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December 16, 1994

To: Members of the Executive Board
From: The Secretary
Subject: Need as a Condition for the Use of Fund Resources

Attached for consideration by the Executive Directors is a paper on need as a condition for the use of Fund resources. This paper, together with the paper on precautionary arrangements, enhanced surveillance, and program monitoring (SM/94/298, 12/16/94), is tentatively scheduled for discussion on Monday, January 9, 1995.

Mr. Gianviti (ext. 38329) or Mr. Hagan (ext. 37715) regarding the section on legal aspects or Mr. Dunaway (ext. 37343) on the other sections of the paper is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Need as a Condition for the Use of Fund Resources

**Prepared by the Policy Development and Review Department
and the Legal Department**

(In consultation with other departments)

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December 15, 1994

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I. Introduction and Summary

A fundamental condition underlying the use of Fund resources is that a member country must have a need, generally referred to as a "balance of payments need." The Fund's resources cannot be used in the absence of such need and their use cannot exceed the extent of that need. Through the 1980s, the judgment of need was seldom problematic, as the severity of balance of payments problems faced by countries seeking to use Fund resources made the existence of need largely self-evident. However, with progress being made by a number of countries in addressing debt-related problems and regaining access to private capital inflows, and with increased emphasis on Fund support for members' efforts to address structural problems, where the impact of reforms on a country's external position may be harder to predict, difficult judgments regarding need have become more common. This has given rise to questions by Executive Directors regarding the concept of need and its application in particular cases.

Given the long period since the Executive Board's last discussion of the concept of need, this paper presents for the information of Executive Directors a review of the legal aspects of the requirement of need, a discussion of certain policy issues and economic considerations surrounding the concept, and a review of how the concept has been applied in a sample of recent arrangements. The paper does not propose any changes in current policies and practices.

The main aspects of the paper may be summarized as follows:

Regarding the general resources account, when a member requests a purchase, it must represent "that it has a need because of its balance of payments or its reserve position or developments in its reserves" (Article V, Section 3(b)(ii)). These criteria are alternative rather than cumulative; therefore, a member's request would satisfy the condition of need if any one of the three criteria is met (e.g., notwithstanding a strong reserve position, a member had a deficit in its overall balance of payments). The condition of need is, however, only one of a number of conditions governing a member's use of the Fund's general resources, including the condition that the use be consistent with the policies of the Fund. The existence of a need within the meaning of Article V, Section 3(b)(ii) does not, in itself, entitle the member to use the Fund's resources.

Although the alternative criteria of need are not precisely defined in the Articles, the legislative history provides useful guidance as to how they were intended to apply. As was recognized during the preparation of the Second Amendment, the application of these criteria involves the exercise of considerable judgment. An operational framework has been developed in the Fund over time and serves as a basis for forming the necessary judgments regarding the existence and magnitude of balance of payments deficits and the adequacy of international reserves. In the

implementation of this framework, consideration is given to the varying circumstances of members and the evolution of the international financial system.

When a purchase is requested, the condition of need is only satisfied if the member is experiencing need at that time ("present" need). Accordingly, evidence of a "prospective" need that is expected to arise in the future as a result, inter alia, of the implementation of an economic program, would not provide a basis for a finding of present need, and therefore, would not provide a basis for making a purchase from the Fund. However, it is not necessary for a present need to exist at the time of approval of a stand-by or extended arrangement, as distinct from a purchase under an arrangement. Accordingly, these arrangements may be approved on the basis of a prospective need. Indeed, they may even be approved on the basis of a "potential" need which may--but is not expected to--arise during the period of the arrangement. For purposes of determining access under these arrangements, the Fund takes into consideration the present, prospective and--especially in the case of precautionary arrangements--the potential need that may arise during the period of the arrangement. Nevertheless, a purchase may not exceed the need which actually exists at the time of the purchase request.

The Fund may not challenge a member's representation of need made in the context of a request for a reserve tranche purchase or a purchase under a stand-by or extended arrangement. Accordingly, if all the conditions prescribed in the arrangement have been met, the Fund must meet the purchase request. However, in the case of either a reserve tranche or a purchase under an arrangement, the Fund may take remedial action after the purchase is made if it determines that the purchase took place in the absence of need.

Regarding the use of ESAF resources, since these resources are separate from the Fund's general resources, the rules governing assistance from the ESAF are set forth in the ESAF Trust Instrument. With respect to the requirement of need that is applicable to access to ESAF resources, a member must be experiencing a "protracted balance of payments problem" as a condition for approval of a three-year ESAF arrangement. The indicators utilized for purposes of determining whether a member has a protracted balance of payments problem differ from the alternative criteria that are applicable to the assessment of present need in the context of the use of the Fund's general resources. 1/ For example, when assessing whether an ESAF-eligible member has a protracted balance of payments problem, emphasis is placed on various aspects of the country's external position and the components of its balance of payments rather than solely on its overall balance of payments position. In view of these differences, it is possible that a member experiencing a protracted balance of payments problem would

1/ In most cases, however, members requesting the use of ESAF resources also manifest a present need under the alternative criteria.

not, at the time of the approval of and a drawing under the three-year arrangement, have a present need within the meaning of the alternative criteria set forth in Article V, Section 3(b)(ii). In such cases, however, it would be expected that such a need would arise during the period of the arrangement as a result of, inter alia, the implementation of the Fund-supported program.

When determining access under an ESAF arrangement, the amount of the commitment may not exceed the amount of the present need of the member and any need that is expected to arise during the period of the three-year arrangement. This assessment of present and prospective need is based on the same factors applicable when determining access under stand-by and extended arrangements.

Contrary to the rules governing access to the Fund's general resources, a member is not required to have a present need when it actually requests a disbursement under an ESAF arrangement. Accordingly, it is possible that a disbursement will be made at a time when a member's need is still prospective, although in most cases members have had a present need throughout the period of their arrangements.

Regarding the review of recent practice, the principles governing the use of the Fund's general resources and the use of resources from the ESAF Trust have been applied in a manner that is consistent with the Articles of Agreement, the ESAF Trust Instrument, and other relevant decisions. However, documents prepared for the Executive Board have not provided detailed discussions of need in all individual cases. The staff will seek to strengthen the presentation of need in future staff reports, in particular in cases where need may not be self evident.

In reviewing recent experience, the paper draws attention to the establishment of certain linkages to Fund stand-by and extended arrangements by other creditors. Following the Executive Board's guidance in 1991 in the context of the debt strategy, the staff has discouraged linkages between bank disbursements and members' actual making of purchase from the Fund. More generally, the establishment of such linkages by other creditors can place members under pressure to request purchases from the Fund when need does not exist, in order to prevent the loss of disbursements from these other sources. Where need does exist (and other relevant conditions are met), the provision of Fund financing would, of course, be appropriate. But given the potential for pressure on members to request purchases in inappropriate circumstances, the staff would as a general matter encourage members to avoid allowing rigid linkages to be established between Fund purchases and disbursements from other sources. This would not prevent linkages from being established between creditor actions and a member's eligibility to purchase Fund resources, for example, under precautionary arrangements.

The remainder of this paper is organized as follows: Section II examines the legal requirements associated with the concept of need under different Fund facilities; Section III discusses various operational considerations in assessing a country's balance of payments need; and Section IV reviews a sample of recent Fund arrangements to illustrate how the concept has been applied.

II. Legal Aspects of the Requirement of Need

The use of the Fund's resources is subject to a requirement that a member have a need within the meaning of the Articles of Agreement and other relevant decisions. The Fund's resources cannot be used in the absence of such a need and their use cannot exceed the extent of the need. However, what constitutes "need" is understood differently depending on the context in which the requirement must be satisfied. Under the present Articles and decisions, three distinct conditions of need can be identified.

The first condition of need applies to requests by members for purchases from the General Resources Account under Article V, Section 3 ("access to the general resources"). Among the conditions that a member must meet in order to obtain access to the Fund's general resources, the Articles require that a member represent to have a need "because of its balance of payments or its reserve position or developments in its reserves." 1/

This first condition of need must also be satisfied before a participant in the SDR Department may, as a matter of right, exchange its holdings of SDRs for currency in a transaction with a designated participant. However, in contrast to the case of access to the Fund's general resources where additional conditions are required, this need is the only condition that must be satisfied for a participant to engage in such SDR transactions.

The second condition of need applies to determinations by the Fund that a member is expected to make an early repurchase of the Fund's holdings of its currency in the General Resources Account ("continued use of the general resources"). After a purchase, a member will be expected to make an early repurchase if there has been sufficient "improvement in its balance of payments and reserve position." 2/

The third condition of need applies to the approval of arrangements for loans from the ESAF Trust ("access to the resources of the ESAF Trust"), for

1/ Article V, Section 3(b)(ii).

2/ Article V, Section 7(b).

which a member must have a "protracted balance of payments problem." 1/ However, as in the case of the use of the Fund's general resources, the amount of access to ESAF resources is limited to the member's balance of payments need.

The first part of this section examines the two different conditions of need that are applied in the context of the use of the Fund's general resources (access and continued use). It begins by discussing the scope and modalities of the condition of need relating to access to the Fund's general resources. For example, though a representation of need is always required when a purchase is requested, there are cases where this representation cannot be challenged by the Fund and, therefore, the effectiveness of the requirement of need varies according to whether the request is for a reserve tranche purchase, another outright purchase, or a purchase made under a stand-by or extended arrangement. Drawing on the legislative history of the Second Amendment, the meaning of the condition of need that is to be satisfied for access to the Fund's general resources is then analyzed. Finally, the condition of need that is applied with respect to the continued use of the Fund's general resources is discussed.

The second part of the section discusses the requirement of need relating to access to resources from the ESAF Trust. It describes the meaning of both the condition of "protracted balance of payments problem" and the related condition of need that determines access levels and also explains how they relate to the condition of need that must be satisfied when requesting access to the Fund's general resources.

1. Need as a requirement for the use of the Fund's general resources

a. Access

(1) The scope of the requirement of need

When a member makes a request for a purchase of the Fund's general resources, it must "represent" that it has a need to make the purchase "because of its balance of payments or its reserve position or developments in its reserves." 2/ These criteria, all of which relate to a member's external situation, are exclusive. Accordingly, the representation of any other form of need (e.g., a need to finance a budget deficit) would not meet

1/ "Establishment of the Enhanced Structural Adjustment Facility Trust," Decision 8759-(87/176) ESAF, December 18, 1987, as amended, Section II, paragraph 1(c), Selected Decisions, Nineteenth Issue, p. 24 (hereinafter referred to as the ESAF Trust Instrument).

2/ Article V, Section 3(b)(ii). This representation consists of a written declaration which the member's fiscal agent includes in the purchase request.

the requirements of this provision. However, as indicated by the use of the conjunction "or", each of these elements of need is distinct and only one of them must be present to enable the member to meet the requirement of need.

In principle, the Fund must satisfy itself that a need actually exists at the time of the purchase. However, the Fund may not challenge a representation of need made in a request for either a reserve tranche purchase or a purchase under a stand-by or extended arrangement; in these cases, the Fund may take remedial action only after a purchase has been made if it determines that a need did not exist at the time of the purchase.

