffs (other than coffee), which began in spring 1964 and continued through the greater part of 1965 have not reacted sufficiently on earnings to evoke many opportunities for the use of the facility.

Despite the small number of instances of use, there has been enough experience and enough reflection on the variety of situations that might present themselves to permit of a reconsideration of several of the features of the 1963 Decision. Moreover, a number of suggestions have been made both inside the Fund--notably at the recent Annual Meeting of the Board of Governors--and outside the Fund, as to ways in which the Fund's compensatory financing facility might be amended or improved.

Most of these suggestions are summed up in the three recommendations made by the United Nations Conference on Trade and Development of 1964 to Governments members of the Fund as to changes that might be made in the facility, and in the request which it addressed directly to the Fund. The UNCTAD resolution containing these recommendations and request is reproduced at Appendix A. It will be seen that most of the points made by the Governors are covered in the UNCTAD Resolution referred to above, except for the reference to automatism in the speech of Governor Pugliese, and the reference to terms of trade and import prices in the speech of Governor Wanninayake.

Temporary Character of Shortfall

Drawings under Paragraph 5 of the Compensatory Financing Decision of 1963 may be made only when the requesting member experiences payments difficulties produced by a temporary export shortfall, i.e., by an export shortfall which is "of a short-term character." Such shortfalls, according to Paragraph 7 of the Decision, are to be identified on the basis of "estimates regarding the medium-term trend of the member's exports." In the 1963 Decision itself, no definition of the medium-term trend is given.

1/ The quotas referred to in these percentages are those applicable at the time the drawing was made.

Table 1. Changes in Prices and Export Earnings for Primary Producers in 1962 to 1965

Commodity	Prices[1/] Percentage increase or decrease (-) from previous year 1963	1964	1965	Export Earnings: Countries mainly dependent on specified commodities[2/]	Percentage increase from previous year 1963	1964	1965[3/]
Metals and minerals[4/]	3	21	13	Metals and minerals	9	24	13
Agricultural products	20	-	-12	Agricultural products	12	10	4
Food	31	-	-17				
Coffee	4	30	-5	(a) Coffee	12	8	7
Sugar	185	-31	-64	(b) Mixed tropical foodstuffs	11	11	3
Cocoa	20	-8	-26				
Wheat	1	4	-5	(c) Mainly temperate products	14	12	2
Non-food	4	-	-5	(d) Fibers and rubber	10	2	9
Cotton	2	29	-6				
Wool	18	-	-13				
Rubber	-7	-5	-1	(e) Mixed	7	11	5
				Mixed Mineral and Agricultural	8	7	2
All exports[4/]	18	2	-9	All countries	11	10	4

1/ Group price changes are derived from indices published by the NIESR (London). Specified commodity price series relate to world market quotations for representative grades only, and thus exclude the influence of prices determined under contracts.

2/ Defined as at least one half of export earnings as classified. Excludes countries dependent on petroleum. Data relate to 71 countries.

3/ Provisional.

4/ Excluding petroleum.

However, in the earlier Fund report, "Fund Policies and Procedures in Relation to the Compensatory Financing of Commodity Fluctuations,"1/ the trend or norm was defined for purposes of illustration as the average of actual exports for the five years beginning two years previous and ending two years subsequent to the year for which the trend value was calculated. The same definition was adopted in the staff paper cited on page 10 of the report on "Compensatory Financing of Export Fluctuations,"2/ and it was on the basis of this definition of the "ideal" trend or norm that certain conclusions were drawn in that report as to the best statistical method of estimating it in the absence of complete information.3/ This is also the definition that has been adopted in all applications of the Compensatory Financing Decision to particular countries up to the present time.

In the absence of precise quantitative knowledge as to the nature of the economic forces at work in determining trends and fluctuations, a moving average seems the best and most flexible way--better, for example, than fitting a trend line of any _a priori_ shape--of reflecting what is meant by trend. Moving averages of 4 years, 5 years, or 6 years, respectively, might, any one of them, serve as a reasonable definition of a "medium-term" trend. However, a 5-year period is preferable to the others in that it contains a middle year, the trend value of which can be defined as the average of the period. The trend value for any year in any time series must anticipate the figures for subsequent as well as reflect those of previous years in that series. If this is not done--e.g., if the trend values are determined solely as an average of past years--the trend line might lie persistently above, or below, the actual series to a substantial extent, which would be contrary to the normal meaning of the term "trend." Only if the moving average is centered in the manner illustrated above can one expect to find, over a reasonable period of time, a rough balancing of shortfalls and surpluses of actual exports with respect to trend.4/

Once the best possible estimate has been made of the medium-term trend, and hence of the shortfall, if any, from that trend, in accordance with Paragraph 7 of the Decision, no separate judgment is required as to whether the shortfall in question is "temporary" or of a "short-term" character.

1/ IMF _Staff Papers_, November 1960, p. 9.
2/ J. Marcus Fleming, Rudolf Rhomberg, and Lorette Boissonneault, "Export Norms and Their Role in Compensatory Financing," _Staff Papers_, Vol. X, 1963.
3/ "Compensatory Financing of Export Fluctuations," pp. 17-18.
4/ The balancing of surpluses and deficits is far from perfect, however; in any 5-year period there is likely to be either an excess of surpluses over deficits exceeding 50 per cent of gross surpluses, or an excess of shortfalls over surpluses exceeding 50 per cent of gross shortfalls. This, however, appears to be quite unavoidable. There is no way of defining a norm or trend consistently from year to year in such a way as to secure a perfect balance of surpluses and shortfalls over any given period.

The definition of the trend itself is such as to make it likely--though one can never be certain--that shortfalls with respect to it will be of short duration.[1] Any attempt to make a separate determination as to whether a given shortfall would cease to exist within, say, 2 or 3 years would involve estimating for that period ahead not only actual exports--which, as is indicated in the following section, may be involved in the estimation of the current norm--but also the export trend itself. To forecast the latter would involve estimating exports for still further years ahead. This, in the present state of forecasting techniques, would appear to be impracticable, and a determination that a shortfall of a given magnitude exists should, therefore, be taken as satisfying the requirement that the shortfall is of a short-term character.

Estimation of Trend and Shortfall

In paragraph 7 of the 1963 Decision it is laid down that the Fund will seek to establish reasonable estimates regarding the medium-term trend of the member's exports "on the basis of appropriate statistical data in conjunction with qualitative information about its exports prospects." This phrase appears to foreshadow a two-sided approach--"statistical" and "qualitative"--to the problem of estimation. However, while statistical estimation can be carried out without qualitative appraisal, qualitative appraisal can scarcely be applied without the aid of some statistical information, and the true alternative approaches are those of statistical automatism and the exercise of judgment, respectively.

In the three cases in which the Decision has been applied thus far, the estimation of normal exports has represented a compromise between (a) a figure or figures arrived at through the application of automatic formulae to past statistical data, and (b) an estimate based on a combination of these data with a forecast for actual exports two years ahead, these forecasts in turn being arrived at by a process of market appraisal using all available information.

The combination of the two methods in one form or another is justified by the knowledge that the result of either method is to a considerable extent uncertain. Any formula admittedly gives a precise answer; but no formula can be devised that gives a good approximation of the medium-term trend, as here defined, on the basis of past statistical data. On the other hand, any forecasting exercise must to some extent be subjective and uncertain. Given these facts it is necessary to strike a reasonable balance between these two methods, each less than satisfactory, which at the same time assures countries as much uniformity of treatment as possible from one case to the other.

1/ Calculations covering 48 countries show that almost 50 per cent of all shortfalls with respect to a norm defined as above last only 1 year, nearly 85 per cent no more than 2 years, and 96 per cent no more than 3 years.

As regards the automatic statistical approach to the estimation of the norm, the Fund has, in the past, used two types of formula, a "general" formula and a "national" formula, in both of which the norm for any given year is estimated as a weighted average of actual exports for the year in question and the two preceding years. In both cases the weights assigned to the various years are those which experience (of some ten years or more) shows to provide the best approximation to the "true" norm as defined above.1/

The "general" formula, used in calculations contained in the Fund's Report on "Compensatory Financing of Export Fluctuations," in all three applications of the Decision to date attaches a weight of .50 to the exports of the year for which the shortfall is being estimated, .25 to the preceding year, and .25 to the second preceding year. These weights were arrived at on the basis of analysis of the experience of some 48 countries over a period of nine testable years (thirteen years of data). While not absolutely the best of the formulae tested, it was chosen as a good formula with rounded weights close to those of the optimal formula.

"National" formulae have differed from country to country, the formula for each country being arrived at on the basis of experience affecting that country alone. It is intended to discontinue the use of "national" formulae on the ground that they are based on too small a number of observations, and complicate the statistical side of the exercise.

As regards the more subjective or "qualitative" estimate primarily based on market analysis, it is in the nature of the case more difficult to describe the method used, which varies from country to country. In all cases the procedure is first to estimate the average exports in the two years following the year for which the shortfall is being determined and then to take an average of the five years centered on the shortfall year. The forecast in question is conducted largely on the basis of commodity analysis, taking into account the prospective price movements for the commodity in question and the prospective volume movements in the country in question. For the great majority of primary exporting Fund members, 60 per cent to 90 per cent of total exports take place in a rather small number (1 to 4) of commodities, thus a large proportion of most countries' trade can be estimated on the basis of commodity market analysis. But there remains a sizeable residual for which no such analysis is possible and it may well prove desirable in particular cases to make a more or less automatic statistical estimate for this part of the exports. In this event the partial results of market analysis for major commodities would be combined with a more mechanical result for the residual to arrive at a global estimate.

1/ The "true norm" for exports, x, in any year t, i.e., $\bar{x}_t$ is defined as $\frac{x_{t-2} + x_{t-1} + x_t + x_{t+1} + x_{t+2}}{5}$. The problem is to find weights w_o, w_1, w_2, such that the estimated norm $x_t^* = w_2x_{t-2} + w_1x_{t-1} + w_ox_t$ provides the best approximation to $\bar{x}_t$ for all values of t. This is found by regression analysis for years in which the relevant export data are available.

In the past, "statistical" and "qualitative" estimates have been given approximately equal weight in determining the final estimate of the trend of exports. However, the "qualitative" estimates, involving a direct forecast of exports two years ahead, have been found in practice to yield better results than the formula. Experience has tended to bear out the judgment that a "better estimate could be made by the exercise of judgment based on an analysis of the causal factors at work than by any mathematical formula, however skillfully contrived, which is based on the mere statistical magnitude of current and previous exports."1/ In future, it would seem advisable to give somewhat greater weight than in the past to the "qualitative" as against the statistical estimate.

Proposals Regarding the Mode of Determining the Shortfall

A. Weight to be Given to Past Years

In the Resolution on the Study of Measures Relative to the Compensatory Credit System of the International Monetary Fund, set forth at Annex A.IV.17 of its Report, the UNCTAD made the following request:

"The Conference

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2. Requests that the International Monetary Fund, in its determination of the shortfall in export receipts, consider giving greater weight to the actual experience of the three preceding years."

This request, though it appears to be purely technical, in fact involves a point of principle. At present, as has been explained above, the Fund's compensatory financing facility is designed to compensate for shortfalls from the presumed current trend level of exports rather than from a previous trend level. It is designed to help countries to bring their export availabilities--export receipts plus compensatory drawings less repayments of such drawings--closer to the presumed trend level rather than to provide them with a financial buffer against reductions as compared with their previous standards. While it might be entirely appropriate to provide countries with such a buffer, it would seem preferable to supply this through the ordinary drawing facilities of the Fund, use of which could be made conditional, where necessary, on the adoption of measures to adapt the economy to new export conditions, or to improve the trend of exports, than through the compensatory financing facility, the use of which is more automatic.

1/ Compensatory Financing of Export Fluctuations, A Report of the International Monetary Fund, February 1963, page 10.

It is because the aim of compensatory financing is conceived in the manner described above, that in the assessment of the norm with reference to which the shortfall is calculated account is taken of the expected exports of the ensuing years, that a substantial weight in the determination of the norm is given to the current year's exports, and that no weight is given, for example, to exports three or more years anterior to the year with respect to which the shortfall is being calculated. The weights assigned to the current and preceding years in the estimation of the export norm--insofar as it is estimated by formula--were arrived at on the basis of experience as to which weights gave the closest estimate of the current trend and the best implied forecast of the two years subsequent to the shortfall year.

