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INTERNATIONAL MONETARY FUND

#4 Minutes of Executive Board Meeting 79/19

3:00 p.m., February 6, 1979

W. B. Dale, Acting Chairman

Executive Directors

J. Amuzegar
S. Y. Cross

S. D. Deshmukh

B. J. Drabble
M. Finaish
F. Garcés
M. B. Jalal
A. Kafka
B. Kharmawan
M. Matsunaga

E. Pieske
H. O. Ruding

R. J. Whitelaw

Alternate Executive Directors

M. Yeganeh

H. G. Schneider

C. P. Caranicas

Y. A. Nimatallah
T. A. Harewood
S. Siwatibau
R. Masunaga
D. Samuel-Lajeunesse
C. Chipeta, Temporary
A. Buira
C. Bouchard, Temporary
G. Laske
T. de Vries
P. Kent
G. Blöndal
R. J. Lang

L. Van Houtven, Secretary
R. S. Franklin, Assistant

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Also Present

Sir Richard King, Executive Secretary, Development Committee;
A. Karaosmanoglu, Director, Development Policy, IBRD. African Department:
O. B. Makalou, Deputy Director. European Department: S. L. Rothman.
Exchange and Trade Relations Department: E. Sturc, Director; D. K. Palmer,
Deputy Director. Legal Department: G. P. Nicoletopoulos, Associate
General Counsel; P. R. Lachman. Research Department: J. J. Polak,
Economic Counsellor and Director; G. I. Brown, K.-Y. Chu, L. U. Ecevit,
L. M. Goreux, E. C. Hwa, N. M. Kaibni, G. Khatchadourian, K. Krishnamurty,
J. S. Smith, P. C. Ugolini. Treasurer's Department: D. S. Cutler,
W. J. Shields. Information Office: H. Hartmann. Assistants to Executive
Directors: T. K. Ahmad, H. G. Askari, C. J. Bailey, I. K. M. Björk-Klevby,
R. De Beckker, K. L. Deshpande, W.-D. Donecker, L. E. Escobar, E. P. Fine,
H. Flinch, J. A. Fraser, J. Guill, G. Haller, M. A. Janjua, A. Karimi,
K. W. Kim, T. Kitamura, R. E. Myers, V. K. S. Nair, J. R. Novaes de Almeida,
P. Peroz, A. V. Romualdez, M. Shadman, G. Suárez, P. S. Tjokronegoro,
A. van der Hal.

1. COMPENSATORY FINANCING FACILITY - POSSIBLE CHANGES

The Executive Directors continued from the previous meeting (EBM/79/18, 2/6/79) their consideration of a preliminary staff paper on possible changes in the compensatory financing facility (SM/79/24, 1/19/79; Sup. 1, 1/23/79; and Sup. 2, 2/2/79).

Mr. Jalal felt that the compensatory financing facility could be expanded to accommodate more fully the need for short-term financing of export shortfalls beyond direct government control. At present, the size of the drawing as measured by need, even after the liberalization of the facility in 1975, was still restricted by the quota limitation. Moreover, the facility was biased against countries heavily dependent upon services.

His authorities had given strong support to the Common Fund, Mr. Jalal continued, and in that spirit he welcomed the German proposal. However, as the staff had observed, the idea of a separate commodity window had its shortcomings, particularly with respect to the list of commodities to be covered; for example, he saw no justification for excluding oil from the list. Export stabilization schemes limited to specific categories of exports might induce an inappropriate pattern of export specialization over the long term.

He would have preferred to see an attempt to relate the German proposal to the Common Fund rather than the compensatory financing facility, Mr. Jalal remarked. As any separate commodity window was bound to have the same general objective as the compensatory financing facility, there was likely to be some duplication, leading to an increase in administrative burdens for donor and recipient countries alike and to the likelihood of double compensation. His authorities could support the establishment of a commodity window if all commodities were to be included and if the window was coordinated with the Common Fund. However, as the staff had pointed out, a modified and extended compensatory financing facility might be preferable.

There were three overriding goals, Mr. Jalal considered, in the operation of the compensatory financing facility: to assist countries to the extent of their shortfall; to provide equitable treatment for all countries, particularly by eliminating commodity biases; and to eliminate requests based on illogical or marginal shortfalls. In order to attain those goals, certain modifications to the facility were necessary. First, drawings should be expanded to cover the calculated shortfall without being limited by the size of a member's quota. As a second-best approach, he could support a larger drawing in relation to quota, or some combination of the shortfall and the quota restriction, whichever was the greater. If it would help to make the suggested increase more acceptable, he could also go along with the 2 per cent deductibility clause, although he would not support such a provision without agreement on an increase in the availability of resources.