(a) Reserve tranche purchases. The member must represent that it has a need for a reserve tranche purchase, but the Fund may not challenge this representation. 1/ However, if the Fund determines that a need did not, in fact, exist at the time of the purchase, it could take the following remedial actions. First, because the making of a reserve tranche purchase absent need would constitute the use of the Fund's general resources in a manner contrary to the purposes of the Fund within the meaning of Article V, Section 5, the Fund would have the authority under that provision to limit the member's use of the Fund's general resources and, in certain circumstances, declare the member ineligible. Second, although the reserve tranche purchase is not subject to repurchase, the Fund could sell the member's currency by adjusting its policies regarding the use of currencies in the operational budget. 2/

(b) Other outright purchases. For all purchases other than reserve tranche purchases and purchases made under a stand-by or extended arrangement, the Fund must satisfy itself that a need exists within the meaning of Article V, Section 3(b)(ii) before it approves the purchase. Accordingly, this requirement applies not only to outright credit tranche purchases (e.g., for emergency assistance), but also to purchases made under the Compensatory and Contingency Financing Facility (CCFF), the Buffer Stock Facility (BSF), and the Systemic Transformation Facility (STF). In all these cases, resources are made available (in some cases to support a member's program) without an existing commitment of resources under an arrangement. Thus, under the STF, for example, a determination of need must be made at the time of both the first and second purchases under that facility. Moreover, to the extent that the purchase is made under a

1/ Article V, Section 3(c).

2/ The availability of this remedy was described in the Commentary to the First Amendment of the Articles in the context of gold tranche purchases; see Establishment of a Facility Based on Special Drawing Rights in the International Monetary Fund and Modifications in the Rules and Practices of the Fund: A Report by the Executive Directors to the Board of Governors Proposing Amendment of the Articles of Agreement (April 1968), Part II, paragraph 32 (hereinafter referred to as "First Amendment Documents"). See also the statement by the General Counsel during the discussions which led to the Second Amendment (EBM/75/15 (2/12/75), p. 18).

facility that has been established to deal with special balance of payments problems (the CCFF, the BSF or the STF), the level of access may not exceed that portion of the need attributable to the special balance of payments problem in question. 1/

(c) Approval of stand-by arrangements and extended arrangements and purchases under such arrangements. A member's representation of need is not a condition for the approval of a stand-by or extended arrangement. This feature of stand-by and extended arrangements stems from the origin of the stand-by arrangement as an instrument to provide a member with an assurance of access to Fund resources should the need arise (subject to the member meeting the conditions specified in the arrangement). 2/

In view of the above, stand-by and extended arrangements may be requested for purely precautionary purposes, in that the member does not intend or expect to make any purchases during the period of the arrangement. Such a precautionary purpose does not, however, affect the legal character of the arrangement. A statement by the authorities of their intention not to make a purchase during the arrangement is not a binding commitment, and therefore, does not prevent the member from making such purchases if all conditions set forth in the arrangement are fulfilled. Accordingly, in the formulation of the level of conditionality to be applied, the Fund must be in a position to conclude at the time of approval of the arrangement that the member will have the capacity to repay the Fund should it make all of the purchases under the arrangement. Moreover, the fact that the arrangement is precautionary does not exempt the member from having to pay a commitment fee upon the approval of the arrangement.

When a member actually requests a purchase under a stand-by or extended arrangement, it must represent that it has a need. However, the Fund cannot challenge this representation, and if all the conditions prescribed in the arrangement have been met, the Fund must meet the purchase request. The inability of the Fund to challenge a representation prior to providing the member with the requested purchase derives from the conditional assurance regarding the future availability of resources which the Fund provides when

1/ For example, as stated in paragraph 2 of the decision establishing the Systemic Transformation Facility, financing under the facility is limited to, inter alia, the "balance of payments difficulties stemming from the disruptions" in a member's trade and payments arrangements described in paragraph 1 of the decision (Decision No. 10348-(93/61), April 23, 1993, as amended, Selected Decisions, Nineteenth Issue, p. 182).

2/ For historical background, see Joseph Gold, Financial Assistance by the International Monetary Fund: Law and Practice, (IMF Pamphlet Series, No. 27, 2nd ed., 1980).

it approves a stand-by or extended arrangement. 1/ For the same reason, the Fund may not refuse to complete a review under an arrangement solely because of the absence of need.

Although the Fund may not challenge a representation of need prior to the making of a purchase, it may take remedial action after the purchase is made if it determines that the purchase took place in the absence of need. As in the case of a reserve tranche purchase made in the absence of need, the Fund could take action under Article V, Section 5 to limit the member's use of the Fund's general resources, including subsequent purchases under the arrangement, or to declare the member ineligible. In that context, the Fund could decide to make the effectiveness of a decision on limitation or ineligibility depend on whether the member made an early repurchase of the amount that had been purchased in the absence of an actual need. 2/

In most cases, need exists from the beginning of an arrangement and, accordingly, members have requested the first purchase immediately upon approval of the arrangement. In some cases, however, need does not exist at the time of approval of the arrangement, and the member is not in a position to make a valid representation of need. If, in such cases, the staff had evidence of a member's intent to make a request for a purchase upon approval of the arrangement, notwithstanding the absence of need, the staff would not be in a position to recommend approval of the arrangement.

For purposes of determining access under an arrangement, consideration is given to the size of the present need (if any) and, in addition, the prospective or potential need that may arise during the period of the arrangement. However, any purchase under such an arrangement may not exceed the need which actually exists at the time of the purchase request.

(2) The meaning of need: the alternative criteria

As noted above, for a member desiring to make a purchase of the Fund's general resources, the condition of need is satisfied on the basis of the member's "balance of payments or its reserve position or developments in its reserves" (Article V, Section 3(b)(ii)). In view of the fact that these

1/ Article XXX(b).

2/ The Fund's policy on misreporting and noncomplying purchases under Fund arrangements could not provide the basis for an early repurchase expectation. This policy is only applicable where a purchase has been made on the basis of incorrect information regarding the observance of performance criteria or other objective conditions applicable to purchases under the terms of the arrangement or the decision approving the arrangement ("Misreporting and Noncomplying Purchases Under Fund Arrangements-- Guidelines on Corrective Action," Decision 7842-(84/165), November 16, 1984, Selected Decisions, Nineteenth Issue, p. 93).

terms are not defined in the Articles, a review of the legislative history is a necessary means of understanding how the drafters intended these criteria to be interpreted and applied.

The observations set forth below regarding the meaning of each of these criteria are therefore derived, in large part, from the Executive Board discussions that took place when these provisions were drafted during discussions that led to the Second Amendment. In this regard, it should be noted that, although the language that was incorporated at the time of the Second Amendment differs from the text of the original Articles, 1/ both the relevant Executive Board discussions and the Commentary on the Second Amendment make it clear that the revisions were made "largely in order to give expression to the practices that have evolved in the course of the years on the basis of the [pre-Second Amendment] provisions." 2/ For this reason, the observations set forth below also take into consideration a staff paper (and the Executive Board discussions of this paper) on the subject of need issued in 1976 (the "1976 paper"), several months after the Board of Governors' adoption of the resolution proposing enactment of the Second Amendment but before the Second Amendment took effect. 3/ The 1976 paper analyzed the newly revised provisions in the context of the Fund's existing practices.

Before discussing the legislative history of each of the specific criteria, it is important to recognize that access to the Fund's general resources was not the only consideration that inspired the definition of need in Article V, Section 3(b)(ii). At the outset of the Second Amendment process, a decision was taken to unify the concept of need that was to be applied as a condition for both the use of the Fund's general resources and the use by participants of their SDR holdings in transactions with

1/ The original Article V, Section 3(a)(i) stated: "[t]he member desiring to purchase the currency represents that it is presently needed for making in that currency payments which are consistent with the provisions of this Agreement."

2/ Proposed Second Amendment to the Articles of Agreement of the International Monetary Fund: A Report by the Executive Directors to the Board of Governors (March 1976), Part II, Chapter D, Section 1 (hereinafter referred to as the "Commentary").

3/ "Requirement of Need for the Use of Fund Resources and Special Drawing Rights," SM/76/197 (9/17/76). Also taken into consideration is the supplement of the 1976 paper that was issued following the Executive Board discussions, "Requirement of Need--Some Further Observations," SM/76/197, Sup. 1 (2/4/77). In certain passages of this section, statements that are attributed to the 1976 Paper refer to either the main paper or its supplement; the relevant citation specifies which paper is being referred to.

designated participants. 1/ As is discussed further below, this decision had an important consequence on the drafting of Article V, Section 3(b)(ii). In view of the Fund's desire to promote the SDR as a reserve asset, the drafters believed that the language of Article V, Section 3(b)(ii) (and therefore the language of the Article XIX, Section 3, the provision relating to the requirement of need to use SDRs) should be designed, in part, to encourage the use of SDRs by participants. This encouragement was not intended, however, to make access to the Fund's general resources easier. As was made clear during the relevant discussions, a member that satisfied the condition of need could still be limited in its access to the Fund's general resources on the basis of the Fund's policies on access, while the Fund was not granted the same authority for limiting the use of SDRs.

(a) Need because of a member's "balance of payments". As was explained by the staff during the preparation of the Second Amendment, a member has a need because of its "balance of payments" within the meaning of Article V, Section 3(b)(ii) when it has a "balance of payments deficit according to definitions of balance of payments." 2/ Although it was reiterated during the drafting process that the concept of balance of payments incorporated both current and capital account transactions, other aspects of this concept were not specifically addressed during these discussions. The 1976 paper did, however, provide an analysis of the concept, setting forth the "general approach" that had been applied since the beginning of Fund operations. 3/ With respect to this analysis, the following points are worthy of note.

First, a country's overall balance of payments is calculated by making a distinction between (i) "autonomous transactions", which are "undertaken for their own sake" and which give rise to the country's overall balance of payments surplus or deficit and (ii) those other transactions that are undertaken for the purpose of financing a balance of payments deficit or an increase in reserves. For accounting purposes, the former are referred to as "above the line" transactions, while the latter are "below the line" transactions. As was pointed out in the 1976 paper, whether a transaction was classified as above or below the line affects the calculation of the overall balance and, therefore, could determine whether a deficit existed and, if so, its size. Although in most cases this classification can be made by applying standard accounting conventions, the 1976 Paper recognized that, with respect to certain transactions that have both autonomous and

1/ As noted in the Commentary: "The provision relating to the requirement of 'need' [for the use of Fund resources] has been formulated in a manner that brings it into line with the comparable requirement of 'need' under Article XIX, Section 3(a) for the use of special drawing rights by participants." Commentary, Part II, Chapter D, Section 7.

2/ "Commentary on Comprehensive Draft Amendment of the Articles of Agreement," DAA/75/3 (3/14/75), p. 10.

3/ SM/76/197, op. cit., pp. 3-9.

balance of payments financing characteristics, the process required the exercise of judgment and that, in cases of doubt, the Fund practice had been to resolve the issue in the member's favor. 1/

Second, in view of the fact that the concept of balance of payments that is applied in the context of need includes both current and capital transactions, need under this criterion could arise because of a deficit owing partially or fully to net capital outflows. In that situation, access to the Fund's resources is limited by Article VI, which precludes the use of the Fund's general resources (other than reserve tranche purchases) to meet "a large or sustained outflow of capital."