A formula in which no weight was given to the shortfall year would, for this reason, tend to lead to a higher estimate of the trend value, and hence a larger shortfall and a larger drawing entitlement. Because of the long-term upward trend of exports, however, this effect would generally be offset to some extent by the inclusion in the weighting formula of the third year preceding the shortfall, or of still earlier years. From Table 2 it can be seen that a formula for trend estimation giving equal weights to the three years preceding the shortfall would have led, over the period 1951 to 1964, to somewhat larger drawing entitlements than the present formula. The same table, however, shows that the "performance" of the scheme (as measured by the degree to which compensatory drawings and repurchases bring export availabilities closer the true trend value, and the degree to which they tend to smooth out export availabilities) would not have been improved, but if anything, worsened by such a change in formula. It is not the object of the compensatory facility to aim at the largest possible amount of drawings, and, as will be shown below, there are ways in which it would be possible for an increase in drawings outstanding to improve the performance of the scheme significantly, or even for the scheme to be improved without a net increase in drawings outstanding.

Some further points deserve mention.

The element of forecasting involved in the determination of a current rather than a past trend value of exports, though irksome and subject to uncertainty, is a good discipline for country and Fund alike, and may help to counteract the natural tendency to delay adaptations to changing circumstances.

More important is the fact that measurement solely from a past level would frequently yield "shortfalls" which could not by any means be described as "temporary." While countries with a rising trend of exports, even when the rise was subject to serious interruption, would seldom, if ever, be deemed to have shortfalls, those with a generally falling trend of exports would experience persistent shortfalls. Such a change in formula would necessitate the introduction of a separate determination as to whether or not the shortfall was temporary--a determination which, as already indicated, would involve forecasting much further ahead and hence a higher degree of guesswork than that involved in the determination of the trend by present methods.

The other alternative would be to drop the proviso that export shortfalls--or rather declines--should be temporary. But this would scarcely be compatible with the legal requirement of temporariness in the use of Fund resources.

For these reasons it seems on balance undesirable to alter the present concept of the export norm.

Table 2. Fund Compensatory Financing Facility: Comparison of Weighting Systems over Years 1951 to 1964 1/

Limit Per Cent of Quota	Coefficients Applied to Years t	t-1	t-2	t-3	Drawing Entitlement 2/	Average Drawings Outstanding 3/	Approximation Ratio 4/	Smoothness Ratio 5/
.25	0	1/3	1/3	1/3	1.04	.31	.022	.028
.25	.50	.25	.25		.97	.29	.023	.029
.50	0	1/3	1/3	1/3	1.82	.54	.033	.046
.50	.50	.25	.25		1.61	.48	.034	.046

1/ Scheme applied to a sample of 48 countries. Drawings are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of the level of exports in those years. The quotas in per cent of which the limits are expressed are not present quotas but those obtaining at the relevant dates during the period 1951 to 1964.

2/ Cumulative total entitlements over the period in billions of U.S. dollars.

3/ Average for all years of total amounts outstanding in billions of U.S. dollars.

4/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

5/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

B. Degree of Reliance on Automatic Formulae

Governor Pugliese, of Argentina, speaking at the 1965 Annual Meeting of the Fund on behalf of 19 Latin American countries and the Philippines, mentioned as one of the fundamental aspects of the Fund's compensatory financing decision which it would be advisable to consider,

> "3. In conclusion, we would emphasize the non-automatic nature of the drawings permitted. In the decisions on individual cases submitted to the consideration of the Executive Board there has been some flexibility, although in all of them there has been no lack of a subjective assessment in the determination both of the amount to be compensated and of the circumstances in which the loss of income occurs."

This question, so far as it concerns the determination of the shortfall, has already been considered at some length above.

It has been the experience of the Fund, based not only on its own export forecasts but on those of outside bodies, that a closer estimate of the medium-term trend can be arrived at by the use of short-term forecasts based on commodity analysis than by reliance on the best statistical formula. While greater reliance on formulae might give countries a slightly higher degree of certainty as to the amount of compensation they could rely on, the proposed balance between the two methods of estimation would seem to give as much weight as is prudent to the "automatic" element in the estimation process.

C. Account to be Taken of Terms of Trade

At the 1965 Annual Meeting of the Fund, Governor Wanninayake of Ceylon made a suggestion in the following terms:

> "I was encouraged by the reference by Mr. Schweitzer to the work that the Fund is now undertaking to improve the compensatory financing facility. Several speakers have urged that compensatory assistance should be provided for a decline in the terms of trade rather than for a fall in export earnings alone. My own country's experience in recent years vividly illustrates the importance of this reform. We suffered a decline in the terms of trade by 13 per cent in two years alone, but since this was almost entirely due to an increase in import prices we were unable to avail ourselves of the compensatory financing facility. I do sincerely hope that this particular improvement in the scheme will be made effective at an early date."

The terms of trade refer to the ratio between a country's export prices and its import prices. Fluctuations in export prices are, of course, reflected, along with fluctuations in export quantities, in the flucutations in export proceeds. It might be argued that price fluctuations are more properly

compensable than quantity fluctuations in that they are less easily affected by the policies of the exporting countries. On the other hand, some of the commonest and most genuinely short-run fluctuations in export proceeds are those arising from crop failures. More harm than good would probably be done by attempting to distinguish the specific roles of price and quantity in the fluctuations in export proceeds.

The case is different where price fluctuations are concerned. There is undoubtedly a good economic case for compensating not the money value but the real value, or importing power, of exports. An estimate of the latter could be arrived at by deflating exports (for the purpose of arriving at the trend value of exports) by an import price index based on the shortfall year.

There are, however, a number of practical and other objections to this procedure. Most primary producing countries have no import price index. Of those import price indices that exist many are unrepresentative or unreliable. Moreover, such indices usually become available several months later than the data on export proceeds, so that the lag in the granting of a compensatory drawing behind the occurrence of the export shortfall would necessarily be increased. It might be thought that, where the import price indices of developing countries are unavailable, unreliable, or late in appearing, estimates could be formed on the basis of the export and import price indices of industrial countries. Such data, however, would provide extremely uncertain and disputable estimates for the imports of any individual developing country. It has to be borne in mind that the developing countries that experience the largest fluctuations in import prices do so because they are substantial importers of primary products, often from other developing countries. Apart from such cases, the import price indices of primary producing countries do not, as a rule, show very large movements within a short period of years. For all these reasons, it seems better, at this time, to continue to adhere to the principle of compensating for shortfalls in export proceeds rather than in the importing power of exports.

<u>Responsibility for Shortfall</u>

According to Paragraph 5(a) of the Compensatory Financing Decision of 1963, one of the conditions of a compensatory drawing is that this export shortfall should be "largely attributable to circumstances beyond the control of the member." Where this condition is clearly not satisfied, it would be inappropriate for a drawing to be made under the compensatory facility. However, there may be ambiguous cases where difficulties of interpretation arise. A shortfall can sometimes be attributed with equal propriety to any one of a number of causes, some of which may be under the member's control and others not. For example, suppose a combination of the following:

(a) a <u>rise</u> in foreign demand for the country's exports;

(b) a short crop due to weather;

(c) a rise in home consumption of the export product due to inflation, subsidization, or some other factor for which the government is responsible.

Given the rise in prices resulting from (a), the shortfall in export value may be no greater than could be entirely accounted for by <u>either</u> (b) or (c). Again, suppose that a shortfall takes place in the exports of a given product due to "act of God" but that an increase in the export of other products, which would otherwise have offset the shortfall, fails to occur because of the policies of the member. Again, there may be cases where the shortfall would not have occurred without certain policies of the member but these policies were reasonable in the light of all the circumstances, or cases where the shortfall could have been prevented by certain policies but abstention from these policies on the part of the member was reasonable in the light of all the circumstances.

In such ambiguous cases an interpretation favorable to the member requesting the compensatory drawing should generally be adopted, and whenever the shortfall can be largely attributed to "circumstances beyond the control of the member" it should be so attributed.

<u>Policy Conditions</u>

One of the conditions for drawing under Paragraph 5 of the 1963 Decision is that "the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties."

In the application of the Decision to individual cases, the Fund, in accordance with the intention of the Decision, has not attempted to reach agreement with the member on what the nature of these solutions would have to be. This has been left to subsequent discussions, and has not stood in the way of prompt action on a request for compensatory drawings. Nevertheless, in one case in which a compensatory drawing was requested, the country concerned made, at the time of the request, a statement of the policies it intended to follow. In the two other cases of compensatory drawings, the Fund subsequently reached agreements on appropriate policies with the countries in question.

<u>Period for Which Shortfall is Calculated</u>

Thus far it has been the practice of the Fund to require that any request for the use of the compensatory facility shall relate to an export shortfall over the latest twelve-month period for which, at the time of the request, a reliable estimate of actual exports can be made. There must, in any event, be some maximum lapse of time within which any claim for compensation with respect to the exports of a given period should be made, and if the compensatory facility is to fulfil its purpose of enabling countries to stabilize their external expenditures as much as possible in the face of fluctuations in receipts, it seems desirable that the time lag between shortfall and compensatory financing should be as short as possible. (As indicated below, countries need not be deterred from applying for a compensatory drawing as soon as a shortfall appears by the fear that they will thereby preclude themselves from claiming a larger compensation a little later if the shortfall has by then increased.)1/

The present practice enables a claim for a compensatory drawing to be made at any time during the year with respect to the twelve-month period immediately preceding. The question arises whether this right should be restricted in any way. There would seem to be no advantage in a system under which such claims could be made only with respect, say, to calendar years. A more plausible case could be made for ruling that, where exports are marked by seasonality, claims for compensatory drawings should be made only with respect to twelve-month periods which include all those months over which the principal export crop is liable to be marketed abroad. Otherwise, it might be argued, countries which marketed their crops early one year and late the following season might show a shortfall over a twelve-month period that spanned two seasons, whereas no shortfall would appear from a comparison of crop years. Bearing in mind, however, that most countries have a number of export crops with different seasonalities, it is doubtful whether the variability of seasonality is sufficient to justify the introduction of a restriction which would both reduce the value of the facility to the country and complicate its administration. It would be no easy task to determine for each country with respect to which twelve-month periods applications for compensatory financing would not be entertained. It should also be borne in mind that any shortfall that appeared to be artificially induced by deliberate delay in the marketing of a crop would be unlikely to be regarded as "largely attributable to circumstances beyond the control of the member" and in this event would not qualify for a compensatory drawing.

The arrangement outlined in the first paragraph of this section can be criticized from another angle, namely that even a time lag of a few months between the shortfall and the compensatory drawing is undesirable, and that it would be better if the drawing could coincide with the shortfall. This means that the drawing would have to take place at a time when the precise amount of the shortfall was unknown. In order to meet this point and to encourage the use of the stand-by and ordinary drawing facilities for the compensation of export shortfalls, it is proposed, subject to what is said below, to allow members, within a six months period of any drawing other than a gold tranche drawing, to reclassify all or part of it as a compensatory drawing under Paragraph 5 of the Decision. The drawing, when first made, would have to satisfy the ordinary conditions for drawing in the tranche in question, or, if made under standby, the requirements appropriate to drawing under the standby. The reclassification of the drawing would have

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1/ See page 16 below.

to satisfy the conditions for a compensatory drawing under Paragraph 5 of the Decision with respect to an export shortfall for the latest twelve months for which data were available prior to the reclassification. The amount reclassified could not exceed the amount of that shortfall. Such reclassification would confer on the drawings the privilege of additionality as defined in (ii) of Paragraph 6 of the 1963 Decision (with any enhancement of that privilege that may result from the separation of the compensatory facility from other drawing facilities, discussed below). It would not, however, reconstitute rights to draw under standby.

It is estimated that if both the compensatory facility and the privilege of reclassification had existed over the period 1959-64, and the latter had been exercised to the full--which might not in all cases have been to the country's advantage--some 20 to 25 per cent of all non-compensatory drawings could have been so reclassified.

Problem of Double Compensation

It would neither be equitable, nor in accordance with the intention of the Decision on Compensatory Financing, that any member should be compensated twice for the same shortfall, or more precisely, that the sum of any drawings made with respect to any given shortfall should exceed the amount of the shortfall.

Under the Decision a member can draw from the Fund with respect to a payments deficit arising out of an export shortfall either in the form of a drawing under ordinary tranche policies (referred to in Paragraph 4 of the Decision) or in the form of a drawing under the special policies outlined in Paragraph 5 of the Decision. Moreover, it is intended, as indicated in the preceding section, that a drawing originally made under ordinary tranche policies could in certain circumstances be reclassified. The problem of double compensation may arise either with respect to two drawings under Paragraph 5, or with respect to a pair of drawings, one under Paragraph 5 and another under Paragraph 4.

In the case of two drawings under Paragraph 5, it is proposed that, if the period with respect to which a second such drawing is requested to be made (or reclassified) overlaps with that for which a first such drawing has been made (or reclassified), the first drawing would be prorated over the twelve months with respect to which it was given, and such part of it as corresponded to the overlap between the two periods would be subtracted from the drawing entitlement with respect to the second period.