(b) Need because of a member's "reserve position". During the preparation of the Second Amendment, it was recognized that, while "balance of payments" and "developments in member's reserves" were flow concepts that are measured over a period of time, a member's "reserve position" was a stock concept that was capable of assessment at a point in time. 2/ It was also understood that, for purposes of Article V, Section 3(b)(ii), the reserve position in question was that of gross reserves rather than net reserves. 3/

For purposes of applying the criterion of "reserve position", it was recognized that the central issue was the determination of whether a given gross reserve position gave rise to need, a process involving the exercise of judgment. As noted by the Economic Counsellor during the drafting process: "[e]stablishing a need to use the Fund's resources in terms of the balance of payments situation was relatively easy, since a member's balance was either in surplus or in deficit. Establishing a comparable need in terms of reserves would, however, require the Executive Directors to determine whether the members' position was relatively weak." 4/

In the 1976 paper, the staff set forth its understanding of the considerations which the Fund had traditionally taken into account when assessing the adequacy of a member's reserve position. As a general matter, it noted that "[t]he most compelling case of a need because of reserve position is the one in which the member's holdings are at or below the level

1/ During the Executive Board discussion of the 1976 paper, one Executive Director challenged the advisability of resolving these matters in favor of the member, arguing that each case had to be evaluated on its merits. EBM/76/151 (10/29/76), p. 19.

2/ SM/76/197, op. cit., p. 9.

3/ Ibid., p. 9; (Furthermore, "reserve position must be understood as referring to gross assets, not to some concept of reserves, since the use of Fund resources or (on the basis of most concepts of accounting) of SDRs does not produce any change in the size of the net stock of reserves."); see also EBM/75/34 (3/21/75), p. 10.

4/ EBM/75/34 (3/21/75) p. 9.

of minimum working balances." 1/ More specifically, it listed a number of factors that had been, as a matter of practice, taken into consideration when assessing need on the basis of this criterion:

In these cases, any need based on reserve position would be related to some special set of circumstances. In making a judgment as to what may be considered low reserves, the Fund takes into account such factors as the volume of foreign trade, the variability of exports and imports, the size of the Fund quota, the past behavior of reserves, the size of gross and net reserves and prospective developments in them, the traditional level of reserves maintained by the member, seasonal factors, and the size of short-term liabilities. 2/

Consistent with the principle that the three criteria are to be appraised independently of each other, one of the considerations that is not included in the above list is whether the member had a balance of payments deficit. As was reiterated in the explanatory notes to one of the later drafts of the Second Amendment, "the criterion of need in these provisions will be satisfied either if the member has a balance of payments deficit or if, for example, the member has a weak reserve position without at the same time having a balance of payments deficit according to the definitions of balance of payments." 3/

(c) Need because of "developments in ... reserves". As is evidenced by the legislative history of both the First and Second Amendment, the criterion of "developments in [a member's] reserves" was designed to enable the Fund to provide a member with financing in those situations where it may have a need but does not have a deficit in its balance of payments and its reserve position is not judged to be low.

During the preparation of the First Amendment, which provided for the creation of the SDR, there was considerable discussion regarding the condition of need that would have to be satisfied before a participant could, as a matter of right, exchange its SDRs for currency in a transaction with a designated participant. Specifically, there was concern that a participant whose currency was a reserve currency (in particular, the United States) could be precluded from using its SDR holdings if the requirement of need was based on the existence of a balance of payments deficit. This was due to the fact that, when a participant converts its currency held by

1/ SM/76/197, op. cit., p. 9.

2/ Ibid., p. 9. From this list, it may be noted that the adequacy of the stock of reserves is to be gauged against both stock concepts (e.g., the size of short-term liabilities) and flow concepts (e.g., trade). The inclusion of flow concepts means that the adequacy of the level of reserves though determined at a point in time may be normalized against variables measured within a period of time. Indeed, a commonly used indicator for the adequacy of reserves has been gross reserves in terms of months of imports.

3/ DAA/75/3, op. cit., p. 10.

another participant as reserves, there is a simultaneous reduction in its gross reserves and in its liabilities, and there is no effect on the balance of payments position. Several Executive Directors believed, however, that in such a case, the participant should still be entitled to use its SDRs. 1/ The text on need that was eventually adopted in respect of the SDR included a reference to "balance of payments need or developments in ..." the specified reserves of the participants. 2/

The inclusion of the term "developments in its reserves" in Article V, Section 3(b)(ii) at the time of the Second Amendment reflected similar concerns regarding the availability of Fund financing to members with reserve currencies, albeit in a different context. Specifically, it was included as a result of concerns expressed by certain Executive Directors as to whether the criteria of "balance of payments or its reserve situation" (which was contained in an earlier draft) 3/ would enable members of the EEC "snake arrangement" to use the Fund's resources for the purpose of settling balances under that arrangement. 4/ It was recognized that, in those circumstances, the discharge of these liabilities may not give rise to a balance of payments deficit and that the member may also be in a very

1/ See EBM/67/104 (12/15/67) p. 23.

2/ As is made clear in the commentary on the First Amendment, the phrase "developments in reserves" was designed to accommodate the above-described situation:

Because these [balance of payments] needs can be defined in various ways, reference is also made to 'developments in its [a participant's] official holdings of gold, foreign exchange, and special drawing rights, and its reserve position in the Fund,' to indicate that these developments, even if attributable to conversions of balances of the member's currency and not to a balance of payments deficit, can give rise to a need to use special drawing rights.

First Amendment Documents, part I, paragraph 15.

3/ "Comprehensive Draft Amendment of the Articles of Agreement," DAA/75/2 (3/12/75), p. 17.

4/ EBM/75/34 (3/21/75), p. 11.

strong reserve position. For this reason, an Executive Director suggested that the third criterion (already included in respect of use of SDRs since the First Amendment) be inserted to cover this "exceptional situation." 1/

The Commentary provides that the criterion of "development in reserves" is satisfied "if there is an unfavorable development in [the member's] reserves, e.g., because of an impending discharge of liabilities, even though it does not have a deficit in its balance of payments according to accepted definitions of the balance of payments." 2/ As noted in the 1976 paper, the example cited in the Commentary was intended to refer to discharges that, by virtue of the member's currency being a reserve currency, would not result in a balance of payments deficit. 3/ The 1976 paper recognized, however, that there could be other situations where a member may not have a balance of payments deficit or weak reserve position but still have a need because of a "development in its reserves" within the meaning of this provision. 4/

At the time of the establishment of the Enhanced Structural Adjustment Facility in 1987, further consideration was given by the Fund as to the circumstances in which this third criterion of need could be applicable. Specifically, in response to concerns expressed by lenders to the ESAF Trust that their claims to the Trust be sufficiently liquid, it was stated that the Fund's general resources could be made available to such lenders on the basis of this third criterion of need in the event that a determination could be made that the need was attributable to a temporary liquidity

1/ The specific request came from the Executive Director for the Netherlands:

Mr. Liefstinck remarked that he felt somewhat uneasy about draft Section 3(b)(ii). There would certainly be cases--such as those Mr. Pieske had in mind--in which a member that had neither an overall balance of payments deficit nor a weak gross reserve position would request to make a purchase. Any interpretation of the revised text to cover those cases seemed quite hazardous, and, therefore, an additional provision should state that 'notwithstanding the provision of Section 3(b)(ii) above, the Fund may sell the currencies of another member in order to settle obligations.' His proposal would provide for an exceptional use of the Fund's resources by members that had no overall balance of payments problems.

ERM/75/34 (3/21/75), p. 12.

2/ Commentary, Part II, Chapter D, Section 7.

3/ SM/76/197, p. 10.

4/ Ibid.

problem rather than a balance of payments problem. 1/ As noted in the relevant staff paper, in determining whether the need was attributable to a liquidity problem, the Fund would assess the extent to which the problem was temporary and self-reversing. 2/

(d) General considerations. A review of the record also highlights the following general issues that are relevant for purposes of interpreting the three criteria of need.

(1) During the Second Amendment process, a number of Executive Directors were concerned that a condition of need that relied on alternative rather than cumulative criteria might make access to the fund's resources overly generous. Specifically, if a member had a balance of payments deficit and high level of reserves, should it not draw down these reserves before it had access to the Fund's resources? Similarly, should not a member's ability to borrow resources from alternative sources also have a bearing as to whether the member had a need for the Fund's resources? In response to these concerns, the staff pointed out that, as a matter of Fund practice prior to the Second Amendment, a member's representation of need on the basis of a balance of payments deficit had not been challenged solely because of its strong reserve position. Indeed, as is evidenced from the very beginning of the drafting process, all of the drafts of criteria relating to need were designed to reflect that practice. It was also emphasized that, in view of the fact that the condition of need for purposes

1/ The Chairman's remarks at the conclusion of the relevant discussion included the following statement:

Two issues of substance raised during this meeting deserve special mention. First, it was reconfirmed that lending to the ESAF Trust could be considered as part of a member's official reserves by the Fund. Second, it was explained that access to the Fund's general resources could be provided for members that had extended loans to the Trust and that needed liquidity in an amount not exceeding their claim. Purchases under these circumstances would be allowed if the member represented that it had a need, because of developments in its reserves in the sense of Article V, Section 3(b)(ii), and the Fund agreed that the purchase was justified taking into account the amount of the requested purchase and the existence of a claim on the Trust. If the liquidity problem can be addressed on its own, there would be no need for an adjustment program to solve the balance of payments problem.

(Buff 87/269 (12/28/87))

2/ "Enhancement of the Structural Adjustment Facility - Operational Arrangements"; EBS/87/245 (11/25/87), pp. 9-10.

of the Fund's general resources was the same as that which applied as a condition for the use of SDRs, the use of cumulative criteria would make the SDR less attractive. 1/

Finally, the 1976 Paper stressed that a determination of the existence of need would not give the member automatic access to the Fund's resources. As it had done in the past, the Fund could always decide, as a matter of access policy, that a member which otherwise met the test of need would, for example, have to exhaust other sources of financing before it had access to the Fund's resources. 2/ Consistent with the above, the current access guidelines, established in 1983, explicitly provide that a member's balance

1/ During the discussion of the 1976 Paper, the Economic Counsellor noted the following:

Some speakers, the Economic Counsellor recalled, thought that need should be judged in terms of the size of the payments deficit and the level of reserves. Similar suggestions had been considered on previous occasions and had been wisely rejected. He recalled in that connection that the concept of need was a unified concept, and that any quantitative rules on need would have to apply to the use of SDRs as well as that of Fund credit. The SDR would be a less attractive reserve asset if a member using its SDRs ran a substantial risk of being challenged by the Fund after the event because of the small size of its deficit or the adequacy of its reserves.

EBN/76/152 (10/29/76), p. 8.

2/ The 1976 Paper noted the following:

In connection with a particular policy, the Fund may want a member to meet part of its need through an inflow of capital or by use of its reserves. This approach was followed in the case of the Fund's oil facility. The adoption of this approach does not imply that the member does not have a need to the extent that such other possibilities for meeting its difficulties exist. It simply introduces, as a matter of policy, the criterion that a member--having fulfilled the requirement of balance of payments need--should in addition be making an effort on its own part to meet this need when seeking recourse to the Fund. However, the member's use of its holdings of SDRs, for example, to meet part or all of this need is not put in question; the criterion applies only to the use of Fund resources under a certain facility and is not a modification of need.

SM/76/197, Sup. 1, pp. 4-5.

of payments need is only one of a number of factors that is to be taken into account when determining the amount of access to be provided under arrangements. For example, the access guidelines provide that, in a number of situations, the Fund should play a catalytic role, noting that the "great bulk of the external financing must normally be provided on appropriate terms from sources other than the Fund." 1/

(2) During the preparation of the Second Amendment, considerable attention was paid to the appropriate time frame within which need should be evaluated, particularly with respect to a member's balance of payments deficit. In one of the earlier drafts of the provision, reference to a member's "present and prospective balance of payments and reserve position" was included. 2/ During the discussions, a number of Executive Directors expressed concern that this language would create difficulties. As noted by one Executive Director, "the inclusion of prospective positions would give rise to difficulties when members that were in a balanced or comfortable situation at present based requests for purchase on anticipated developments." 3/ Another Executive Director voiced the following reservation:

Assessment of a member's prospective balance of payments might give rise to difficulties if the member could argue convincingly that its development plan would keep its balance of payments in deficit and that it should therefore be entitled to draw in order to cope with future balance of payments difficulties. 4/

In view of this discussion, the draft provision was revised, inter alia, to eliminate the reference to both "present and prospective." The word "present" was also deleted because, as noted by the Acting Chairman, it might also be subject to the interpretation that it "called for a narrow, and short-term or immediate view." 5/

The 1976 Paper recognized that, when assessing need, the utilization of a time frame was unavoidable. First, it noted that, with respect to a member's balance of payments position, it was a flow concept that necessarily involved a period of time. Second, because of both statistical delays and the time it takes to prepare a program, it was inevitable that the Fund would be evaluating a member's position as it existed in the recent

1/ The Chairman's Summing Up at the Conclusion of the Discussion on Criteria for the Amount of Access in Individual Cases (12/2/83), Selected Decisions, Eighteenth Issue, pp. 98-99.

2/ "Draft Amendments on Use of the Fund's Resources--Revision and Commentary," DAA/74/4. Sup. 1 (11/13/74), p. 3.

3/ EBM/75/15 (2/12/75), p. 17.

4/ Ibid., p. 23.

5/ Ibid., p. 24.

past. For these reasons, a short-term projection into the future was also considered necessary to ensure that any need that arose in the recent past continued to exist:

This means that some time almost inevitably elapses between the onset of the need and the related availability to the member of the resources. As an assurance that the member continues to have a need, however, the Fund may also pay some attention to what can be foreseen about prospects for the immediate future, at the same time fully recognizing that even short-term forecasts cannot be entirely reliable. In practice, the Fund's time horizon with respect to need rather clearly extends backward or forward from the moment at which the question is being considered by no more than a year or so. 1/

However, the 1976 Paper drew an important distinction between the above-described time frame and the concept of prospective need. While it recognized that a prospective need may provide the basis for the approval of a stand-by or extended arrangement, in those cases where the member wished to make a purchase immediately upon the approval of the arrangement, a need must exist at the time of the request and that this need might be justified "as the result either of a balance of payments deficit in the recent past or of the present weakness in the reserve position stemming from that same deficit." 2/ In those cases, "[a]ny background paper would undoubtedly make reference to both the balance of payments and reserve position; however, it would probably not specify which of the two justifications was being relied on." 3/

As noted earlier in this section, the determination of overall access under an arrangement will be made on the basis not only of the member's present need, but also on the basis of the prospective or potential need that may arise during the period of the arrangement. As will be discussed in the subsequent section, the determination of prospective or potential need involves not only the utilization of a longer time frame but also requires an assessment of a wider variety of factors.

(3) There was considerable discussion regarding how these criteria would be applied in the context of floating exchange rates. During its discussion of the meaning of a balance of payments deficit, the 1976 staff paper noted that "[o]bviously, a weakness in the balance of payments that was allowed to manifest itself solely in a deterioration of the exchange rate would not create a deficit and the question of need could therefore not arise in that situation." 4/

1/ SM/76/197, op. cit., p. 11.

2/ Ibid., p. 13.

3/ Ibid., p. 13.

4/ Ibid., p. 3.

During an Executive Board meeting, a number of Executive Directors expressed concern over this statement, stating that it could be interpreted as meaning that a member maintaining a floating rate had no need for reserves. An Executive Director felt that such a position "went too far", noting that speculative attacks could in certain ways be related to the size of the member's reserves. 1/ In response to these concerns, the Economic Counsellor recognized that a lack of need for reserves would only arise in a "pure" float, noting that "if a member in the situation he had described was not intervening or was not planning to do so, it could not say that it had a need for foreign exchange." 2/

(4) Finally, one of the stated purposes of the 1976 Paper was to obtain guidance from the Executive Board as to how the concept of need, as articulated in the revised Articles, should be applied in the future. During the Executive Board discussions, Executive Directors were reluctant to establish any guidelines that would add greater specificity to the general criteria set forth in the Articles. There was a concern that such a "codification" of the concept of need would create unnecessary inflexibility. 3/ For this reason, they urged that the concept of need should continue to be applied on a case-by-case basis, consistent with past practice. As noted by the Acting Chairman at the conclusion of the relevant meeting "by and large Executive Directors seemed content for the time being to pursue the traditional approach--a kind of case-by-case, or 'common law' approach." 4/

b. Continued use

A member that has purchased the Fund's general resources may be subject to an early repurchase expectation on the grounds that there has been sufficient improvement in its "balance of payments and reserve position." 5/ As is indicated by the use of the conjunction "and", and in contrast with the condition of "need" as a condition to access to the Fund's general resources, this concept requires an assessment of the member's position with respect to both its balance of payments and external reserves.

After the Second Amendment came into effect, the Fund adopted guidelines so as to give members "clear guidance on what the Fund will regard as meeting the expectation of Article V, Section 7(b)" (the "Early Repurchase Guidelines"). 6/ Accordingly, the Early Repurchase Guidelines set forth

1/ EBM/76/151 (10/29/76), p. 25.

2/ EBM/76/152 (10/29/76), p. 9.

3/ See EBM/76/151, op. cit., p. 28ff.

4/ EBM/76/152, op. cit. (10/29/76), p. 12.

5/ Article V, Section 7(b). Although it has not yet done so, the Fund has the authority to adopt policies under which this expectation could be transformed into an obligation.

6/ "Repurchases in the Light of Improvements in a Member's Balance of Payments and Reserve Position," SM/77/258 (10/31/77), p. 2.

the criteria that the Fund applies for purposes of determining: (i) whether a member's balance of payments and reserve position had sufficiently improved to trigger an early repurchase expectation; and (ii) the repurchase schedule that would apply during this period of improvement. With respect to the first criterion, i.e., the meaning of improvement, the Early Repurchase Guidelines rely on those criteria that are applied when assessing whether a member's balance of payments and reserve position are sufficiently strong for purposes of the quarterly designation plan and the operational budget. 1/

As stated in the Commentary on drafts on the Second Amendment, the "criterion [of improvement] is a combined one that can be satisfied if the improvement in one element compensates for a slower improvement in the other." 2/ When the Early Repurchase Guidelines were proposed, it was recognized that this would be particularly relevant in those instances where a much improved balance of payments position was not reflected in increases in reserves by virtue of a member's decision to reduce its indebtedness to creditors other than the Fund. In those cases, the staff believed that the member should be expected to make an early repurchase. 3/

Applying the same principle, it was also recognized that a member whose weak balance of payments position qualified it to make a purchase from the Fund may, conceivably, have a sufficiently strong and, therefore, offsetting reserve position to create an expectation of repurchase. 4/ As an operational matter, however, the possibility of this occurrence was avoided by the inclusion in the Early Repurchase Guidelines of a paragraph which provides that a member making "a purchase in the credit tranches or under a special policy of the Fund will not be expected, however, to make early repurchases until the quarter following the second full quarter after its purchase." 5/ Accordingly, an expectation of repurchase is effectively forestalled during the period when a member is making purchases as scheduled under an arrangement. It was recognized that "[t]his might carry some risk that a member might purchase in order to avoid an expectation of repurchase, and the way in which this proposal operates would need to be examined in the light of experience." 6/

1/ These guidelines implement Article V, Section 3(d) (which relates to the selection of currencies for the operational budget) and Article XIX, Section 5(a) (which relates to the criteria to be applied when designating participants to accept SDRs).

2/ Commentary, Part II, Chapter E, Section 2(ii).

3/ SM/77/258, op. cit., p. 3.

4/ Ibid., p. 5.

5/ Decision No. 6172-(79/101), June 28, 1979, paragraph No. 1, Selected Decisions, Nineteenth Issue, p. 210.

6/ SM/78/74 (3/8/78), p. 4.

2. Need as a requirement for access to ESAF resources

Resources made available under ESAF arrangements are separate from the Fund's general resources. Accordingly, assistance from the ESAF is governed exclusively by the ESAF Trust Instrument, as recently amended, rather than by the specific provisions of the Articles discussed above. 1/ As seen below, the requirement of need that is applicable to the use of ESAF resources also differs from the specific condition that governs access to the Fund's general resources.

a. The requirement of need

Unlike stand-by or extended arrangements, ESAF arrangements cannot be approved for purely precautionary purposes: as a condition for the approval of a three-year arrangement under the ESAF, the Fund must be satisfied that the ESAF-eligible member has a "protracted balance of payments problem." 2/ However, the meaning of this condition differs from the condition of need that is applicable to the use of the Fund's general resources and, as is discussed in Section 2 (b) below, does not necessarily require that a member meet any of the criteria of need discussed in the previous part of this section at the time of the approval of the arrangement. 3/

For purposes of determining access under an ESAF arrangement, the amount of the commitment may not exceed the present need of the member and any prospective need that is expected to arise during the period of the three-year arrangement. This assessment of present and prospective need is based on the same factors applicable when determining access under stand-by and extended arrangements. However, contrary to the rules governing the Fund's general resources, a member is not required to represent that it has a present need when it actually requests a disbursement under an ESAF arrangement. Accordingly, although in most cases it can be expected that a member will have a need throughout the period of the arrangement, it is possible that a disbursement will be made at a time when the member's need is still prospective.

If, after the approval of a three-year arrangement, the Fund determines that the member's balance of payments position has deteriorated, it may increase access under the arrangement at the time of the approval of the second or third annual arrangement. The Fund may also increase the overall amount committed under a three-year arrangement at the time of a mid-term review if it determines that the deterioration is because of "adverse external contingencies occurring during the period of the arrangement." 4/

1/ ESAF Trust Instrument, Section II, paragraph 2(c).

2/ ESAF Trust Instrument, Section II, paragraph 1(c).

3/ In fact, however, most countries seeking access to ESAF resources meet some or all of these criteria.

4/ ESAF Trust Instrument, Section II, paragraph 2(d).

Conversely, the Fund could reduce the amount of the commitment made under the three-year arrangement at the time of the approval of the second or third annual arrangement (which could include a reduction to zero and, accordingly, nonapproval of the arrangement) if a determination were made that there have been developments in the balance of payments position of the member that "are substantially more favorable than envisaged at the time of approval of the three year arrangement and the improvement for the member derives in particular from improvements in the external environment." 1/ This reduction could not take place at the time of the completion of a review under the arrangement.

A member's continued use of ESAF resources is not subject to the continued existence of a protracted balance of payments problem. Accordingly, the Instrument contains no provisions authorizing the Fund to require the member to make an early repayment of such resources in the event of an improvement in its balance of payments position.

b. The meaning of "protracted balance of payments problem"

As is noted above, the Fund must determine that the requesting member has a "protracted balance of payments problem" before it can approve a three-year arrangement. Since the origin of this term is to be found in the Structural Adjustment Facility, an understanding of this concept involves an historical review of certain aspects of that facility. 2/

The term "protracted balance of payments problem" first appeared in an August 1985 staff paper 3/ which, following a request from the Interim Committee, explored possible ways in which resources of the Special Disbursement Account could be made available to low-income countries on concessional terms following the termination of the Trust Fund. The authority to provide assistance from the Special Disbursement Account to developing countries on special terms was derived from Article V, Section 12(f) which provides, in part, that "balance of payments assistance could be made available on special terms to developing members in difficult circumstances, and for this purpose the Fund shall take into account the level of per capita income."