As regards the problem of avoiding double counting as between a Paragraph 5 drawing and an ordinary drawing which can be considered as at least partly undertaken for compensatory purposes, there is no real difficulty if the ordinary drawing follows the Paragraph 5 drawing and is not made under a stand-by accorded before the latter drawing. In that case, the Paragraph 5 drawing will simply be "taken into account" as one of the many factors affecting the balance of payments situation of the drawing country on the occasion of any subsequent drawing or standby.

The real difficulty arises if a Paragraph 5 drawing or reclassification is requested after an ordinary drawing or standby arrangement. We then have to ask whether the payments situation with respect to which the drawing or standby was given included any part of the export shortfall with respect to which the Paragraph 5 drawing or reclassification is now requested. Such a question would be hard to answer since an ordinary drawing or standby is not usually given to meet the payments deficit of any precisely defined period, still less to meet fluctuations in any specific item in the balance of payments.

One approach would be for some specific statement to be made by the Fund at the time of the ordinary drawing or standby arrangement as to the proportion thereof, if any, that should be regarded as granted with respect to an export shortfall, and as to the period of the shortfall. In the case of standbys, however, account is more often taken of the possibility of future shortfalls than of the accomplished fact of past shortfalls, and it is impossible to be precise as regards either the amount or the timing of future shortfalls. Some conventional rules will, therefore, have to be adopted as to the period and magnitude of the export shortfall deemed to be compensated by ordinary drawings or drawings under standby made prior to the request for a drawing or reclassification under the compensatory facility.

Separation of the Compensatory Facility from other Drawing Facilities

One of the measures which the UNCTAD proposed for consideration by Fund member governments runs as follows:

> "(2) To place compensatory credits entirely outside the structure of the gold and successive credit tranches, so that the drawing of compensatory credits would not directly or indirectly prejudice a member's ability to make an ordinary drawing."

Presumably the measure recommended is to be interpreted in the sense that the amount drawn under the compensatory financing facility would be ignored by the Fund in computing the amount of drawing facilities still available to members under the principles applicable to the gold tranche, the first credit tranche, etc., as well as in computing the practical maximum drawing facilities open to members. In other words, the Fund would treat a drawing request by a member as if its holdings of member currency were less than its actual holdings by the amount of any drawings outstanding under the compensatory financing facility. At present the Fund is prepared to waive the 200 per cent limit to the extent that compensatory drawings are outstanding. If the UNCTAD recommendation were accepted, the limits for gold tranche and first credit tranche policies would be extended beyond 100 per cent and beyond 125 per cent of holdings, respectively, to the extent that compensatory drawings were outstanding. Most compensatory drawings are likely to occur after a country has used its gold tranche and probably also its first credit tranche. To ignore the compensatory drawings not only from the standpoint of the total drawing facilities of a member but also from the standpoint of tranche policies to be applied to the member would have the advantage of rendering the facility clearly additional in all respects. On the other hand, at any given level of holdings it would somewhat reduce the Fund's ability to secure satisfactory corrective programs in the case of ordinary drawings. It would not affect the level of charges corresponding to any given level of Fund holdings, nor would it affect the applicability to compensatory drawings of the repurchase provisions of Article V, Section 7(b). The Fund is prepared to separate the compensatory facility from other drawing facilities in the sense described above.

The Limit on Compensatory Drawings

One measure recommended by UNCTAD to Governments members of the Fund for study is:

> "(1) To increase as soon as possible the amount allocated by the Fund to compensatory financing over and above its current transactions, from 25 per cent to 50 per cent of a member country's quota."

It should be noted that the limit of 25 per cent of quota on outstanding compensatory drawings under Paragraph 5 of the Decision is not an absolute one, but applies only "normally." However, it would clearly be undesirable for compensatory drawings to be accorded frequently or as a general rule in excess of the "normal" maximum. This would raise issues of discrimination, both with respect to the compensatory drawing facility and total drawing facilities accorded to different countries. It would also defeat one purpose of the compensatory facility, namely that a country can, to a large extent, rely on obtaining compensatory financing in the circumstances for which it is designed, and should, therefore, not have to rely on "rallonges" of this facility.

It is also important to bear in mind that the limit on drawings under the facility is not the limit on the amount a country may draw as a result of a payments difficulty arising out of an export shortfall. It is always open to the country to request an additional drawing under the ordinary drawing policies applicable to its tranche position with the Fund. Admittedly, this would reduce the amount of drawing facilities available for other purposes.

If one disregards the foregoing considerations, there can be little doubt but that over any extended period of years an expansion of the 25 per cent limit on outstanding compensatory drawings would add significantly to the value of the assistance provided. Calculations as to how the Fund's compensatory facility might have worked if it had been applied, on a pure formula basis,[1] to the export earnings of primary producing

1/ It is, of course, impossible to establish in retrospect precisely what compensation would have been payable over the period 1951 to 1964 under the present scheme and with a higher limit respectively, inasmuch as estimates of trend and shortfall would have been affected by qualitative appraisal as well as by formula.

countries over the period from 1951 to 1964, and if it had been used to the full, indicate that an extension of the limit on outstanding drawings from 25 to 50 per cent of quota would have increased the effectiveness of assistance provided under the facility in a proportion roughly commensurate with the increased "cost" involved. The extent to which export availabilities are brought closer to the trend value of exports would have been increased by almost 50 per cent, the extent to which availabilities are smoothed out would have risen by some 60 per cent, while the average drawings outstanding would have risen by some 65 per cent. The data are set forth at Table 3.

In the rather favorable circumstances which have prevailed since the compensatory financing decision, only three compensatory drawings have taken place. It is noteworthy, however, that in one of them (the case of Sudan), the amount of compensation which would *prima facie* have been paid under the facility was restricted by the existence of the 25 per cent maximum. In the other two cases the amount of compensation paid was not so restricted but in each case a single compensatory drawing absorbed, respectively, 86 per cent and 71 per cent of a quota tranche.

Table 3. Compensatory Financing: Fund Scheme with Varied Limits Applied to Data for Years 1951-64 1/

Limit	Approximation Ratio 2/	Smoothness Ratio 3/	Average Drawings Outstanding 4/
.25 of Quota	.023	.029	.29
.50 of Quota			
(a) Unqualified	.034	.046	.48
(b) Qualified as to rate of use 5/	.035	.047	.45
None	.100	.121	1.36

1/ Scheme applied to a sample of 48 countries. Coefficients of .5, .25 and .25 applied to years t, t-1, and t-2, respectively, to compute shortfalls. Drawings are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of the level of exports in those years. The quotas in per cent of which the limits are expressed are not present quotas but those obtaining at the relevant dates during the period 1951 to 1964.

2/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

3/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

4/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

5/ Drawings outstanding may not increase in any year by more than 25 per cent of quota.

From a compensatory financing standpoint there is much to be said for extending the limit of the facility from 25 to 50 per cent. Since, however, it would involve an addition to the amount of liquidity which the Fund provides on liberal conditions, it might tend to reduce countries' willingness to have recourse to facilities of a more strictly conditional character. This weakening of conditionality, which will be somewhat intensified by the separation of the compensatory facility from other drawing facilities which has been recommended in the preceding section, is perhaps the most important disadvantage of the proposal under consideration.

Account should also be taken of the possible effect on the Fund's own liquidity, i.e., its effect on the probable level of drawings relative to resources provided by quotas in the Fund. As shown in Table 3, if the compensatory facility had existed over the period 1951-64, and if all the 48 countries covered by the table had made full use of that facility, an extension of the limit from 25 per cent to 50 per cent of present quotas would have increased the average amount of compensatory drawings outstanding from $290 million to $480 million. From the standpoint of Fund liquidity, however, what matters is not so much the average amount of compensatory drawings outstanding as the amount liable to be outstanding at peak periods. It is estimated that, on the assumptions set forth above, the extension of the limit from 25 per cent to 50 per cent would have raised the maximum amount of compensatory drawings outstanding within the period from $400 million to $740 million or, say, from 18 per cent to 33 per cent of the quotas of the countries concerned in the year--1955--in which these maxima occurred. On the assumption that potential peak year compensatory drawings outstanding at any given percentage limit have expanded since 1955 in proportion to quotas it may be estimated on the basis of the new quotas becoming effective in 1966, that outstanding drawings for a peak year like 1955 would now amount to somewhat more than $1,100 and $2,000 million for the 25 per cent and 50 per cent limits, respectively. Since, however, countries with adequate reserves will often not use opportunities for compensatory drawings that are open to them, or will not exercise their full entitlement to such drawings, and since any use made of the compensatory facility is likely to reduce to some extent requests for ordinary drawings, the true magnitude of the additional use of Fund resources at peak periods involved in the extension of the limit would be unlikely to exceed, say, $400 million to $500 million. Moreover, past experience would suggest that while peak years for compensatory drawings outstanding would be likely to occur in years when non-compensatory outstandings were relatively high, they would not be likely to coincide precisely with the peak years for non-compensatory drawings outstanding.1/

Balancing the divergent considerations discussed in this section, the Fund has decided that:

(i) the limit on the use of the compensatory facility under Paragraph 5 of the Compensatory Financing Decision of 1963 should be raised from 25 per cent to 50 per cent of quota; but that

(ii) the new limit should apply in all circumstances and not merely as with the present limit, "normally";2/

(iii) in any twelve month period the net expansion in drawings outstanding under Paragraph 5 of the Decision should not exceed 25 per cent of quota; and

(iv) any drawings the effect of which would be to raise drawings outstanding under Paragraph 5 of the Decision beyond 25 per cent of quota will be granted only if the member country, in addition to fulfilling the requirements of the Decision, is found to have been following policies reasonably conducive to the development of its exports.

1/ Outstanding Drawings in Relation to Fund Quotas, 1951-64
(in per cent of total Fund quotas)

	Actual Fund Drawings: All countries	Actual Fund Drawings: Less developed countries	Hypothetical compensatory drawings1/
1951	12.1	3.5	0.1
1952	11.0	3.0	2.6
1953	10.5	3.7	5.0
1954	8.3	4.0	4.5
1955	6.0	3.3	4.0
1956	11.9	3.8	3.9
1957	21.8	7.9	3.2
1958	21.2	8.6	4.6
1959	11.0	5.8	2.3
1960	6.9	5.9	1.3
1961	18.0	8.7	1.4
1962	11.6	9.0	1.6
1963	11.6	9.6	0.9
1964	16.1	8.9	0.7

1/ Mixed Repurchase Scheme with qualified 50 per cent limit.

2/ The relevant words of the Decision are: "The amount of drawings outstanding under this decision will not normally exceed 25 per cent of the member's quota."

The limitation suggested under (iii) above will impose a delaying effect in utilizing the compensatory facility to the full extent proposed under (i). As will be seen from Table 3, this arrangement would probably yield slightly better results with respect both to approximation to export trend and to smoothness of export availabilities than would an unqualified limit of 50 per cent of quota, and would be slightly less expensive to the Fund in terms of drawings outstanding.

In connection with the delaying effect of proposal (iii), it should be borne in mind that Consultations under Article XIV or Article VIII would provide an opportunity for testing the extent to which a member had implemented its undertakings under earlier compensatory drawings to "cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties," and also the extent to which it was complying with the conditions set forth at (iv) above.

If the resources needed by a member to deal with a particular shortfall exceeded the amount permitted under condition (iii) above and the member desired additional assistance from the Fund, it would enter into discussions with the Fund for a drawing on the terms normally applicable to the tranche in which the country found itself.[1] This would be a drawing under Paragraph 4 of the 1963 Decision, and, as such, would not be limited in magnitude to any a priori percentage of the member's quota.

Repayment of Compensatory Drawings

The third measure recommended by UNCTAD for study by Fund member governments is:

> "(3) To explore ways to secure possible refinancing of compensatory financing obligations of the developing countries in the event of a persistent shortfall in export receipts beyond the control of the country affected."

While there is no specific provision in the Compensatory Financing Decision of 1963 for refinancing of compensatory drawings, refinancing on a short- to medium-term basis would, in effect, be possible under present procedures in the circumstances that appear to be envisaged in the recommendation, viz., in the case where at the time when the repurchase falls due there is a shortfall in export receipts beyond the control of the affected country. The repurchase would, of course, restore the compensatory financing facility pro tanto, and if at that time an export shortfall of the type described persisted, the member would be in a position to apply for a new drawing under this facility. It would not, however, be able to increase its outstanding compensatory drawings as much as if there had been no repurchase obligation. Moreover, a country that had

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1/ In accordance with the proposal at p. 17 above, the terms in question would, of course, be determined by the Fund's holdings of the member's currency, exclusive of those arising from drawings outstanding under Paragraph 5 of the Compensatory Financing Decision.

made a compensatory drawing might suffer hardship by having to repurchase in a year in which, even though it had no shortfall, neither had it any excess of exports over the norm out of which it could afford to make repayment.

This raises the much more fundamental issue as to whether repayments for compensatory drawings should take place according to the normal 3 to 5 years rule, or whether they should take place, entirely or to a considerable extent, in years in which exports exceed the estimated trend value. As can be seen from Table 4 below, schemes in which (a) repurchases were made exclusively out of export excesses, and (b) the full amount of such excesses was directed to repurchases would probably, over the years 1951 to 1964, have enhanced the degree of approximation to the export trend by over 20 per cent, and the smoothing effect of the facility on export availabilities by over 50 per cent as compared to schemes involving repurchase under the 3 to 5 year rule. This holds true whether the limit on outstanding drawings is 25 per cent or 50 per cent of quota. For schemes without limits the superiority of compensatory repurchase would have been still greater.

Contrary to what might perhaps at first sight be assumed, the change in the timing of repurchases would also, save in the "no limit" case, have reduced the average length of time for which compensatory drawings remained outstanding and hence have reduced the average amount of compensatory drawings outstanding at any one time. It seems probable, therefore, that a system whereby compensatory drawings are repaid out of export excesses rather than under the 3 to 5 year rule would do much to improve the performance of the facility without any additional "cost"--indeed with a reduction in cost--in terms of drawings outstanding.

In order to apply this method of repayment for compensatory drawings, calculations would have to be made at twelve-monthly intervals to see whether or not export excesses had occurred. These calculations might be made with respect to calendar years or Fund financial years, beginning with the first complete year following the drawing. Alternatively, and preferably, they might be made for each twelve-months period, beginning with the twelve months immediately following that with respect to which the drawing had been granted. Since it would be a matter not of a drawing facility, but of a repayment obligation, it would be inappropriate to rely to any extent on qualitative estimation of a necessarily subjective kind in calculating the export excess. This should be done on the basis of the statistical formula adopted as an element in the calculation of shortfalls.

[The following passage, to the end of the section on "Compensatory Facility and Fund Liquidity," diverges substantially from the corresponding passage from the foot of p. 22 to p. 26 inclusive in SM/65/101, and proposes a type of mixed repayment system for compensatory drawings different from that proposed in SM/65/101. These changes were made to meet the point made by a number of Executive Directors that repurchases out of export excesses, though avoiding the difficulties that would arise from repurchase requirements occurring at a time of poor or mediocre exports, might have difficulties of their own in that the amount of the repurchase obligation would not be known in advance. The system now proposed attempts to avoid or mitigate both sets of difficulties, in a manner not unduly expensive to the Fund.]

Two difficulties arise with respect to this fully compensatory system of repurchases out of export excesses. The first concerns the predictability of repurchase obligations. Countries might occasionally find it difficult to repurchase compensatory drawings to the full extent of any excess of actual over trend value of exports, partly because an expansion in exports would probably entail some increase in import requirements, and partly because the obligation to repay would not be known with certainty until after the event. This difficulty should not be exaggerated. Owing to the manner in which export excesses are calculated, only one half of any increase in exports over the average level in the two years preceding the excess year could give rise to a repurchase, and if serious problems on repurchase should nevertheless arise owing to circumstances affecting other items in the balance of payments, it would always be possible for the Fund, under appropriate conditions, to agree to an ordinary drawing at the time of the compensatory repurchase. Nevertheless, it is possible that countries might prefer to have their repurchase obligations expressed in a more predictable form.

The second difficulty arises from the fact that under the system of repurchase out of export excesses a proportion of the repurchases of compensatory drawings would probably remain outstanding for longer periods than has hitherto been deemed compatible with the temporary character of Fund assistance. This does not mean that repayment would normally be more delayed than under the 3 to 5 year rule. Indeed, if, as indicated in Table 4, the amount of compensatory drawings outstanding is generally likely to be less when repayments are geared to exports than when they are made under the 3 to 5 year rule, the average length of time for which a drawing remains outstanding will probably be less in the former than in the latter case. More direct measurements of probable periods for which compensatory drawings would remain outstanding if repayments were also on a compensatory basis are given in Table 5, which is based on the experience of the years 1951-64. From this it can be seen that, even with an unqualified limit of 50 per cent of quota, some two thirds of all compensatory drawings would be repaid within 3 years, and more than four fifths within 5 years. The residue remaining outstanding beyond 8 years might be about 1 per cent. In considering these results, it should be borne in mind that the repurchase obligations under Article V, Section 7, would, of course, continue to apply--a fact which could not be taken into account in the calculations set forth at Table 5.

Table 4. Compensatory Financing: Fund Scheme with Varied Forms of Repayment, 1951-64 1/

Repayments System	Fixed Term 2/	Compensatory 3/	Mixed 4/
	25 Per Cent of Quota Limit		
Approximation Ratio 5/	.023	.028	.026
Smoothness Ratio 6/	.029	.045	.036
Average Drawings Outstanding 7/	.29	.17	.26
	50 Per Cent of Quota Limit (Unqualified)		
Approximation Ratio	.034	.042	.041
Smoothness Ratio	.046	.072	.060
Average Drawings Outstanding	.48	.36	.48
	50 Per Cent of Quota Limit (Qualified)		
Approximation Ratio	.035	.043	.042
Smoothness Ratio	.047	.071	.060
Average Drawings Outstanding	.45	.28	.42
	No Limit		
Approximation Ratio	.100	.155	.160
Smoothness Ratio	.121	.216	.205
Average Drawings Outstanding	1.36	1.49	1.77

1/ Weights of .50, .25 and .25 applied to years t, t-1, and t-2, respectively, for estimating calculated norm. 100 per cent compensation of calculated shortfall.

2/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

3/ 100 per cent of export excesses applied to repayment in all years.

4/ Repayment in five equal instalments, beginning in the year following the shortfall year: repayments on past drawings are deducted from exports for the purpose of computing shortfalls.

5/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

6/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

7/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

If the requirement that the Fund assistance be "temporary" could be deemed to be adequately met by the manner in which export shortfalls and excesses are calculated, and by the statistical probability that the average period of repayment will be short, this change is one which it would be advisable to adopt. However, it is considered that this requirement calls for a fixed maximum term for every drawing, which would make it difficult to adopt the repayment system under consideration in an unmodified form.

A "mixed" system on the following lines would seem to meet both of the difficulties referred to above and to combine many of the advantages of "compensatory" and "fixed term" repurchase respectively:

(a) Compensatory drawings would be repaid in equal annual instalments over a five-year period.

(b) In estimating export shortfalls for the purpose of making compensatory drawings, the Fund would, if the member so requested, deduct from the figure for actual exports any repurchases on past compensatory drawings that had been made within x months prior to the new compensatory drawing. Such deductions would not affect the computation of the export norm for the shortfall year.

(c) Any request for compensatory drawings involving a deduction such as that described at (b) above would be met only if the Fund was satisfied that the member, in addition to fulfilling the requirements of paragraph 5 of the Compensatory Financing Decision, had been following policies reasonably conducive to the development of its exports.

To the extent that a member took advantage of the deduction, the effect of this arrangement would be that the member would repay, with respect to any compensatory drawing, either the due instalment for the year or its export excess, whichever was the less. This would be easier on the member, in respect of the predictability and possibly the amount of the repayment in certain years, than the system of full compensatory repayment out of export excesses. ~~On the other hand,~~ It would differ from that system in two other ways. ~~namely, that the "refinancing" of~~ Normal repurchases ~~would not be automatic but~~ would be the occasion for a new compensatory drawing ~~on which the trends would be appraised~~ provided an appraisal partly on a qualitative and not entirely on a formula basis justified such a drawing; and ~~in which~~ the member ~~would have to~~ declared that it was prepared to discuss its policies with the Fund. ~~and would have to show that it had~~ been pursuing reasonable export policies. (i) ~~This last requirement would apply whether the "refinancing" drawing took place in the first or in the second compensatory tranche.~~

(i) The addition of para (c) introduces the concept that the country would have to assure the Fund ~~also~~ that it had been pursuing reasonable export policies even where the drawing ~~occasioned~~, in so far as it was occasioned by a repurchase, would fall within the first compensatory tranche

Table 5. Duration of Drawings under Compensatory Repayments System[1]

(Period = 1951-64)

	25% of Quota Limit		50% of Quota Limit (Qualified)		50% of Quota Limit (Unqualified)	
	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings
Total drawings	.89	100	1.24	100	1.45	100
Repaid:						
Within 3 years	.74	83	.97	78	.97	67
Outstanding after:						
Fifth year	.09	10	.15	12	.27	18
Eighth year	.01	about 1[2]		about 1[2]		about 1[2]

1/ Coefficients of .5, .25 and .25 applied to years t, t-1, and t-2, respectively, to compute shortfalls. Full compensation of shortfalls is assumed. One hundred per cent of excesses applied to repayment.

2/ Since some of the drawings in question were still outstanding at the end of the period but had not yet reached their eighth year, this figure is an estimate.

As will be seen from Table 4, the performance of this "mixed" system of repurchase, over the years 1951-64, as measured by the approximation ratio and the smoothness ratio, would probably have been better than that of the "fixed term" (3 to 5 years) system of repurchase, and only slightly worse--except where there are no limits to outstanding drawings--than a fully compensatory system of repurchase out of export earnings.

The "cost" in terms of drawings outstanding is higher for the "mixed" system than for a fully compensatory system of repurchase. This is the price that has to be paid for increasing the predictability of repurchase obligations. The cost is, however, no greater--so long as the outstanding drawings of individual countries are limited to 25 per cent or 50 per cent of quota--than under the present system of repurchase within 3 to 5 years.

Changes in the Compensatory Facility and Fund Liquidity

On page 20 above an estimate was made of the possible charge on Fund liquidity that might arise from additional drawings associated with an extension of individual country limits on outstanding compensatory drawings from 25 per cent to 50 per cent of quota. At this point, a similar calculation is in order as to the charge on Fund liquidity that might result from adopting both of the principal measures suggested above, viz., (a) the extension of the limit from 25 per cent to 50 per cent with the qualification that the increase in outstandings in any year should not exceed 25 per cent, and (b) the adoption of the "mixed" system of repurchase discussed above in place of the fixed-term system of repurchase which applies at present. Some additional claims on Fund resources might also arise from the proposed separation of the compensatory facility from the other drawing facilities of the Fund, but this cannot be quantified and is unlikely to be large.

As can be seen from Table 4, the transition from "fixed term" repurchase with a 25 per cent of quota limit, to a "mixed" system of repurchase with a qualified 50 per cent of quota limit would, over the 1951-64 period, have involved an increase in the average level of potential compensatory drawings outstanding from $290 million to $420 million, i.e., an increase of $130 million. The maximum level of potential compensatory drawings outstanding would likewise have risen from $400 million (in 1955) to $560 million (in 1958), i.e., by $160 million. On the assumption that peak year potential compensatory drawings outstanding have expanded since 1955-8 in proportion to quotas, the proposed changes in limits and repurchase systems might, under present conditions, raise maximum potential compensatory drawings from $1,100 million to $1,500 million, i.e., by $400 million. Allowing for failure to use the full entitlement to compensatory drawings and other factors, it seems unlikely that the increase in peak year drawings occasioned by the proposed changes would in practice exceed $200 million.

Conclusions and Decision

Decision No. 1477-(63/8) of February 27, 1963, on Compensatory Financing of Export Fluctuations is amended by the deletion of paragraphs (5) through (8) and the substitution of the following paragraphs:

"(5) The Fund has reviewed its policies to determine how it could more readily assist members, particularly primary exporters, encountering payments difficulties produced by temporary export shortfalls, and has decided that such members can expect that their requests for drawings will be met where the Fund is satisfied that

(a) the shortfall is of a short-term character and is largely attributable to circumstances beyond the control of the member; and

(b) the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

[Alternative A] [Drawings outstanding under this paragraph may not exceed 50 per cent of the member's quota and may not be increased by a net amount of more than 25 per cent of the member's quota in any 12-month period. Moreover, requests for drawings which would increase the drawings outstanding under this paragraph beyond 25 per cent of the member's quota will be met only if the Fund is satisfied that the member has been following policies reasonably conducive to the development of its exports.]

[Alternative B] [Drawings outstanding under this paragraph may amount to 50 per cent of the member's quota provided that: (i) such drawings will not be increased by a net amount of more than 25 per cent of the member's quota in any 12-month period, and (ii) requests for drawings which would increase the drawings outstanding under this paragraph beyond 25 per cent of the member's quota will be met if the Fund is satisfied that the member has been following policies reasonably conducive to the development of its exports.]
only

(6) A member requesting a drawing under paragraph (5) will be expected to represent that it will make a repurchase corresponding to the drawing in equal annual installments to commence one year after the drawing and to be completed not later than five years after the drawing. However, in estimating export shortfalls for the purpose of drawings under paragraph (5), the Fund will, if the member so requests, deduct from the figures for actual exports an amount equivalent to any repurchase made with respect to past drawings under paragraph (5) within ____ months of the request for the new drawing. A request for a drawing involving in full or in part such a deduction will be met by the Fund if it is satisfied that the member, in addition to fulfilling the requirements of paragraph (5), has been following policies reasonably conducive to the development of its exports.