The operational definition to the concept of "protracted balance of payments problem" was set out in a December 1985 staff paper. 4/ As the passage quoted below makes clear, the determination of the existence of a protracted balance of payments problem would be based exclusively on

1/ Ibid.

2/ See EBS/87/230 (11/9/87), p. 8.

3/ "Use of Resources of the Special Disbursement Account Arising from Termination of the Trust Fund - Preliminary Considerations," EBS/85/183 (8/6/85), p. 16.

4/ "Use of Resources of the Special Disbursement Account," EBS/85/283 (12/17/85).

criteria that are different than those that are applied as a condition for access to the Fund's general resources. The staff believed that with many low-income countries, underlying balance of payments problems did not necessarily manifest themselves in a manner that would satisfy the traditional criteria of need; namely, an actual balance of payments deficit and low reserves. For this reason, emphasis would have to be placed on those indicators that would normally evidence "poor external performance":

To qualify for the use of SDA resources, an IDA-eligible country would have to be in need of such resources and to face a protracted balance of payments problem. The determination of the existence of a protracted balance of payments problem would involve examination of past, current, and prospective balance of payments developments. Such an assessment would need to take into account various aspects of external performance, since a determination of the severity of an external imbalance cannot be based on any single objective indicator. An unsustainably large current account deficit, for example, need not constitute evidence of a protracted problem, if the sources of the deficit can reasonably be expected to be reversed over a relatively short period, given the country's external prospects and its ability to implement timely and effective adjustment policies. A small deficit, on the other hand, may reflect severe constraints imposed by limited availability of external finance or foreign exchange reserves rather than an absence of balance of payments problems.

Thus, besides the behavior of the current account deficit, evidence of a protracted balance of payments problem would be sought in the behavior of other current account indicators, such as a stagnant or declining volume of exports, a depressed volume of imports, or a deterioration in the terms of trade; in external finance indicators such as deteriorating access to capital markets or rising costs of debt service; and in declining reserves. Such developments could be expected to be associated with stagnant or declining economic activity. Assessment of the behavior of these indicators would take account of both the magnitude and the duration of any unfavorable developments. Protracted balance of payments problems, moreover, would often be reflected in difficulties in undertaking an orderly process of adjustment, which could be evidenced by tightened exchange restrictions, payments arrears, or prolonged use of Fund resources.

Analysis of these indicators would be both retrospective and prospective, and would take account of other factors that would influence a country's path toward external adjustment, as measured, for example, by projected medium-term financing gaps. The analysis would need to allow for the fact that external prospects and the ability to adapt to them vary considerably from country to country. Moreover, the fact that a country's medium-term prospects are relatively favorable because of a determined effort to deal with past protracted problems would not necessarily preclude access to these resources if a continued

structural adjustment effort was required that would extend over a number of years, during which economic growth would continue to be constrained to less than its potential. 1/

From the above analysis, several principles emerge. First, the appraisal of the existence of such a problem would be based primarily on an analysis of the components of the members balance of payments rather than its overall balance of payments position. Second, a member experiencing such a problem may not satisfy any of the traditional criteria of need (i.e., a balance of payments deficit or low reserves) because it is suppressing their manifestation by, inter alia, constraining economic growth. Third, as a transitional consequence of a member's adoption of growth-oriented adjustment policies, it is expected that the traditional indicators of overall balance of payment problems will become manifest.

During the Executive Board discussion of the December 1985 paper, most Executive Directors endorsed the staff's approach. However, a number of Executive Directors desired that even greater emphasis be placed on the breadth of the indicators that the staff was to take into consideration. There was particular concern that any reliance on traditional "need" indicators would penalize members that had avoided balance of payments deficits through the adoption of "prudent policies." The Chairman's Summing Up reflected this concern. 2/

1/ Ibid., pp. 4 and 7.

2/ The relevant portion of the Chairman's Summing Up reads as follows:

The staff analysis of possible determinants of protracted balance of payments difficulties was, on the whole, considered to be useful, but several Directors stressed that the criteria suggested by the staff should not be applied in a mechanical way. Rather, flexibility will be needed in assessing, on a case-by-case basis, the position of individual countries making requests. A number of Directors particularly emphasized that need to take a broad view of the notion of 'protracted balance of payments problems' and advised against indicators that were too simple or mechanistic. In particular, I noted the relevant questions relating to those countries having serious balance of payments problems that may not be protracted in the sense defined by the staff, owing to the implementation of appropriate adjustment policies in the past. Directors enjoined the management and the staff to consider such questions carefully when examining any request received from an IDA-eligible country. Also, it was noted that given the volatility of external circumstances, a reconsideration of country's position could well be called for over time.

In March 1986, the Executive Board discussed the proposed regulations that would govern the operation of the new facility. In addition to the requirement of the existence of protracted balance of payments problems prior to the approval of a three-year arrangement, the proposed regulations required a finding of an actual balance of payments need upon the approval of each annual arrangement, the latter finding to be based on the criteria that were applied in the Trust Fund and continued to apply in the general resources account; i.e., balance of payments, reserve position and developments in reserves. During the discussion, a number of Executive Directors expressed concern that the inclusion of these indicators in the annual assessment of need would be incompatible with the concept of a "protracted balance of payments problem" that had previously been agreed upon. The Chairman also noted this potential inconsistency. 1/ In view of these concerns, it was agreed that, while an assessment of need would be made prior to the approval of each annual arrangement, the reference to these criteria would be deleted so as to ensure that such an annual assessment would not be stricter than the assessment to be made prior to the approval of the three-year arrangement. 2/

At the time of the first review of the operation of the SAF, which was conducted in 1987, the desire on the part of Executive Directors to exercise flexibility for the benefit of eligible members continued to be evident. The staff's review paper noted that the criterion being applied when assessing "protracted balance of payments problem" was the same as that outlined in the December 1985 staff paper (quoted above) and that it was

1/ The record reveals the following statement:

The Chairman remarked that the problem was one of consistency: how to put the assessment of the immediate balance of payments position and the determination of a protracted balance of payments problem in a consistent framework. The latter would determine whether an eligible member was qualified to use the resources in the light of the many relevant parameters indicative of such a problem - such as weak foreign exchange position, the existence of restrictions, and payments arrears. To revert to the narrow, short-term definition of balance of payments need for annual disbursements under the facility might introduce a certain inconsistency into the decision.

EBM/86/56 (3/26/86), p. 37.

2/ As noted above, an improvement in a member's balance of payments position could provide the basis for a reduction (or denial) of access under the second or third year annual arrangement, but only if these improvements derive, in particular, from improvements in the external environment.

being applied flexibly. 1/ The staff sought guidance from the Board as to whether such flexibility should continue. Although certain Executive Directors expressed concern about the "looseness" of the criterion, most Executive Directors continued to urge flexibility, with some expressing the opinion that a low income country, by definition, had a protracted balance of payments problem. In his Summing Up, the Chairman characterized the views of the Board on this subject as follows:

While the existence of protracted balance of payments problems should remain a criterion for use of the facility, most Directors emphasized that, a priori, a low-income country satisfied this criterion. They reiterated that the assessment should involve considerable flexibility and should not be based on the mechanical application of statistical indicators. 2/

c. Determining access

Under the SAF, actual access was, in practice, the same in terms of quotas for all qualifying members. This was due, in part, to the fact that access was not differentiated on the basis of need: once an eligible member was judged to have a "protracted balance of payments problem", it was assumed that this problem justified maximum access under the facility. At the time of the creation of the ESAF, however, the Fund considered it necessary to differentiate access among members. 3/ Accordingly, under the ESAF Trust, access to eligible members that are experiencing a

1/ "Structural Adjustment Facility (SAF)--Review of Experience," EBS/87/46 (2/27/87).

2/ Buff 87/118 (6/23/87), p. 4.

3/ To this end, it was noted:

Access to existing SAF resources is uniform; that is, each member that qualifies is permitted to borrow up to the same amount relative to quota, subject to need. However, ... access under the enhanced SAF for all qualifying members should be differentiated on the basis of need and the strength of adjustment programs adopted by those members. ... To determine access under the enhanced SAF in individual cases, the following broad guidelines are proposed for consideration by the Board. First, account must be taken of the immediate size and likely duration of the member's balance of payments need. Second, sufficient recovery in the balance of payments must be in prospect to provide appropriate assurance that enhanced SAF loans can be repaid on schedule without strain.

protracted balance of payments problem "shall be determined on the basis of an assessment of the balance of payments need of the members, the strength of its adjustment program, the amount of the member's outstanding use of credit extended by the Fund, and its record in using Fund credit in the past." 1/

For purposes of determining access under ESAF arrangements, the Fund has taken into consideration: (i) the actual need of the member (on the basis of the member's balance of payments, reserve position, and developments in reserves) and (ii) the prospective need that will develop during the period of the arrangement as a result of, inter alia, the implementation of the Fund-supported program. 2/ As noted earlier, in those rare instances where a member does not have an actual need upon the approval of the arrangement, a member would be able to receive a disbursement on the basis of a prospective need by virtue of the absence of a requirement that a member represent actual need at the time of the disbursement request.

III. Operational Considerations in Assessing Need

While the Articles and the relevant legislative history establish the criteria to be applied in assessing need, the application of these criteria at an operational level requires the exercise of considerable judgment, in part reflecting the evolution of the international financial system. Issues in this context are addressed in the first part of this section. The second part discusses the assessment of underlying balance of payments imbalances

1/ ESAF Trust Instrument, Section II, paragraph 2(c).

2/ In the section relating to access under the ESAF during the discussion of the ESAF successor, one of the staff papers noted as follows:

As has been the Fund's policy and practice so far, assessing the presence of a balance of payments need would continue to be based on a range of indicators (changes in net official reserves, the level of gross reserves, and prospective developments in reserves) and other sources of potential financing, and would take into account various aspects of past and prospective external performance. As already indicated, current ESAF users would not be precluded from access to the ESAF successor, if there is continuing need for exceptional balance of payments support and for structural reforms to remove impediments to economic growth at the country's full potential and achieve external viability.

which, although they may not give rise to an immediate need, would be expected to result in a prospective need during the period of an arrangement.

1. Assessing present need

a. Balance of payments deficits

As noted in Section II, a member would be judged to have a balance of payments need if it incurs a deficit as measured in its balance of payments accounts. The Fund has developed several concepts of imbalance that are used for analytical and operational purposes. They essentially involve making a distinction in the recorded balance of payments flows between autonomous transactions (i.e., transactions undertaken for their own sake) and those transactions that finance them. The sum of the former represents a country's overall external payments position. Financing of this position is provided by the government in the form of changes in official reserves and "exceptional" financing.

Exceptional financing denotes any arrangement by a country's authorities that is intended to provide financing for the balance of payments. This financing may take the form of official borrowing or borrowing by other domestic residents induced by the government; transfers, including forgiveness of government external debt and grants received by the government from foreign official agencies; direct or other equity investment involved with debt reduction (e.g., debt/equity swaps); and other transactions related to debt reorganization, such as rescheduling of existing debt or the accumulation of external payment arrears. 1/

While the conceptual framework is well defined, the actual measurement of the balance of payments deficit is less precise owing to the substantial element of judgment involved in making the distinction between autonomous transactions and financing items. 2/

b. Reserve levels

A country's reserve position refers to the stock of gross international reserve assets held at a point in time. As noted in Section II, a need to use Fund resources could arise if reserves were judged to be at a low level or because of developments in reserves. 3/ A compelling case for the

1/ The definition and treatment of exceptional financing is explained in more detail in Balance of Payments Manual, International Monetary Fund, Fifth Edition, 1993, pp. 102-103 and Appendix IV.