(7) Whenever the Fund's holdings of a member's currency resulting from an outstanding compensatory drawing under paragraph (5) are reduced, by the member's repurchase or otherwise, this will restore pro tanto the member's facility to make a further compensatory drawing under that paragraph, should the need arise.

(8) When drawings are made under paragraph (5), the Fund will so indicate in an appropriate manner. Within six months from the date of any drawing in the credit tranches which is not under paragraph (5) and to the extent that it is still outstanding a member may request that all or part of the drawing be reclassified and treated, for all purposes of this decision, as a drawing made under paragraph (5). The Fund will agree to such a request if at the time of the request the member meets the requirements for a drawing of an equal amount under paragraph (5) and makes the representation as to repurchase appropriate to such drawings, which representation will then be substituted for the original repurchase representation.

(9) In order to implement the Fund's policies in connection with compensatory financing of export shortfalls, the Fund will be prepared to waive the limit on Fund holdings of 200 per cent of quota, where appropriate. In particular, the Fund will be prepared to waive this limit (i) where a waiver is necessary to permit compensatory drawings to be made under paragraphs (4) and (5) above, or (ii) to the extent that drawings in accordance with paragraph (5) are still outstanding.

Moreover, the Fund will apply its tranche policies to drawing requests by a member as if the Fund's holdings of the member's currency were less than its actual holdings of that currency by the amount of any drawings outstanding under paragraph (5).

(10) In order to identify more clearly what are to be regarded as export shortfalls of a short-term character, the Fund, in conjunction with the member concerned, will seek to establish reasonable estimates regarding the medium-term trend of the member's exports on the basis of appropriate statistical data in conjunction with qualitative information about its export prospects.

(11) The provision of credit to deal with the balance of payments effects of export fluctuations provides immediate relief for a country's short-term difficulties. In many cases, however, it will also be necessary to introduce measures of a policy character in order to attain a satisfactory and lasting solution to a country's balance of payments problems. Members generally have actively cooperated with the Fund to find and adopt the measures necessary to this end. Beyond immediate balance of payments difficulties, the primary exporting countries are, in many instances, facing unfavorable long-term export trends, and all are trying to meet the challenge of achieving more rapid and sustained development through a strengthening and broadening of their economies. The last mentioned problem will require action in many fields and over many years by both the primary exporting countries and the industrial countries, separately and in concert, including readier access to the markets of the developed countries for the products of the developing countries and an appropriate and sustained flow of technical and financial assistance to the developing countries. The Fund considers that its activities can provide valuable assistance in helping to establish a climate within which longer-term measures can be more effectively pursued."

Mr Polak

MEMORANDUM

TO: Mr. Rhomberg
Miss Boissonneault

April 11, 1966

FROM: J. Marcus Fleming

SUBJECT: Compensatory Financing

I have been reading your memorandum of March 14.

To be meaningful in terms of Fund liquidity, all the figures in the chart on outstanding drawings and compensatory drawings should, I think, be expressed in terms of total Fund quotas. Do you think this could be done?

The fact that the standard error for forecasting the five-year moving average centered on t+3 is the same as the implied error for forecasting t+1 and t+2 seems to indicate the greater uncertainty of t+3, t+4, and t+5 is offset by the larger number of years in the average (?). I do not see how you deduce from these results that the error in forecasting the average of t-1, t, t+1, t+2, and t+3 would be no greater than that in forecasting the average of t-2, t-1, t, t+1, and t+2. Yet that is what seems to be implied in the last sentence of your memo (p. 5).

As regards the last sentence in your section IV, I would expect moving averages centered on t+2 and t+3 to be more efficiently forecast by commodity analysis (possibly). However, I should be greatly surprised if it was more effectively forecast by extrapolation than by autoregression. (This is something I learned from Rhomberg.) However, test it out if you want to.

Your results for lagged and non-lagged compensation are interesting, though I would belittle their importance for the same reason you do yourself. The main lesson I draw is there is a lot to be said for the Finch system of reclassification, or possibly still more for an outright system of tentative and reversible compensatory drawings made during the compensation year.

cc: Mr. Polak ✓
Mr. Ridler

Mr. Polak

Mr. J. Marcus Fleming March 18, 1966

R. R. Rhomberg

Compensatory Financing: Paper by Mr. Schiavo-Campo

There are two innovations in this paper. One concerns the testing of compensatory schemes. The author accepts our smoothness ratio though not the approximation ratio, and he adds two other tests, namely: (a) "a short-term instability ratio," which measures the relative magnitude of year-to-year changes in availabilities compared to year-to-year changes in the original export series; and (b) a medium-term predictability ratio whose purpose is not quite clear to me, but which measures the relative degree of predictability of availabilities compared to the predictability of exports (both predicted from an auto-regression defined on current and past years' exports).

The second innovation concerns a proposal for compensation and repayment called "the periodical restitution proposal." Countries are to be (partially) compensated for declines in exports from the preceding year and would have to repay (or prepay) a part of any increase in exports over the preceding year. After a specified period of years (the precise number, n, of years is a parameter of the scheme to be chosen after suitable testing) any excess of compensation over repayment, or prepayment, would have to be repaid over the next n years and any excess of repayment and prepayment over compensation received would be paid back to the country over the next n years.

The proposal is somewhat vague on a number of questions which arise. (1) How will the payments of these excesses, either to the country or from the country to the agency, relate to new compensations or repayments? (2) Does the dividing line between the "first period" of n years, for which excesses one way or the other are measured, and the "second period," during which they are to be made good, move forward in a leap-frog fashion, or are these arbitrarily selected periods of n years each during which the scheme operates in quite a different fashion?

The exposition of the formulae for compensation, repayment, etc. unfortunately does not shed more light on these and other questions than does the verbal exposition. Further clarification would have to be sought before we could test such a scheme.

There may be some merit in the new kind of test proposed under the name of "short-term instability ratio" and we could experiment with it on our own schemes. There may also be some merit in certain ideas of the new scheme proposed by the author, provided the questions relating to the provisions intended to ensure the short-term character of compensatory financing could be dealt with in a satisfactory manner.

cc: Mr. Polak

For Mr. Polak

Mr. J. Marcus Fleming — March 15, 1966

R. R. Rhomberg and L. Boissonneault

Compensatory Financing: Revision of Table 4, SM/65/101

The attached is the revision of Table 4 of the compensatory financing paper, calculated in accordance with the new quota limits (i.e., limits based on quotas in existence at the time of the hypothetical drawings).

The proportion of outstanding drawings after the third year is substantially smaller than it was in the original table. In fact, the amounts outstanding for more than three years but less than five years are reduced considerably more than are the amounts outstanding for more than five years. In this connection, it is worth pointing out that one single country, Colombia, is responsible for the amount outstanding after eight years. (A small amount of Indonesia's outstanding drawing at the end of 1964 has also been allocated to the category of drawings outstanding after eight years, and another portion of this outstanding amount to the category outstanding after five years.)

Attachment

cc: Mr. Polak
Mr. Ridler

Table 4. Duration of Drawings under Compensatory Repayments System[1]

(Period = 1951-64)

	25% of Quota Limit		50% of Quota Limit (Qualified)		50% of Quota Limit (Unqualified)	
	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings
Total drawings	0.89	100	1.24	100	1.45	100
Repaid:						
Within 3 years	0.74	83	0.97	78	0.97	67
Outstanding after:						
Fifth year	.09	10	.15	12	.27	18
Eighth year	.01	about 1[2]		about 1[2]		about 1[2]

Footnotes as in original.

Mr. Polak

Mr. J. Marcus Fleming

March 14, 1966

R. R. Rhomberg and L. Boissonneault

Compensatory Financing: Various Technical Notes

I. Computations with New Quota Limits

The information contained in Tables 2 and 3 of SM/65/101 is now available with limits based on quotas in existence on April 30 of the year for which the compensatory drawing or repurchase is assumed to be made. In addition to the three repayments systems shown in Table 3 of that paper, a fourth repayment system has been added under which repayment would be in five equal installments beginning in the year following the shortfall year; under this new system, repayments are deducted from exports of the current year for purposes of computing any shortfall in that year. The revised table is attached. Table 2 of the paper consists of the first column of Table 3. The second and fourth lines of Table 1 of SM/65/101 can also be taken from the attached table. The values for THE first and third lines are still to be computed and will be supplied tomorrow.1/ Our computations make it possible to revise Table 4, but this is a hand computing job and will take some additional time.

II. Coincidence of Peaks in Actual Outstanding Fund Drawings and Hypothetical Compensatory Drawings

The attached chart has been redrawn with hypothetical outstanding compensatory drawings based on the new computations with quotas in existence at the time of drawing. The other two lines showing outstanding Fund drawings by all countries and by less developed countries are the same as on the charts submitted earlier.

Outstanding compensatory drawings during the period 1953-58 are much lower than they were in the computations based on 1964 quotas, but the general shape of the curve is not altered. In particular--contrary to my expectation--the peak in 1953 is not lower than the peak of 1958. This is due in part to one other alteration, or rather correction, made in the computation for the mixed repayments system. In the earlier runs, repayments were assumed to occur _after_, rather than before, the maximum possible drawing in a particular year was determined. As a result, some countries were not allowed, as they should have been, to increase outstanding drawings by 25 per cent of quota in a given year or up to 50 per cent of quota at any time.

1/ They have now been added in the attached revision of Table 1.

The conclusions with respect to a coincidence of peak drawings would seem to be the same as that of my earlier note on this subject, namely, that no consistent pattern can be detected.

III. Reclassification of Ordinary Drawings as Compensatory

In order to determine what proportion of ordinary drawings, whether outright or under standby, could have been reclassified as compensatory drawings within a six-month period after each ordinary drawing, quarterly data for the 48 countries of our sample have been inspected for the period 1959-64. During this period total drawings of the 48 countries, excluding two compensatory drawings by Brazil and United Arab Republic, amounted to $1,794 million. Of this amount, $401 million could have been reclassified as compensatory at the end of either the first or second quarter following each drawing, because shortfalls up to the limit of the drawing would have existed with respect to 12-month periods ending in one or the other of these quarters. The proportion of all non-compensatory drawings for the six-year period which could have been reclassified is thus 22.4 per cent. If the exercise had been conducted with monthly data, the proportion might have been somewhat higher, but would probably not have been very much larger than one quarter of all non-compensatory drawings.

IV. Auto-regressive Forecasts of Five-Year Moving Averages Two and Three Years in the Future

As you suggested, auto-regressive formulae have been computed for forecasting the five-year moving averages centered on years t+2 and t+3, respectively, from export data for the years t, t-1, and t-2. As expected, the standard errors of these forecasts are larger than that for forecasting the five-year moving average centered on year t. Interestingly, however, they are not larger than the implied standard error, from our old computation, for forecasting the average of the two unknown years in the five-year moving average centered on the year t. The standard error for that moving average was just under 10 per cent and the implied standard error of the forecast of the two unknown years was thus just under 25 per cent.

By comparison, the standard error for forecasting the five-year moving average centered on year t+2 is about 19 per cent, and that for the five-year moving average centered on year t+3 is 25 per cent.

The coefficients attached to exports of years t, t-1, and t-2 for the forecast of the ideal norm two years ahead are respectively 0.84, 0.02, 0.17 (with a sum of 1.035); those for the forecast of the ideal norm three years ahead are 0.73, 0.11, 0.19 (with a sum of 1.033).

Errors in the moving average of 20 or 25 per cent are, of course, very large. I am sure that moving averages could be forecast more efficiently by other methods, such as straight extrapolation of a past trend of moving averages or commodity analysis.

V. Effect of Timing of Drawings and Repurchases on Approximation and Smoothness Ratios

In our discussions, the point has at various times been made that the smoothing of availabilities which we measure by the smoothness ratio (and the corresponding measure of approximation to the five-year moving average, i.e., the approximation ratio) depends on the timing of compensatory drawings and repurchases. Our standard computations assume that drawings and compensatory repurchases will be made in the years of shortfall or excess, respectively. In practice, however, drawings could be made, at the earliest, three to six months after the end of a twelve-month period for which there is a shortfall. If this is a period of maximum shortfall (so that the months of largest shortfall occur in the middle of the twelve-month period), this presumably means that the drawing can be obtained nine to twelve months after the month in which--allowing for seasonal adjustment--the maximum shortfall could be said to have occurred. Similar considerations apply to compensatory repurchases.

In order to ascertain the effect of this shift in time on the measures of effectiveness of the compensatory policy, we have computed the usual measures for a hypothetical country (called Compfinia) that is assumed to have export fluctuations of the type occurring in our data for the 48 countries and a quota limit in proper relation to the size of exports. The computations were alternatively carried out with the assumed fluctuations of exports (a) around a rising trend of 3 per cent per annum (Compfinia I) and (b) around a horizontal trend (Compfinia II). The schemes were assumed to run for thirty years with quotas adjusted every five years. These computations were made, in the first instance, in order to arrive at a judgment of the effect on our approximation and smoothness ratios of taking a longer period, in which the results would be less influenced by the beginning years during which the policy is not yet fully operative, especially in view of the Korean war disturbances of the beginning period in our computations

The second attached table shows the results of these computations. A qualified 50 per cent quota limit is assumed throughout. For Compfinia I, the country with an upward trend in exports, the computations are made for the fixed, compensatory, and mixed repayments systems. For the fixed and mixed systems, the computations are also shown with drawings occurring in the year following the shortfall year and repurchase[5], to the extent that they are compensatory, in the year after the year of excess; fixed-schedule repurchases follow the (lagged) drawings in the fourth and fifth year. The computations for Compfinia II, the country without an upward trend in exports, are given for the three repayment systems but not for the lagged drawings and repayments.

In these two hypothetical countries the approximation and smoothness ratios, when computed in accordance with our standard procedure, are all considerably higher than the average approximation and smoothness ratios found in the 48 country sample. Part of the reason is undoubtedly that in a number of countries of our sample no shortfall arises, so that the average ratios are to that extend biased towards zero. Compfinia I and II compare rather to countries like Argentina or Brazil (for which approximation and smoothness ratios of 0.200 to 0.400 were found) than to the average for the 48 countries (for which the corresponding ratios were between one fifth and one tenth of those for Argentina and Brazil).

It may be noted that in the absence of an upward trend approximation and smoothness ratios tend to be higher and the average amount outstanding larger--except under fixed repurchases--than when an upward trend is assumed. (The maximum amount outstanding is in each case determined by the limit applicable at the peak period.)

In the present context attention should be drawn to the fact that in the two cases where drawings and repurchases were assumed to be lagged by one year in relation to the years of export shortfall or excess, the smoothness and approximation ratios were both negative. That is to say, the operation of the scheme resulted in export availabilities which were less smooth, and approximated the five-year moving average less closely, than did the original exports.

Any argument in favor of compensatory financing based on the presumed smoothing properties of a compensatory scheme would, therefore, have to rely on the point that governments are enabled by the Fund's compensatory facility to smoothen imports in view of <u>expected</u>, rather than <u>actually received</u>, compensatory drawings. Since any government could do this anyway, provided it held sufficiently large reserves, the argumentation about the timing of drawings and repurchases (with the exception of that noted below) looses much of its force. What remains, is the effect of the compensatory facility on the average amount of outstanding drawings over a period of years during which export earnings are relatively depressed. Any increase in the average amount of outstanding Fund drawings resulting from the operation of the compensatory scheme would provide additional reserves to primary producing countries as a group, and would to that extent enable them to provide better than they otherwise could for the smoothing of imports in the face of fluctuating export receipts.

The one valid point with respect to the timing of compensatory drawings and repurchases concerns provisions to make shortfalls and drawings (as well as excesses and repayments) more nearly simultaneous. Some provisions along these lines are already suggested in SM/65/101, but they may not go far enough to meet the point emerging from the computations discussed here. I am sure that this must remain a topic for further study with a view towards a possible next round of discussion of the policy some years from now. The idea one may wish to pursue is the following: Just as our formula predicts a shortfall for the "current" year (i.e., for the latest twelve-month period for which firm data are available), so we could design one which predicts the shortfall for the twelve-month period following that covered by the latest data, or for a twelve-month period including the latest six months for which data can be obtained. In view of the results given under Section IV above, the error in such a shortfall forecast may not be larger than that found in our present formula.

Attachment

cc: Mr. Polak
Mr. Ridler

DM/65/101
Table 3. Revised
March 14, 1966

Table 3. Compensatory Financing: Fund Scheme with Varied Forms of Repayment, 1951-64[1]

Repayments System	Fixed Term[2]	Compensatory[3]	Mixed[4]	Five-year fixed term modified[a]
		25% of Quota Limit		
Approximation Ratio[5]	.023	.028	.028	.026
Smoothness Ratio[6]	.029	.045	.045	.036
Average Drawings Outstanding[7]	.29	.17	.17	.26
		50% of Quota Limit (Unqualified)		
Approximation Ratio	.034	.042	.042	.041
Smoothness Ratio	.046	.072	.071	.060
Average Drawings Outstanding	.48	.36	.33	.48
		50% of Quota Limit (Qualified)		
Approximation Ratio	.035	.043	.042	0.042
Smoothness Ratio	.047	.071	.070	0.060
Average Drawings Outstanding	.45	.28	.27	.42
		No Limit		
Approximation Ratio	.100	.155	.121	0.160
Smoothness Ratio	.121	.216	.188	0.205
Average Drawings Outstanding	1.36	1.49	1.02	1.77

Footnotes as in original, except:

[a] Repayment in five equal installments beginning in the year following the shortfall year; repayments on past drawings are deducted from exports for the purpose of computing shortfalls.

DM/65/101
Table 1: Revised
March 15, 1966

Table 1. Fund Compensatory Financing Facility:
Comparison of Weighting Systems over Years 1951 to 1964[1]

Limit Per Cent of Quota	Coefficients Applied to Years					Drawing Entitlement[2]	Average Drawings Outstanding[3]	Approximation Ratio[4]	Smoothness Ratio[5]
	t	t-1	t-2	t-3	t-[illegible]				
.25	0	1/3	1/3	1/3		1.04	.31	.022	.028
.25	.50	.25	.25			0.97	.29	.023	.029
.50	0	1/3	1/3	1/3		1.82	.54	.033	.046
.50	.50	.25	.25			1.61	.48	.034	.046

Footnotes as in original.

Compensatory Financing for Hypothetical Countries

(Qualified 50 per cent limit)

	Approximation Ratio	Smoothness Ratio	Outstanding Drawings	
			Average	Maximum
Compfinia I (with 3 per cent upward trend)				
Standard computation				
Fixed repayments	.095	.070	5.5	13
Compensatory repayments	.123	.097	2.6	10
Mixed repayments	.121	.096	2.5	10
Transactions lagged one year				
Fixed repayments	-.021	-.059	5.5	13
Mixed repayments	-.047	-.061	2.5	10
Compfinia II (no trend)				
Standard computation				
Fixed repayments	.105	.077	5.4	10
Compensatory repayments	.151	.111	3.7	10
Mixed repayments	.139	.112	3.2	10

Mr Polak

Deputy Managing Director March 8, 1966

J. Marcus Fleming

Brazilian Commitment to Repurchase Compensatory Drawing
Your Memorandum to Files of February 1

I would not have supposed that even if a new repurchase system were adopted it would apply retrospectively to past compensatory drawings with respect to which repurchase commitments of a different kind had been given.

As you very rightly pointed out to Messrs. Bicalho and Coutinho, if the Brazilian drawing had been made from the start under the proposed new repurchase arrangements substantial repurchases would already have taken place.

In fact, the Brazilian drawing would already have been completely repaid by this time. That drawing was made in 1963 with respect to a shortfall for calendar year 1962. Under the proposed compensatory repurchase arrangements, Brazil would have repaid $49 million in 1964 with respect to an export excess of that amount for 1963, and the remaining $11 million in 1965 with respect to an export excess of $61 million for 1964.

cc: Mr. Schweitzer
Mr. Gold
Mr. Polak
Mr. Del Canto
Mr. Sturc

Mr. Polak

MEMORANDUM

TO: The Managing Director
The Deputy Managing Director

March 7, 1966

FROM: J. Marcus Fleming

SUBJECT: Compensatory Financing

There are two main questions for decision:

1. What should be prepared for discussion in the Board and when; and
2. What line should our representative take at the meeting of the UNCTAD Committee on Invisibles.

The second question cannot be answered until the first has been.

Paper for the Board

I do not believe we should discuss in the Board the line our representative will take in Geneva.

The next paper the Board is asked to discuss on compensatory financing should, in my opinion, be a policy paper containing a draft decision on changes to be made in the facility. The paper should be drafted with a view to ultimate publication.

The main argument against this course would be that the industrial countries would be unlikely to consent to changes in the facility except as part of a package including international liquidity, that the package in question is unlikely to be agreed upon in the near future, and that therefore we should fill in time and create the appearance of some Board activity on the subject of compensatory financing by having it discuss notes on some of the issues raised at the first informal discussion of the subject. The main topics for such notes or papers would be:

1. Interrelationship of the Fund proposals with those of the Bank Staff.

2. More elaborate consideration of the question of compensating for changes in the terms of trade (or rather, compensating for changes in the importing power of exports rather than the value of exports).

3. A study of the "true cycles" in the exports of the less developed countries.

4. An examination of the degree of seasonality and variations in seasonality in the exports of the less developed countries.

5. A study as to which countries under our proposals could have reclassified ordinary drawings as compensatory over the last five years.

6. A study of the extent to which peaks and troughs of compensatory drawings have coincided with those of ordinary drawings.

As regards (1), it would seem unnecessary for us to complicate our relations with the Bank, as such a study might do, before it becomes evident whether the Bank proposal has a future or is going to fall of its own weight. We shall be in a better position to judge this after the meeting of the UNTAD Committee on Invisibles.

As regards (2), we cannot say much more than was said in the earlier paper without criticizing in detail the import indices of particular countries. Action on this issue should rather take the form of a long-term effort to improve these import price statistics.

(3) is another hopeless proposition. Even if traces of cyclicality were discovered in the exports of particular countries, this could scarcely have any practical effect on the nature of the compensatory scheme which we would propose. It is a topic for longer-term research.

As regards (4), (5) and (6), some work is being undertaken and the fruits thereof can be included in any paper which we produce, but they are probably not sufficiently meaty to provide material for separate papers.

In any event, it should be our objective, so far as possible to detach compensatory financing from any liquidity package, and have it considered on its own merits. The sort of schemes that we are recommending do not cost enough to constitute a solatium for the underdeveloped countries for being left out of the distribution of liquidity or to use up any set-aside that may be allotted to the Fund in connection with liquidity creation. If industrial countries wish to delay action on compensatory financing, we should put the responsibility squarely on their shoulders by preparing a policy paper as suggested above.

A paper of the kind described above should, in my opinion, contain:

(a) a slightly expanded "propaganda" section including some of the material on quotas that Mr. Dale mentioned at the meeting (Mr. Altman is preparing something on these lines).

(b) a considerably abbreviated version of some of the questions of application of the present policies discussed in Part I of our previous paper; (We do not want to go too much into detail on this for fear of tying our own hands.)

(c) a discussion of the desirability of various suggestions for change very much on the lines of Part II of the previous paper but including some of the Part I discussion of the measurement of the shortfall, and also the proposal for the reclassification facility, and

(d) a draft Decision.

By and large, the Board's discussion of our first paper was extraordinarily favorable. In the few cases in which objections were raised to the proposals, those objections tended to fall on either side of the proposal. However, it would be desirable to consider, inter alia,

(a) the possibility of making the repayments system a little easier than the one we had proposed;

(b) the question of the limits on the qualitative assessment of the norm;

(c) the question of the allocation of repurchases.

Work should begin at once on redrafting the paper on the lines discussed above. A certain amount of time, however, will be required for the drafting of the Decision. Also, all the calculations have to be redone, since now that the quotas have been increased we can no longer with any plausibility use present day quotas to indicate the probable effects of the different limits on the efficiency of the compensation. The limits will now have to be based on quotas contemporary with the shortfalls presumed to be compensated. This work is under way.

It would seem unlikely that a paper could be got to the Board much before the second half of April, nor does there seem to be much likelihood that the industrial countries will be willing to take action on it for some time after that.

Statement for the Committee on Invisibles

The Fund compensatory scheme is not one of the main topics for discussion at the Committee on Invisibles, and we should not suggest that a separate agenda item should be created for the purpose of discussing it. Nevertheless, it may be appropriate for the Fund representative to make some sort of progress report, e.g., in connection with the discussion on supplementary financing. Such a statement would presumably report that no further use had been made of the facility, give some reasons why, go on to say that we were reconsidering the facility, and give the reasons why we were not disposed to alter the determination of the shortfall in the direction that UNCTAD had suggested. It would also indicate sketchily the sort of suggestions for change that were up for discussion by the Board and might go further to indicate, in a very neutral manner, a number of pros and cons.

Any remarks our representative might make about the Bank supplementary scheme should be in answer to questions or misstatements regarding the way in which it interrelates with the Fund's facility (as that stands at present).

cc: Mr. Gold
Mr. Polak
Mr. Sturc
Mr. Nicoletopoulos
Mr. Finch

Mr. Polak

Mr. Schweitzer March 7, 1966

Frank A. Southard, Jr. (Initialed) F.A.S.