2/ For a further discussion of the issues involved in such judgments, see (SM/76/197).

3/ Legal and basic operational considerations regarding need arising because of "developments in reserves" are discussed fully in Section II above.

existence of need could be made in the event that a country's gross reserve holdings were considered to be at such a low level that it would find it difficult to incur a balance of payments deficit, without recourse to running arrears, unless it was willing and able to engage in other forms of exceptional financing or to impose restrictions on international transactions. A variety of factors need to be considered in making a judgment as to what constitutes a weak reserve position, and the relevance and importance of these factors will vary across countries, necessitating case-by-case determinations.

A first set of considerations relates to what assets should be regarded as part of a country's international reserves. The standard definition of reserve assets may have to be adjusted to take into account certain country-specific factors. 1/ The ability of the authorities to use their reserves may vary depending on the type of asset. For example, gold that is pledged or that cannot be sold for political reasons could not be immediately used to finance a balance of payments deficit and, typically, would tend to be excluded from the definition of reserve assets in Fund programs. In addition, the holder of a country's foreign assets needs to be considered. Where appropriate, foreign currency assets held by the banking system and the government, as well as those of the central bank, might be counted as part of international reserves.

Judging the adequacy of the level of international reserves involves a number of considerations, relating to both the current level of reserves and to the sustainability of the reserve position. Factors to be considered include the volume of foreign trade, the variability of exports and imports, the traditional level of reserves maintained by a country, seasonal factors, the potential importance of transitory factors which may create "fragility" in the reserve position, the size and variability of capital flows, the level of external arrears, contingent claims on a country's foreign reserves (e.g., forward exchange cover provided by the central bank), and the existence of spontaneous access to international capital markets.

Access to international capital markets may have some particularly important implications for assessing the adequacy of a country's reserve position. Ready access to lines of credit or to new capital market issues can reduce the need for holding a substantial level of liquid foreign assets as reserves. Conversely, reliance on such capital market access can entail an additional element of vulnerability to a country's balance of payments situation, as such access might conceivably be limited or cease to be

1/ Reserve assets consist of those external assets that are readily available to and controlled by a country's monetary authorities for such purposes as: (i) direct financing of external payments imbalances and/or (ii) indirectly regulating the magnitude of such imbalances through intervention in exchange markets to affect the currency's exchange rate. A complete discussion of reserve assets is presented in Balance of Payments Manual, Fifth Edition, 1993, Chapter XXI, pp. 97-100.

available in the event of a crisis. Such access also has a bearing on how a country's schedule of amortization payments on its foreign debt should be factored into an assessment of the adequacy of international reserves; a relevant factor is the degree to which impending obligations may be rolled over on a voluntary basis. Where a spontaneous refinancing may be difficult to arrange, it would seem prudent to make allowance for a gradual build-up in reserves to meet impending obligations, and this would be taken into account in assessing the adequacy of the level of reserves. Moreover, a country's ability to continue to borrow to finance a balance of payments deficit may be influenced by its relationship with the Fund. A Fund arrangement may be taken to represent a signal that a country is following an appropriate economic policy framework so that the market may deem it to be creditworthy.

An assessment of the adequacy of the level of international reserves might also consider the nature of the country's exchange rate regime. In principle, a country with a fixed exchange rate could be expected to need a higher level of reserves to assist in defending the rate than a country which allowed its currency to float. However, in practice, distinctions as to the adequacy of reserves based on the exchange rate regime are generally difficult to make. The majority of Fund members have adopted some type of floating exchange rate regime, with the degree to which the currency is allowed to float varying over time depending on both domestic and external developments. Moreover, a country may shift the nature of the exchange rate regime depending on circumstances and its economic policy objectives. 1/ In the end, any judgment regarding the reserve cover's adequacy would have to reflect the country's current and prospective exchange rate policy rather than make reference only to more general classifications of exchange rate systems.

A particular question may arise as to how to assess the reserve position in the case of countries with currency board exchange arrangements. The appropriate level of reserves under such a system may need to take account of the mandated foreign exchange cover for the monetary base plus an additional reserve cushion to provide some flexibility in case of unexpected events. A judgment as to the adequacy of this reserve cushion should be the determining factor in assessing the reserve position. Thus, where the monetary base is large, a country could conceivably have a high level of reserves relative to imports but still have a balance of payments need because its reserve cushion is viewed as not being adequate.

1/ Such a shift in exchange regimes may also be forced on a country. For example, owing to a rundown in its reserves, a country may have to allow its currency to float (or float more freely) until adjustment policies adopted have their intended effect and reserves are rebuilt.

2. Assessing prospective need

a. Underlying balance of payments imbalances

Various factors may also suggest the existence of an underlying balance of payments disequilibrium, which may not be directly reflected in the recorded international accounts and, therefore, do not give rise to a present need. For instance, the exchange rate regime or the way in which it is implemented can serve to mask the underlying external position. In a flexible exchange rate regime, balance of payments equilibrium is generally maintained--at least over time--by movements in the exchange rate. Sharp movements in the rate, however, may be indicative of underlying macroeconomic imbalances (e.g., owing to overly expansionary financial policies) that are being reflected in pressures on the external position. The burden of adjustment imposed on a country's economy by such large exchange rate movements can be substantial. A buildup in speculative pressures and differences in the speed of adjustment between goods and services markets, on the one hand, and financial markets, on the other, can lead to significant overshooting in the exchange rate. At the same time, macroeconomic policy actions to correct the situation may take effect only with a lag. In these circumstances, the authorities might choose to intervene to hold the exchange rate at a level above the freely determined market rate to limit overshooting. Such an action would entail a need for financing. 1/

In a fixed exchange rate regime, manipulation of the exchange system can be reflected in the emergence of segmentation of the market. Substantial deviations could emerge between the official exchange rate and rates in unofficial and informal foreign exchange markets. While the measured balance of payments position might appear sustainable, such differences between exchange rates would suggest an underlying external disequilibrium. Policy actions to eliminate them and unify the exchange market may lead to the emergence of an actual balance of payments deficit.

Underlying balance of payments disequilibria may also exist as a result of economic policies which directly suppress some external transactions. For a variety of reasons (including attempts to preserve the external balance), prohibitive tariffs, quotas, or bans may be imposed on trade in goods and services and controls imposed on capital flows. Thus, while a country's measured balance of payments position may be in balance or even in surplus, a reduction in or removal of trade barriers and capital controls could initially give rise to a deficit in the external position. 2/

1/ Use by a country of a managed floating exchange rate regime gives rise to a need for international reserves and could produce a balance of payments need owing to a low level of reserves.

2/ Removal of trade restrictions and capital controls would be expected in time to strengthen the external position as economic efficiency is improved.

Underlying weakness in a country's balance of payments position could also serve as a brake on economic growth. In order to preserve its external position, a country may have to pursue undesirably restrictive financial policies so as to restrain growth in domestic demand. Such weakness in the external balance could reflect structural impediments that adversely affect the supply capacity of the economy. While it may be possible to maintain a sufficiently restrictive policy stance for an extended period of time, in the end, the external position cannot be judged to be desirable (or ultimately viable from a medium-term prospective). Policy actions to redress structural impediments may entail a deterioration in the external position resulting in a balance of payments deficit in the shorter term. Because the balance of payments is heavily influenced by domestic policies, structural reforms in many sectors--not just the external sector--may affect the external balance. Moreover, countries often implement a broad range of structural reforms at the same time, complemented by supportive macro-economic policies, making it virtually impossible to separate out the contribution of individual policy actions to the emergence of an external deficit.

b. Fund support for addressing underlying imbalances

Providing support for a member's efforts to deal with underlying payments imbalances was part of the motivation for the establishment by the Fund of the Extended Fund Facility and the SAF/ESAF. Under these facilities, the Fund explicitly provides assistance in order to help a member implement an economic program aimed at addressing structural imbalances in production, trade, and relative prices. In addition, under guidelines approved by the Executive Board in May 1989, the Fund provides financing for bank debt and debt service reduction (DDSR) packages. ^{1/} The objective is to help a country to achieve a viable balance of payments position in the context of a medium-term growth-oriented economic program supported by a stand-by or extended arrangement, over a period when normal access to credit markets is expected to be re-established. A need for assistance arises from dealing with a debt problem that constitutes an impediment to the member's ability to realize external viability and a satisfactory rate of economic growth. The STF also is designed to help members to begin to address balance of payments difficulties associated with structural problems, in this case arising from severe disruptions of a member's traditional trade and payments arrangements due to a shift from significant reliance on trading at nonmarket prices (such as prevailed among the CMEA members and among the states of the FSU) to multilateral, market-based trade.

It remains the case that Fund resources cannot be used for general developmental purposes. In particular, such a financing role would be directly in conflict with the revolving character of the Fund's general resources. The distinction between financing to support the removal of

^{1/} See EBS/89/96.

structural impediments to growth and financing to sustain general development efforts is not, however, always an easy one to make. A key to making the distinction operational would seem to lie in ensuring that Fund resources provided under extended and ESAF arrangements are associated with strong and well-identified structural reforms that do indeed provide clear prospects for a country to attain stronger growth on a sustainable basis, while progressing adequately toward external viability--which would imply, inter alia, that the member would cease to need further recourse to exceptional financing. 1/

IV. Review of Recent Practice on Need

To illustrate how the concept of balance of payments need has been applied, a sample of arrangements was selected. In recognition of the differing objectives and duration of the various types of Fund arrangements, the sample includes stand-by and extended arrangements and arrangements under the ESAF that have been approved since 1989. 2/ The sample embraces countries facing a wide variety of external constraints. While it is generally representative of the arrangements approved during this period, the sample was selected especially to include instances where need was an issue raised in consideration of a member's request for an arrangement or a purchase under one. In the cases reviewed, need was not always dealt with explicitly in the papers prepared for the Executive Board. In most cases, it was reflected in the description of recent developments, the presentation of a medium-term balance of payments scenario, the explanation of the proposed arrangement, or the staff appraisal. In others, the need was less apparent in papers submitted to the Executive Board, but it was brought out in Executive Board discussions and reflected in subsequent staff papers.

1/ In the context of an extended arrangement, the member's policy program is expected to be adequate to achieve balance of payments viability by the time repurchases begin under the arrangement (Selected Decisions, Nineteenth issue, p. 97). For an ESAF arrangement, the policy program is expected to involve a substantial effort to strengthen the member's external payments position such that substantial progress toward medium-term balance of payments viability is achieved during the program period (Selected Decisions, Nineteenth issue, p. 42).

2/ Purchases under the compensatory mechanism of the CCF and the STF were not considered in view of the special nature of these facilities. As was set out in Section II, the terms of both facilities require a representation of need resulting from special balance of payments problems. For similar reasons, purchases of additional resources for DDSR operations also were not considered. There were no purchases under other Fund facilities and policies (i.e., the BSF and emergency assistance) during this period.

1. General resources

a. Stand-by arrangements

Among the sample of 16 stand-by arrangements for ten members, 1/ a clear and immediate balance of payments need was typically evident on the basis of the existence of measured balance of payments deficits or low levels of gross reserves. In all but three of the cases (Argentina 1991, Hungary 1993, and Uruguay 1990) sizable overall balance of payments deficits were recorded in the calendar year before the program began or, in the case of programs approved near year-end, the year in which the program began.

The experience with recent stand-by arrangements does not point to any precise level of gross reserve cover which has been interpreted as indicating low reserves. Gross reserves were generally no higher than three or four months of imports at the start of the programs surveyed; in some cases (Czech Republic in 1993, Egypt 1991, and Pakistan 1993) measured gross reserves provided less than two months of import cover. In cases where the level of reserves was significantly higher, appeal was made to a variety of factors to assess their adequacy. Higher levels of gross reserves at the start of the program period were often not sustainable, having been bolstered by the accumulation of arrears (Argentina 1991, El Salvador 1990, and Ecuador 1989 and 1991). In some instances the level of gross reserves had been increased by short-term borrowing by the central bank which, in the circumstances, could not be rolled-over (for example, Argentina 1989). The adequacy of gross reserves was also judged in the light of the vulnerability of the balance of payments to private capital outflows. In the case of Hungary (1993), the reserve position, which was equivalent to over five months of imports before the start of the program, was judged to be vulnerable, particularly in light of rising external amortization payments.

A country with low reserves may request an arrangement mainly to bolster its reserve position and to increase confidence in its economic policies. The Czech Republic's stand-by arrangement in 1993 serves as a good illustration. In the period prior to the arrangement, reserves fell to just over two weeks of import cover in the wake of the dissolution of Czechoslovakia. A front-loaded arrangement was approved as a vehicle for an

1/ The arrangements were with: Argentina (1989 and 1991), Central African Republic (1994), Chile (1993), Czech Republic (1993), Ecuador (1989 and 1991), Egypt (1991), El Salvador (1990, 1992 and 1993), Hungary (1990 and 1993), Pakistan (1993), and Uruguay (1990 and 1992). In most of these cases, a purchase was made immediately upon approval, and therefore, the member was required to make a representation of present need at that time. In the case of Chile, the first purchase under the arrangement was made within the reserve tranche. The stand-by arrangements with El Salvador were treated as precautionary and no purchases were made.

injection of reserves with the expectation that this purchase, in conjunction with the policy package it supported--which broadly represented a continuation of existing policies, including the maintenance of a fixed exchange rate--would elicit a rapid reversal of capital flight. 1/

In the case of Uruguay, gross reserves were the equivalent of 3.4 months of imports, while the deficit in the overall balance of payments amounted to roughly 0.4 percent of GDP. In addition, a balance of payments need was expected to result from the completion of a DDSR operation. This operation was viewed as helping the country toward achieving a viable balance of payments position that was consistent with a more rapid and sustainable rate of economic growth.

The way in which balance of payments need is assessed in the case of members that belong to a monetary union involves some unique features. In a fully functioning monetary union, the individual members do not hold international reserves. Rather, the union does, and it could have a balance of payments need owing to a low level of reserves--but the union is not a member of the Fund. Moreover, since the individual members do not have direct control over the reserves of the monetary union, movements in the union's reserves would not directly provide financing for the individual member's balance of payments. Consequently, the balance (surplus or deficit) in each member's external accounts would occur as a result of the member's recourse to exceptional financing (such as arrears on external debt payments).

This treatment for members of a monetary union can be illustrated by the Central African Republic's (C.A.R.) request for a stand-by arrangement in March 1994. The staff report presented a standard balance of payments table, including movements in international reserves, noting that these reserves had risen to eight months of imports at the end of 1993. However, while the rules of the Central African Monetary Area allow for this attribution to the C.A.R. of a portion of the union's commonly held reserves, these reserves are not freely available to the C.A.R. Government to meet its external obligations, since each member's access to reserves is dependent on its ability to generate resources from taxes and from bank and nonbank financing to exchange for foreign currencies. 2/ An overall deficit in the balance of payments was reflected in the C.A.R. Government's recourse to exceptional financing in the form of substantial external payments arrears to private and official creditors (including the Fund) that took place in the period prior to the approval of the stand-by arrangement.

1/ In the event, the arrangement had its intended impact; one purchase was made upon approval of the arrangement in March 1993, and this amount was repurchased in September 1993.

2/ Bank financing, in turn, is constrained by the Central Bank's statutory limit on financing to each member government.

b. Extended arrangements

Balance of payments problems to be addressed in the case of extended arrangements relate, inter alia, to structural maladjustments in production and trade, widespread distortions in prices and costs, and economies characterized by slow growth and inherently weak balance of payments positions which prevents pursuit of a more active development policy. Nevertheless, the condition of balance of payments need that must be satisfied before a member can make a purchase is the same as under a stand-by arrangement. In all of the cases reviewed, with the exception of Egypt, the member had an immediate need upon approval of the arrangement; in all cases, access took into account potential need and the prospective need that would arise as a result of the implementation of the economic policy program supported by the arrangement. 1/

Argentina's extended arrangement, which was approved in March 1992, followed two stand-by arrangements in the two previous years. At the outset, the reserve position of the central bank was improving rapidly, but the country continued to run arrears to some official creditors and to commercial creditors. Although the level of gross reserves stood at the equivalent of nine months of imports, there were concerns about the adequacy of reserves since most of them were committed to backing the monetary base under the new convertibility law and, thus, were not readily available as a cushion in the event of external shocks. The arrangement also sought to facilitate the re-establishment of external viability, inter alia, through an additional round of Paris Club reschedulings, a restructuring of Argentina's obligations to commercial banks, the elimination of arrears, and the restoration of spontaneous access to capital markets. A balance of payments need was envisaged to arise as a result of the completion of a DDSR operation. To meet this prospective need, set asides for the DDSR operation were requested. Additional financing to fill this need was to come from augmentation of the arrangement prior to the completion of the operation. In the event, the DDSR operation was not completed until the second year of the arrangement, at which time additional resources equivalent to 30 percent of old quota (21.7 percent of new quota) were provided.

In the case of Mexico's 1989 extended arrangement, a balance of payments need was evident at the start of the arrangement in that there was an overall balance of payments deficit and gross reserves had declined to the equivalent of just under two months of imports and interest payments. A prospective need was anticipated as a result of implementation of a wide ranging program of structural reforms, including further liberalization of the trade regime and the financial sector. The arrangement also was intended to support a DDSR operation, with an amount equivalent to 30 percent of the total resources made available to be set aside for this purpose. There had been a growing view in the international financial

1/ Arrangements reviewed include: Argentina (1992), Egypt (1993), Hungary (1991), and Mexico (1989).

markets that Mexico's debt could not be serviced on the basis of contractual terms and conditions agreed, a view that had been reflected in rising discounts on Mexican debt in the secondary markets. 1/ A DDSR operation was completed in the second year of the arrangement with use of set asides and the provision of additional resources amounting to 40 percent of old quota (26.6 percent of new quota).

In the latter years of the extended arrangements for Argentina and Mexico, improvements in overall balances and reserve positions exceeded expectations, as private capital inflows increased sharply. At the time of the reviews of the programs for the final year of these arrangements, 2/ both Argentina and Mexico announced their intention not to make further purchases. For Argentina, not requesting purchases was regarded as an important signal of success under the program and success in re-entering international capital markets. Mexico recorded a substantial overall surplus in the balance of payments during the program's third year; however, the extended arrangement was continued as a precautionary arrangement after the completion of the DDSR operation on the grounds that heavy reliance on foreign saving by the private sector had increased Mexico's vulnerability to adverse developments in international capital markets.

Egypt's extended arrangement, which was approved in 1993, was precautionary from the outset. Unlike under the stand-by arrangement which preceded it, there was no evidence of a measured balance of payments deficit or a low reserve position; the overall balance had recorded a surplus of close to US\$4 billion in the fiscal year before the start of the program, and reserves provided close to a full year's import cover. The arrangement envisaged the maintenance of this relatively high level of import cover in recognition of the vulnerability of the balance to payments, in part due to possible reductions in the large flow of workers' remittances. Central to achieving balance of payments viability was the impact of large-scale debt relief from official creditors, including agreed debt relief from Paris Club creditors equivalent to 50 percent of the net present value of debt service. 3/ This Paris Club agreement required that Egypt continue to have an appropriate arrangement with the Fund after the 18-month stand-by arrangement expired in 1993.

The extended arrangement approved for Hungary in 1991 sought to deal with an overall deficit in the balance of payments and pressure on the reserve position (reserves had fallen to the equivalent of two months of

1/ In the year before approval of the extended arrangement, Mexico's external debt was approximately 54 percent of GDP, and scheduled debt service amounted to over 70 percent of export earnings.

2/ The final year refers to the third year in the case of Argentina's extended arrangement and the fourth year in the case of Mexico's.

3/ In the year before approval of Egypt's extended arrangement, debt service payments amounted to under 17 percent of export earnings, taking into account the effect of debt relief.

imports) stemming from capital outflows arising out of concerns about the country's creditworthiness. These concerns also had limited Hungary's further access to the syndicated loan market. In view of the country's large debt servicing burden, the policy program supported by the arrangement also sought to accelerate the structural transformation of the economy in order to re-establish a basis for sustainable economic growth over the medium-term in the context of maintaining relations with foreign creditors and achieving a viable external position.

c. Linkages between stand-by and extended arrangements and other sources of financing

Financial support from other sources contingent on a member's relationship with the Fund has played a role in a number of stand-by arrangements. As a general rule, the Paris Club has linked agreement on debt rescheduling or reduction to the existence of a Fund arrangement. Linkages of commercial bank debt relief to arrangements with the Fund were evident in many cases (e.g., stand-by arrangements for Chile (1989) and Ecuador (1989 and 1991)). Funding from multilateral official sources has also at times been contingent on an arrangement from the Fund. The objectives of various donor and creditor groups in linking their disbursements to Fund arrangements may differ. In many cases, the purpose of the linkage is to ensure that a member's macroeconomic and structural policies are judged by the Fund to be satisfactory. ^{1/} In other cases, however, linkages appear to be motivated also by creditors' and donors' concerns about the availability of financing from the Fund, and in particular, about adequate burden sharing. From the Fund's perspective, linkages have raised some concerns that they might encourage requests for the use of Fund resources in inappropriate circumstances.

In several of the instances in which a country's access to other forms of finance was contingent upon an arrangement from the Fund, the special nature of the situation was reflected in the member's opting to treat the stand-by arrangement as precautionary, either at the outset or in the course of the arrangement. For example, El Salvador made no purchases under the 1990 stand-by arrangement even though performance criteria were met. Similarly, Uruguay indicated to the Fund that it intended to make only the first purchase under the 1992 stand-by arrangement.

In some cases, the linkage imposed by other financing sources has been explicitly tied to the making of purchases from the Fund, giving the member a strong incentive to request such purchases. Such a linkage was a common feature of commercial bank financing packages in cases involving concerted

^{1/} For a further discussion of this issue, see the companion paper "Precautionary Arrangements, Enhanced Surveillance and Program Monitoring", SM/94/298 (12/16/94).

new money flows. 1/ Conversely, "mandatory prepayment" clauses in commercial bank debt rescheduling agreements have at times linked prepayments to the banks to early repurchases to the Fund, potentially interfering with the Fund's ability to administer this policy. 2/

In providing structural and sectoral adjustment loans, the World Bank requires such quick-disbursing assistance to be justified on the basis of a member's need for balance of payments support. The World Bank views its role in providing such support as being a secondary activity. It normally relies on the Fund's assessment of the need for this type of support and expects the member also to seek resources from the Fund to meet at least part of the need. 3/ Linkages to both the existence of a Fund arrangement and to purchases under it reflect the World Bank's desire to obtain the

1/ In reviewing the experience with linkages between commercial bank new money disbursements and Fund purchases, the Executive Board in April 1991 indicated that such linkages to the making of purchases should be discouraged where feasible and accepted by a member only when necessary to obtain a satisfactory bank financing agreement in concerted financing cases. Since then, commercial banks have provided new money to the Philippines in the context of a debt restructuring package. In this case, at the urging of the staff, the authorities attempted to avoid making availability of the bank financing contingent on a purchase from the Fund, but they were not successful.