Compensatory Financing and UNCTAD Meeting

1. I am preparing this memorandum as a partial basis for a meeting on March 8 on compensatory financing. I consider that that meeting should focus on the preparation we should make for the UNCTAD meeting which, as I recall, begins on April 5 in Geneva. Even if we were not confronted with the most recent resolution, adopted at the meeting in New York, we would have had ample reason to expect that our representative at the April meeting will need to make something more than a routine statement on the IMF facility on compensatory financing.

2. In my opinion, the Fund representative at the meeting should be authorized to make a fairly detailed statement which, while not at all comparing in length with the statement likely to be made by the IBRD representative, will at least be accepted as cooperative. I should think the statement might include the following points:

(a) A summary of the IMF compensatory facility as it is at present.

(b) A reference to points mentioned in the UNCTAD resolution of last year.

(c) A frank explanation that, on the whole, the IMF facility is unlikely to be changed radically. This could include a reference to the need to fit compensatory financing into Fund policies and mechanisms. It could also include a forecast that it is unlikely that the statistical test would be changed--or, at least, it could be said that as a technical matter the Fund's staff does not favor a change.

(d) An indication that some of the matters are being studied by the Executive Board. I should think these might be specified, namely, the possibility that compensatory financing might "float", the question of increasing the amount of compensatory financing, and a reconsideration of repurchase arrangements. It would probably not be feasible for us to go into details on these matters unless, as discussed below, there could be some progress made in the Executive Board before April.

3. As for clearance with the Executive Board, I am inclined to agree with Mr. Fleming that we should not submit to the Board for approval the position paper we would use at Geneva. Failing that, I see two options:

(a) We might be able to schedule another Board discussion of our compensatory financing paper before April 1. We could check this quickly with three or four leading Directors. If this could be done, we might use that discussion as a vehicle for indicating the position we would be taking in Geneva. Presumably we cannot have a Board meeting unless the expected supplemental paper can be completed and sent to the Board. Since time is short, the danger is that, even if we could issue the paper this week, reluctant Directors would have an excuse to wait for a few weeks before agreeing to a Board meeting.

(b) If we cannot arrange a Board meeting for April 1, the alternative may be for you to make a statement under the heading of "Other Business" at some Board meeting during March. If we have meantime issued the supplemental paper you could refer to that and to the need for having a Board meeting in the near future. You could then go on to mention the forthcoming UNCTAD meeting and could summarize briefly the position which the Fund representative would take.

cc: ✓Mr. Polak
Mr. Gold
Mr. Sturc
Mr. Fleming
Mr. Nicoletopoulos
Mr. Finch
Mr. Coleby

1. ~~Mr. Fleming~~ J.
2. Mr. Polak

Mr. Polak

February 1, 1966

MEMORANDUM FOR FILES

Subject: Brazilian Commitment to Repurchase Compensatory Drawing

Early today Messrs. Bicalho and Coutinho called on me in order that Mr. Coutinho could explain some second thoughts which Finance Minister Bulhoes had had about the commitment given to the Fund mission and mentioned in the papers before the Executive Board, to repurchase the $60 million stand-by arrangement in June when it will have reached three years. Mr. Coutinho said that there was no doubt at all that the commitment had been given but he explained that Minister Bulhoes had become familiar with the new paper on compensatory financing and he thought that this rather changed the situation. True, it was understood that Brazil would roll over the repurchase by drawing under the new stand-by. However, Brazilian officials had long argued for a floating compensatory tranche. Therefore they would really prefer to follow the lead of the new paper and let the compensatory drawing run on and not make the roll-over drawing under the new stand-by. The Finance Minister would like to know what the Fund management's reaction would be to this.

can they?

I said that I would mention the matter to Mr. Schweitzer at once. But my first reaction was that some Executive Directors would not be happy at a suggestion coming from Brazil or the management, or both, that the paper on compensatory financing be a basis for a change in the arrangements made with Brazil during the negotiations. After all, the paper had had only an informal discussion in the Board so far. I also pointed out that the logic of the situation, if the repurchase scheme contained in the paper was to be followed, would be to determine what Brazil's repurchase commitment would have been in the past three years, taking account of Brazil's export earnings year by year.

Mr. Bicalho and Mr. Coutinho at once said that the Finance Minister would expect that Brazil would follow any such repurchase arrangement rigorously. They then explained that Brazil hoped to avoid drawing under the new stand-by, using it as a second line of reserves only to avoid a decline in Brazilian reserves. From this point of view, to avoid drawing for the purpose of rolling over the compensatory drawing was possibly desirable.

I then said I would speak to the Managing Director and be in touch with Mr. Bicalho during the day. I discussed this matter with the Managing Director before the Board meeting. His reaction was that it would be unwise to mention this matter in the Board meeting on February 2 in connection with the Brazilian stand-by. It would raise doubts and worries in the minds of some Directors. However, Mr. Bicalho could be informed that if progress was made before June in Executive Board consideration of the compensatory paper, then the Managing Director would not regard it as a breach of faith if the Brazilians were to discuss with him the pros and cons of leaving the compensatory drawing outstanding or of repurchasing. In the meantime, there could be discussions with the staff on the technical aspects--i.e., what would the

Brazilian repurchase obligation have been had the proposed new arrangements been enforced in 1960?

I reported the Managing Director's view to Mr. Bicalho and Mr. Coutinho before the Board meeting and they at once said that it was quite satisfactory. Mr. Bicalho repeated this to Mr. Schweitzer after the Board meeting.

JWS

Frank A. Southard, Jr.

cc: Mr. Schweitzer
Mr. Gold
Mr. Polak
Mr. Del Canto
Mr. Sturc
Mr. Koo

Mr. Sture

February 28, 1966

J. J. Polak

Cocoa and Sugar Meetings--Mr. Jones' Letter of February 22nd

Mr. Ridler will not be able to attend these meetings, so I suggest you nominate Mr. Jones as the Fund's representative.

cc: Mr. Rhomberg
Mr. Ridler

22552

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

Geneva Office:
Hotel Intercontinental
chemin du Petit-Saconnex
Geneva

CABLE ADDRESS
INTERFUND

22 February 1966

Dear Ernest:

I notice on the calendar of meetings for the UNCTAD that the U.N. Cocoa Conference: Working Party on Prices and Quotas, will have its meetings in Geneva from March 14th to 29th. During my brief stay in Washington I had a chat with Mr. Ridler and I believe he indicated that he did not think it worthwhile to attend this conference. If this is the case then I had better attend although if it resembles the conference of last October it will consist mainly of waiting for confidential Working Parties to emerge from their rooms after reaching a succession of deadlocks. The Fund may receive an invitation to send an observer to the conference in which case you had better name me if Mr. Ridler is not going.

There is also a Consultative Committee of the U.N. Sugar Conference meeting from March 7th to 10th to which we may or may not be invited. Again you had better use my name if an invitation is received - between both conferences I might have a sweet cup of cocoa.

As for the resumed session of the Committee on Invisibles to take place from April 4th to 13th you will have received my memo regarding representation. If Marcus comes could you please let me know in good time.

From the above you will see that I am going to be pretty fully occupied once more with UNCTAD activities until mid April and I am glad that Roger will be here to attend to the GATT.

Sincerely yours,

Edgar

Edgar Jones

Orig: ETRD
cc: RES

Mr. Ernest Sturc
Director
Exchange and Trade Relations Department
International Monetary Fund
19th and H Streets, N.W.
Washington, D.C. 20431
U.S.A.

Office Memorandum

TO : Mr. Polak

DATE: February 25, 1966

FROM : J. Marcus Fleming *JMF*

SUBJECT : Compensatory Financing

When the Board discussed the compensatory financing paper, Stevens asked that when that paper was presented for a policy decision it should be accompanied by a complementary paper discussing relevant discussions elsewhere, by which he meant the supplementary financing proposal. We ought to come to some sort of decision as to whether it is desirable to produce such a paper, what to say to the British if we do not produce it, and whom to give the job to if we do produce it. I myself think that we should not produce such a paper unless it appears that the principal industrial countries are becoming sufficiently interested in the Bank scheme or in some merger of Bank and Fund schemes to make it a practical issue. I do think, however, that we should help the countries in question to come to some conclusions on this point by pointing out to them informally some of the relevant considerations. It is this question, I confess (much more than the presentation of our own compensatory financing ideas) which seems to me to possibly justify my spending a few days in Geneva at the Invisibles Committee.

On the other hand, I don't think we can wait until April to begin some action on the preparation of a paper if that should turn out to be expedient. I am, therefore, wondering whether we should not ask someone (Ridler ?, someone outside the Research Department ?) to prepare a rough draft of what such a paper might look like.

Mr. Polak

Mr. Southard February 25, 1966

J. Marcus Fleming

UNCTAD--Fund's Compensatory Financing Facility
Your Memorandum to Mr. Polak of February 24

In view of the various things that are on my plate at present (liquidity papers, paper on the wider spread, revision of the compensatory financing paper, chapter of the Annual Report, etc.) and bearing in mind that I am planning a week's vacation--the first in two years--in the second half of March, I think it might be excessive for me to spend nine days of official time in Geneva for UNCTAD.

However, it might be worth while for me to be in Geneva for a few days to explain what can be said about our own compensatory financing and to prevent Friedman from taking us for a ride on the subject of supplementary financing. This would seem to indicate that Mr. Jones should try to pin point the time at which these subjects are likely to come up at the meeting in Geneva.

I do not think that we can submit any document on compensatory financing to UNCTAD at this time. We have nothing firm to tell them, and it would be counterproductive to filibuster.

I think it would be a bad precedent to have the Board discuss the briefing of a Fund staff member who is going to represent the Fund at a UN meeting.

I should hope that too much time need not be spent in a briefing for the Geneva meeting. What is really important is to put a revised policy paper on compensatory financing to the Board, and I should hope to be able to spend a good deal of time in the preparation of such a revision over the next weeks. I do not think that it is possible to have such a policy paper agreed by the staff and discussed by the Board before the UNCTAD meeting--nor would the Board take any action on the matter at this point if it did discuss--but I should have thought that when the Board next discusses compensatory financing it should have such a policy paper before it.

Mr Polak:
I have asked Rudin to do a 6-8pp rough draft of a statement to the Lumnelin Ctee?
JFW

cc: Mr. Schweitzer
Mr. Gold
Mr. Polak ✓
Mr. Sturc
Mr. Finch

Office Memorandum

TO : Mr. Polak

DATE: February 24, 1966

FROM : Frank A. Southard, Jr.

SUBJECT : UNCTAD--Fund's Compensatory Financing Facility

I have taken note of Mr. Sturc's memorandum of February 21 and Mr. Jones' memorandum of February 18. I agree that Mr. Fleming should stand ready to go to the Geneva meeting in April, unless other duties interfere.

In the meantime, it seems to me that we should be preparing a paper, based on the document which is pending before the Executive Board, which would have as much substance in it as feasible, having in mind that it would be submitted to UNCTAD at that meeting, or at least used as a position paper. Possibly Fleming and Finch can collaborate in this task. The touchy aspect, of course, will be what to say about possible changes in our facility if we have not had any further discussion in the Board before the first of April. Maybe we should consider submitting to the Board the draft memorandum which I mentioned above. If the staff is working on a supplemental paper, the memorandum could be attached to it and could be one excuse for having another Board meeting on compensatory financing.

cc: Mr. Schweitzer
Mr. Gold
Mr. Sturc
Mr. Fleming
Mr. Finch

J. J. Polak

Mr. J. Marcus Fleming February 11, 1966

R. R. Rhomberg

Compensatory Financing: Data Requested by State Department

The appended table contains the data requested by Mrs. Gold of the U.S. Department of State. Column 1 shows for each year the excess of shortfalls from the Fund norm (50 per cent of current exports plus 25 per cent of exports in each of the two preceding years) over the amount of drawings to which countries would be entitled in view of the quota limit (25 per cent of quota in any one year up to a maximum of 50 per cent of quota). The second column indicates the sum for all countries of any repayments not covered by excesses of exports over the Fund norm. These two amounts are summed in Column 3 and cumulated in Column 4.

In the early part of the period these amounts are fairly high because of the large shortfalls occurring in the two years following the year of peak export receipts at the beginning of the Korean War. For the years 1951-55 the total is $1,397 million. In the five-year period 1955-59 the total amount of uncompensated shortfalls plus repayments not covered by excess exports is somewhat smaller, namely $921 million. About one half of this amount occurred in the single year of 1958 which is a peak shortfall year. During the last five years of our sample period, 1960-64, the total amount would have only been $265 million. A representative amount for a future five-year period might well be closer to the amount computed for 1955-59 than to the amount found for the most recent five-year period covered by our data, since the occurrence of a year of large shortfalls of the type experienced in 1958 could not be regarded as particularly unusual.