2/ Chile is a notable example. Favorable developments in the country's external position since the expiration of the most recent stand-by arrangement in 1990 have raised the possibility that Chile could be expected to make early repurchases to the Fund. A concern in this regard, however, is that payments pursuant to such expectations could be viewed by the country's bank creditors as prepayments of debt and, thus, could trigger requests from them under the mandatory prepayment clause in Chile's 1988 bank debt rescheduling agreement for Chile to make proportional repayments on its outstanding obligations to the banks; since such repayments would have adversely affected the prospective balance of payments and reserve position of the member, the intentions of the banks had to be ascertained; pending clarification of the situation with the banks, no early repurchase expectation has been established. In line with the Executive Board's recommendations in April 1991, mandatory prepayment clauses in later bank debt restructuring packages for the Philippines and Argentina explicitly avoided linking bank prepayments to early repurchases made pursuant to expectations or obligations established by the Fund.

3/ The World Bank's Operational Directive on Adjustment Lending Policy (OD 8.60 as revised December 21, 1992) indicates that it is important to ensure that a country's overall economic program is adequately funded through support by other creditors and donors, particularly the Fund which has a primary responsibility for stabilization policies (paragraph 45). Thus, the World Bank generally does not view it to be appropriate for the Bank to provide structural and sectoral adjustment loans to a member in conjunction with a precautionary arrangement from the Fund.

Fund's endorsement of an adjustment program and to ensure that the Fund provides part of the support. Exceptions to the World Bank's general requirement have been made on a case-by-case basis. In particular, there have been some cases (e.g., Colombia, Indonesia, and Nigeria) where balance of payments support has been provided by the World Bank when the member did not wish to seek an arrangement from the Fund. An exception was also made in the case of El Salvador (1993); initially, the country was expected to make purchases under what had been intended as a precautionary stand-by arrangement in order to qualify for a high level of access under a World Bank structural adjustment loan. In the event, no purchases were made under the stand-by arrangement, while the first tranche of the structural adjustment loan was disbursed. Even in exceptional cases, the World Bank provides balance of payments support only after due consultation with the Fund and only to the extent that it believes that an unfilled financing gap in the member's balance of payments can be identified.

Linkage of the availability of other financing to the existence of a Fund arrangement or to purchases under that arrangement may put pressure on a member to seek Fund financing when need may not exist in order to prevent the loss of disbursements from these other sources. In the absence of need as defined in this paper, a member cannot use the resources of the Fund. The member should avoid being put into such a potentially difficult position by discouraging linkages to a Fund arrangement, especially linkages to purchases under an arrangement. Alternatively, a member may find itself in a situation where it would be unable to finance its balance of payments deficit and/or a needed build-up in international reserves in the absence of a Fund arrangement or disbursements under it. The existence of an arrangement and the potential availability of Fund resources may serve as a catalyst in generating sufficient funding from other sources. However, other donors and creditors may insist that the member draw on the Fund to provide some share of the necessary financing for its balance of payments. While it would be appropriate for the Fund to provide financing, since in these circumstances a need would exist, the member would still be encouraged to avoid allowing rigid linkages to be established between Fund purchases and disbursements of funds from other sources.

2. Arrangements under the ESAF

As discussed above, approval of a three-year arrangement under the ESAF is conditioned on a finding that an ESAF-eligible member has a protracted balance of payments problem. Access under the arrangement is determined based on an assessment of the member's present and prospective balance of payments need, with the access being reviewed in the context of each annual arrangement on the same basis. In most cases, the assessment of need under an ESAF arrangement, at least initially, was not problematic since underlying difficulties in external positions were evident, indicating the existence of protracted problems. Balance of payments need already existed or was expected to emerge as a consequence of the adoption of growth-oriented macroeconomic and structural adjustment programs. In time, however, the question of need became more problematic in some cases as

countries successfully completed their three-year arrangements. This section focuses on the limited number of cases in which the question of need has been at issue.

Protracted balance of payments problems existed in all of the ESAF cases surveyed at the time of approval of the arrangements. 1/ In determining access, the measured overall external balance in the year before the first annual program was in surplus in the majority of cases and was projected to remain in surplus; however, gross international reserves were judged to be inadequate, especially considering the narrow base of exports and their vulnerability to shocks. 2/ The dependence of ESAF-eligible countries on concessional financing and their related lack of access to commercial sources of finance (other than limited trade credits) also tended to simplify the assessment of the adequacy of gross reserves. There was generally no possibility that reserves could be augmented by a country through recourse to borrowing from commercial sources. Moreover, the policy programs supported by these arrangements, with their emphasis on structural reforms, were expected to give rise to a balance of payments need.

In the case of Nepal, however, concern was expressed by several Directors at the time of the Executive Board's consideration of the three-year ESAF arrangement and the first annual arrangement thereunder (1992) that no clear argument for need had been presented in the staff report. 3/ In the year before the approval of the arrangement, Nepal's gross international reserves provided 5.7 months of import cover, while the overall balance of payments was in surplus. In the course of the Board discussion, appeal was made to a variety of factors to explain the nature of Nepal's prospective balance of payments need during the program period. The staff argued that a need would emerge with implementation of the program's medium-term economic reforms, which placed heavy emphasis on trade and foreign exchange liberalization. Considerable emphasis in the discussion was placed on the catalytic role to be played by the arrangement in the face of the country's potentially large external financing needs, and the point also was made that recent experience had shown the vulnerability of Nepal's reserve position to exogenous shocks. The issue of balance of payments need was addressed explicitly in Nepal's requests for a second annual arrangement under the ESAF in April 1994. At that time, the overall external balance remained in surplus, and gross reserves exceeded six months of imports. It

1/ The countries covered include Bangladesh, The Gambia, Ghana, Nepal, and Zimbabwe.

2/ As was noted in the Review of Experience under ESAF Supported Arrangements (EBS/93/16, Table 11, p. 48), on average a single export accounted for 55 percent and the two leading commodities more than 70 percent of export receipts in the year prior to the first SAF or ESAF arrangement.

3/ The staff representative also indicated that the report had not been as explicit as it should have been in presenting an assessment of Nepal's balance of payments need.

was argued in the staff report, however, that this level of reserves was in part due to private capital inflows whose sustainability was in doubt. A relatively high level of reserves was again justified by the country's narrow export base, its related vulnerability to exogenous shocks, and the fact that wide-ranging trade liberalization would continue to affect the balance of payments. 1/

As the other countries reviewed here progressed to second and third year arrangements under the ESAF, considerations in assessing balance of payments need shifted more toward the prospective emergence of a need as economic policy programs made headway in addressing the factors contributing to an underlying weakness in the countries' external positions. This was especially true in the programs which were successful in alleviating more immediate pressures on gross international reserves through the adoption of appropriate macroeconomic policies. 2/ The case of Zimbabwe was a notable exception. At the time of the request for a second annual arrangement in February 1994, usable gross reserves continued to be judged to be low, in that the figures on the country's gross reserves included various earmarked and illiquid items.

Ghana's performance under its three-year ESAF arrangement was closely in line with the projections included in the initial request for an arrangement in 1988. At the end of the three-year period, during which overall payments surpluses were achieved, in line with programmed levels, reserves rose to over four months of imports, as originally projected. In recognition of this sustained improvement, it was envisaged at the time of approval of the third annual arrangement that the use of Fund resources would not be needed, barring exceptional circumstances, beyond the end of the arrangement. 3/

In addition to the absence of an immediate balance of payments need, as evidenced by overall external surpluses and an adequate level of reserves, no underlying need was judged to be readily apparent in Ghana's case after the end of the third annual arrangement. Although dependence on concessional financing remained high, use of strengthened consultation

1/ Moreover, as noted in Section II, access under an ESAF arrangement cannot be reduced (or approval of the second and third annual arrangements withheld) unless there have been developments in the member's balance of payments position that are substantially more favorable than envisaged at the time of the approval of the three-year arrangement and the improvement, in particular, derives from improvements in the external environment.

2/ Reviewing the experience for all SAF and ESAF arrangements, EBS/93/16 noted that on average import cover for the 19 countries that had arrangements increased from 2.4 to 3.5 months of imports; only four countries suffered declines in reserve cover over the complete period covered by these arrangements (See Table 11, p. 48).

3/ In the event Ghana did make further use of Fund resources, with a purchase of SDR 47 million under the CCFF in 1993.

procedures was expected to provide a framework that would facilitate continued assistance from donors, without the need for Fund financing to play a catalytic role. Since the strengthening of the external position occurred against the background of strong economic growth, there was no suggestion that the balance of payments position was sustainable at only low rates of growth. 1/ During the three annual arrangements under the ESAF, Ghana had continued to implement a wide-ranging program of structural reforms, including a liberalization of the foreign exchange market, the unification of the exchange rate, and sharp reductions in the de facto export taxation of cocoa via increases in the domestic producer price. By the end of the arrangement, major structural impediments to growth had been removed, with the implication that the balance of payments and reserve position was not being supported by distortionary restrictions, and that further reforms, per se, would not give rise to an immediate balance of payments need.

The Gambia moved to the use of the enhanced surveillance procedure in 1993 after the completion of its third annual arrangement under the ESAF. In the year before this procedure began, gross reserves stood at five months of imports, and the authorities agreed that the improvement in the country's external position and the outlook for the year ahead implied that there would be no need for further financial assistance from the Fund. As in the case of Ghana, extensive structural reforms had helped bring about a resumption of growth with lower inflation. However, with very heavy reliance on concessional financing and continued vulnerability to external shocks, it was recognized that the balance of payments remained vulnerable. 2/

Bangladesh also adopted a program under the procedures for enhanced surveillance in 1993 upon completion of its third annual arrangement under the ESAF. Over the course of that ESAF arrangement, developments in the overall balance of payments were more favorable than expected and reserves rose to over six month of imports, and more rapid than envisaged progress was made in bringing down inflation. All of this was achieved, however, in the context of economic growth that consistently fell well short of expectations. As was recognized at the time of Bangladesh's request for

1/ The external debt burden had also fallen even more sharply than originally programmed; debt service declined from almost 70 percent of exports of goods and services in 1988 to under 30 percent at the end of the third year of the ESAF.

2/ In the case of The Gambia, the question of another ESAF arrangement arose in the aftermath of the devaluation of the CFA franc. The Gambia's re-export trade collapsed following the devaluation, trade liberalization in the CFA zone, and the enforcement of normal customs regulations for border trade with Senegal. In the event, political uncertainties in the wake of a military coup d'Etat in July 1994 and the suspension of foreign aid programs have delayed discussions on a medium-term economic policy program.

enhanced surveillance, the success attained under the ESAF arrangement toward macroeconomic stability had not been matched by comparable progress in key areas of structural reform.

By the end of the ESAF arrangement, Bangladesh had no immediate balance of payments need, but neither had there been a breakthrough to faster growth with external viability. The decision to monitor the program under enhanced surveillance, rather than support it through a further ESAF arrangement, was in part based on an assessment that the economic program proposed by the authorities was not sufficiently strong to address needed areas of structural reform. It could be argued that the country continued to face a protracted balance of payments problem and an underlying balance of payments need in the sense that the improvement in the external position had been attained in conjunction with growth rates that fell well below projections or potential.