Attachment

Proposed Fund Scheme for Export Compensation:
Uncompensated Shortfalls Plus Repayments
Not Covered by Excess Exports

	Shortfalls less drawings	Repayments not covered by excesses	Total (1) + (2)	Cumulative Amount of Column 3
	(1)	(2)	(3)	(4)
		(In million U.S. dollars)		
1951	21	0	21	21
1952	639	0	639	660
1953	530	0	530	1,190
1954	147	0	147	1,337
1955	60	0	60	1,397
1956	63	44	108	1,504
1957	137	66	204	1,708
1958	345	102	447	2,155
1959	43	61	104	2,258
1960	11	50	61	2,319
1961	31	17	49	2,368
1962	93	8	101	2,469
1963	12	6	19	2,488
1964	35	0	35	2,523

Mr Polak

Mr. Hicks
Mr. Rhomberg

J. Marcus Fleming

January 26, 1966

Compensatory Financing: Terms of Trade

I am quite anxious to develop the compensatory financing facility by including the effects of import prices and, despite strong opposition from many of my colleagues, managed to retain a reference to the possibility of this in SM/65/101. However, I think that the difficulties of including import price indices have been greatly understated in both of your memoranda. There is no great point in substituting for each country's import price index some global export index of industrial countries. The countries that really suffer from import price changes are those like Ceylon that import a high proportion of primary products, which may rise in price substantially in a short period. The import price indices of different less developed countries diverge substantially in their movements and, whatever may be the case in other contexts, where compensatory financing is concerned we have to do with the balance of payments situation of individual countries and something that applies only to less developed countries as a group is of little or no value. I think, therefore, that we have to seek to progress gradually but I hope perceptibly by pressing for the improvement of national import price indices. The data published in IFS are, I am sure, as good as the present state of the statistics permits. However, I would point out that in the case of Ceylon, whose Governor was responsible for raising the matter, there are two import price indices in IFS which show somewhat different movements.

I would like to comment now on the last two points raised in Mr. Hicks' memorandum regarding the charts. One of the objectives, believe it or not, of issuing those charts was precisely to show how little contribution is made by compensatory financing (at least on a formula basis) towards smoothing out the fluctuations in export proceeds. However, I think it is somewhat of an exaggeration to say that all of the schemes have a zero effect. The most useful thing that could be done, of course, would be to remove all limits, and then I think the effects would be perceptible even to Mr. Hicks. I was very much intrigued by the second suggestion that "the experience of the countries charted shows that a helpful procedure for Compensatory Financing would have been feasible." All we need now is a suggestion for some new way of measuring norm and shortfall that would have enabled compensatory financing to be as helpful as is suggested.

cc: Mr. Polak
Mr. Altman
Mr. Praetorius
Mr. Boccia

JMFleming:hgb
1/26/66

Mr. Polak

Mr. Fleming January 19, 1966

Earl Hicks

Mr. Rhomberg's Memorandum on the Terms of Trade Point in the Compensatory Financing Discussions

Had I seen the draft of SM/65/101 I would have objected to the statement that the terms of trade can not be brought into the calculation because most underdeveloped countries do not have import price indexes. In IFS, in writings of the Bureau, and in our correspondence, we have many times made the point, which I believe to be correct, that the measurement of the export prices of less developed countries is of great importance, but that for import prices general information on the export or wholesale prices of the industrial countries is sufficient. We have argued that it would in many cases be preferable not to construct an import price index with weights that happen to be those of the distribution of a given country's imports in the base year rather than to use an index with weights representative of the imports of underdeveloped countries generally or of world imports. I believe this point can be substantiated.

It seems to me unfortunate that we have put a poor argument to the Board when a better argument has been many times made. This point is one of the clear illustrations that the choice of statements in SM/65/101 seems to the reader to have been made to rationalize a negative conclusion rather than to find the right answer.

The Bureau has given much attention to the measurement of average export and import prices. Data on the subject are published regularly in IFS and would, I hope, be useful if the Compensatory Financing decision should incorporate, as I think it certainly should, the terms of trade.

Since I find myself writing a note on SM/65/101, I should add that the charts illustrating the comparison between operation under the existing decision and operation under the several proposed alternatives demonstrate, instead,

(1) that operation under the existing decision has zero effects and that the difference between the terms of the existing decision and those of the several alternatives is also zero, and

(2) that the experience of the countries charted shows that a helpful procedure for Compensatory Financing would have been feasible since their exports have been cyclical and since finance provided for the short falls could have been repaid from the subsequent recoveries.

cc: Messrs. Polak, Rhomberg, Praetorius, Boccia

Mr.Rhomberg

January 18, 1966

J. J. Polak

Compensatory Financing: Terms of Trade

Your solution would be feasible, I believe, but it misses the main point: the main cause of sudden fluctuations in import prices of developing countries arise from nonindustrial imports. I still believe, therefore, that the reasonable way would be to go at these separately as suggested in my memorandum of January 10 to Mr. Fleming.

cc: Mr. Fleming

Mr. Polak

Mr. J. Marcus Fleming January 17, 1966

R. R. Rhomberg

Compensatory Financing: Terms of Trade

In spite of what was said on this topic in SM/65/101 and in discussions in the Department, I am somewhat impressed with the comment made by Mr. Ghosh in the Board discussion. He acknowledged the existence of practical difficulties but was of the opinion that it should not be beyond the ingenuity of the staff to solve them.

The argument in favor of using in our shortfall calculations not export receipts but the importing power of exports would lie not only in the fact that the latter is the relevant variable from the point of view of the aim of export compensation (as pointed out in SM/65/101), but also in the reduction of the upward trend in the series whose deviations from trend are to be compensated. With a smaller trend growth, the number of prima facie cases of export shortfalls, and the magnitude of the shortfalls, would both tend to be larger.

Two practical arguments are made in SM/65/101 against allowing for import prices in the calculation relating to export compensation: (1) that import prices have not changed very much in recent years and (2) that many countries do not have import price indices and that such indices as are available are published with some delay.

The argumentation under (1) seems to be weak. Granted that import prices have been relatively stable in recent years, primary producing countries may well fear that this may not always be so, and indeed it has not always been so.

As regards (2), it would not be difficult to set up for each primary producing country a weighted index of export prices of industrial countries, with past export shares of industrial countries in a particular primary producing country's total foreign purchases as weights. Export prices of industrial countries are usually available without undue delay. Rather than ignoring the problem completely, one could even justify deflation of export figures by a general price index of exports from industrial to less developed countries without going into the refinement of different weights for individual countries.

It may be that this refinement would be more trouble than it is worth, but we should, at any rate, not argue against making some such adjustment on the basis of past constancy of import prices and unavailability of country import price indices.

cc: Mr. Polak

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

January 11, 1966

To: Members of the Executive Board

From: William B. Dale

Interest has been expressed in the comments I made at yesterday's informal meeting on the subject of advantages derived by certain Fund members from the "compensatory financing" criteria applied to requests for selective quota increases. The attached note and tables represent an expansion of those remarks, together with revised figures due to rechecking.

Attachment

Note on Quota Increases under Compensatory Financing Criteria

Early in 1965, there were 65 Fund members with quotas less than $60 million, the upper limit to which, in practice, the special calculations based on compensatory financing criteria have been applied in evaluating requests for special quota increases. Of these 65 members:

-- 3 received approval for special quota increases under the Second Resolution related to the general quota exercise;

--19 have received approval (or it is in process) for special quota increases, unrelated to the general quota exercise within the time since the Compensatory Financing policy was adopted;

--17 others could justify special quota increases in the future on the basis of Compensatory Financing criteria; and

--26 do not have a case for special quota increases based on Compensatory Financing criteria. Of these 26, several have the advantage of larger quotas than would otherwise be justified because of the Fund's policy on small quotas.

It is true that there are no hard and fast limits on quota increases, and that Directors have at times been willing to recommend approval of quotas larger than statistical calculations would indicate. But there is always at least some difficulty for a country to obtain approval for a quota larger than the relevant statistics show.

Of the 17 countries mentioned above, 15 could justify higher quotas under compensatory financing criteria than under the traditional Bretton Woods formula calculation. The additional quotas attributable to the compensatory financing criteria would be $140 million, which is equal to about 24 per cent above the actual quotas of this group of countries at the time the general quota increase comes into force, and about 20 per cent larger than quotas which would be justified by the traditional Bretton Woods formula.

Of the 19 countries mentioned, 14 have obtained approval of quota increases beyond the amounts indicated by the traditional Bretton Woods formula. The added quotas because of the compensatory financing criteria total $143 million, an amount equal to about 20 per cent above the quotas for this group that would have been indicated by traditional calculations.

Among the countries which have already received approval of larger quotas owing to compensatory financing criteria, total drawings outstanding stood at $153.6 million at the end of November 1965, and gross drawings since the increase of quotas under compensatory financing criteria have been about $80 million.

Table 1

Countries for which Selective Quota Increases under "Compensatory Financing" Criteria have been Approved or are in Process

Country	Quota, March 1963	Final Quota, after General Increase: Actual	Final Quota, after General Increase: In Absence Comp. Fin. Criteria 1/	Difference Attributable to Comp. Fin. Criteria
Saudi Arabia	55.0	90.0	69.0	21.0
Morocco	52.5	90.0	66.0	24.0
Ceylon	45.0	78.0	60.0	18.0
Thailand	45.0	95.0	95.0	--
Malaysia	37.5	125.0	125.0	--
Ghana	35.0	69.0	59.0	10.0
Tunisia	22.5	35.0	29.0	6.0
Jamaica	20.0	30.0	30.0	--
Costa Rica	15.0	25.0	19.0	6.0
Dom. Rep.	15.0	32.0	23.0	9.0
Ecuador	15.0	25.0	22.0	3.0
Guatemala	15.0	25.0	25.0	--
Iraq	15.0	80.0	63.0	17.0
Sudan	15.0	57.0	43.0	14.0
Syria	15.0	32.0	32.0	--
El Salvador	11.2	25.0	19.0	6.0
Honduras	11.2	19.0	15.0	4.0
Jordan	11.2	16.0	15.0	1.0
Nicaragua	11.2	19.0	15.0	4.0
Total	462.5	867.0	724.0	143.0

1/ Quota in March 1963 increased by 25 per cent, subject to rounding formula, or such larger quota as would have been justified under Bretton Woods, Set I, calculation (see EB/CQuota/64/3, November 9, 1964, increased by 25 per cent and subject to rounding formula.

Table 2

Countries which could Justify
"Compensatory Financing" Quota
Increases in the Future
(millions of dollars)

Country	Quota, March 1963	Potential Quota, after General Increase: In Absence Comp. Fin.1/	Potential Quota, after General Increase: With Comp. Fin.3/	Difference Attributable to Comp. Fin.
Kuwait	50.0	69.0	90.0	21.0
Nigeria	50.0	94.0	100.0	6.0
Congo	45.0	57.0	90.0	33.0
Peru	37.5	70.0	85.0	15.0
Burma	30.0	43.0	48.0	5.0
Uruguay	30.0	45.0	55.0	10.0
Viet-Nam	22.5	39.0	40.0	1.0
Trinidad & Tobago	20.0	44.0	44.0	--
Korea	18.8	50.0	50.0	--
Cameroon	15.0	20.0	28.0	8.0
Ivory Coast	15.0	24.0	31.0	7.0
Libya	15.0	20.0	25.0	5.0
Cyprus	11.2	15.0	20.0	5.0
Liberia	11.2	15.0	20.0	5.0
Panama	0.5	17.0	28.0	11.0
Sierra Leone	11.2	15.0	18.0	3.0
Lebanon	6.8	34.0	35.0	1.0
Total	401.0	686.0 2/	826.0	140.0

1/ Quota in March 1963 (or upon entry into the Fund) increased by 25 per cent, subject to rounding formula, or such larger quota as would have been justified under Bretton Woods, Set I, calculation (see EB/CQuota/64/3, November 9, 1964) increased by 25 per cent and subject to rounding formula.

2/ Actual final quotas of these countries, after the general quota increase, but in the absence of requests for special increases, will total $510 million.

3/ From EB/CQuota/65/6, February 9, 1965.

Mr. Fleming Jan. 10, 1966

J. J. Polak

Terms of Trade in Compensatory Financing

It spite of what was said this morning by some Directors, it seems to me that a general adjustment of exports for an import index is totally unworkable.

What seems not impossible to me would be a separate provision in the Compensatory Financing Decision somewhat to the effect that where a country suffers a sudden rise in the value of imports of a particular major commodity on account of a temporary price increase, the Fund may treat such an increase as similar to a reduction in exports. Even this would produce certain difficulties—e.g., in subsequent year when the price declined, but if we made the decisions discretionary with the Fund, we would be able to handle the few extreme cases that countries might encounter.

cc: Mr. Rhomberg
Mr. Ridler