Second, Mr. Jalal stated, he would propose that services be included in the definition of exports in order to put all exports on an equal basis and prevent any bias in favor of certain countries. Finally, the geometric average should be employed in calculating the extent of the shortfall, although in cases where there were erratic movements it might be possible to envisage some combination of the geometric and arithmetic calculations. While on the subject of methods of calculation, he noted that the calculated shortfall was less than the actual shortfall when the short-term averaging method was used. In the case of arithmetic averaging, the maximum possible drawing was 80 per cent of the actual shortfall; that was logical because long-term averaging was impossible, and in any event imports declined along with exports, although after a lag. Hence, the implicit assumption that there was 80 per cent value added in exports would seem reasonable. On the other hand, if the overall import content of exports was below or above that differential, an appropriate adjustment should perhaps be made. In addition, given the principle that one country's exports were another's imports, and that the trade balance was determined by the level of both exports and imports, he would be receptive to the inclusion of the cost of uncontrollable imports--such as cereal imports--in the calculation, not as a separate item but subtracted from exports. Thus, when exports were above the trend and the increase in the cost of cereal imports equaled the export boom, no compensatory financing facility drawing should be forthcoming.

Mr. Kafka considered that since the German proposal was a complement to the compensatory financing facility and to a possible Common Fund, it required serious study. While he did not wish to present a definitive opinion as to whether a commodity window should be implemented inside or outside the Fund, his preliminary reaction was that it might be easier to handle if it was set up outside the Fund. In general, because a study of the implications of setting up a commodity window would require some time, the question should perhaps be deferred until after consideration had been given to improvements in the compensatory financing facility.

It was his feeling, Mr. Kafka continued, that the quota limits of the compensatory financing facility should be raised to at least 75/100 per cent, although he would prefer to increase access to the facility to the extent of the shortfall. Moreover, services should be included among the compensable items, although at the option of the member, since requiring the inclusion of services could create difficulties--statistical and otherwise--for certain members. He did not see the option as a short-term one; rather, it should be a choice that would remain in effect for a number of years.

His authorities maintained an objection to the application of a geometric average in calculating the shortfall, since such a method would penalize fast growing countries, not all of which could be considered well off, Mr. Kafka said. They also opposed any additional conditionality, which would not be in accordance with the logic of a facility that was addressed to short-term, self-reversing shortfalls. He was uncomfortable with the idea of a deductible--even one as low as 2 per cent--or a minimum threshold, since what was a negligible shortfall for one country might not

be so for another. Finally, he would prefer the calculations of the shortfalls to be made in nominal rather than real terms, unless an index or deflator could be used for each country.

Mr. Deshmukh remarked that the staff paper pointed up the discrepancy between the needs of countries that had come about because of a reduction in their export earnings and the assistance those countries had sought under the compensatory financing facility. On page 5 of SM/79/24, it was mentioned that, in the past three years, 46 developing countries had been able to draw only SDR 1.9 billion under the existing compensatory financing scheme. Had there been a commodity window, the drawings could have amounted to SDR 2.7 billion, and even that figure did not take into account the possibility of including services among the compensable items. It was therefore clearly necessary for the Executive Board to arrive at a compromise formula that would enable countries to reduce the large discrepancy between their potential needs and actual drawings under various facilities.

With respect to the method used to calculate the shortfall, Mr. Deshmukh commented that the suggested advantage of changing to the geometric average was perhaps not so significant when one considered the complications that the introduction of such a method would create. He also tended to agree with Mr. Kafka that certain countries experiencing a sharp rise in their exports would stand to lose under the geometric average calculation. Nonetheless, he had an open mind on the matter. He was not, however, so agnostic about the proposal for a 2 per cent deductible, which he found penalizing and arbitrary, at least by comparison with the principle of a threshold. Moreover, if the effects of a 2 per cent deductible were superimposed on the effects of a transition from the arithmetic to the geometric average, the results could be disastrous. Hence, barring some as yet undefined justification, he would resist the proposal for a 2 per cent deductible.

The Swedish variation of the German proposal was of value, particularly as it suggested a larger list of compensable commodities, Mr. Deshmukh said. Groundnuts, for example, had not been included in the German proposal; yet for certain African countries--particularly The Gambia--a large percentage of total exports consisted of that one commodity. Services, too, should perhaps be included in the calculations, although not all countries would derive equal benefit from the inclusion of services. Perhaps the countries themselves should be left to determine whether services should be part of the calculations.

Another constraint to drawings was created by the quota limits, which should be raised from the current level to at least 75/100 per cent, Mr. Deshmukh considered. In that connection, he would welcome in any subsequent staff paper a simulation showing shortfalls of merchandise and commodities under the arithmetic average without a deductible, and without the constraint of quota limits.

Finally, he had an open mind on whether a new commodity window should be created or whether it would suffice to make improvements in the Fund's compensatory financing facility, Mr. Deshmukh remarked. He hoped to elicit the views of his authorities on the question and present their position more clearly in future discussions.

Mr. Garcés felt that the German proposal and the other matters suggested in the guidelines for a further study on stabilization of export earnings by the Senior Officials of the Development Committee--found on page 7 of the Annex to SM/79/24--merited further study. However, since the compensatory financing facility would continue to make an important contribution to the stabilization of export earnings, he would concentrate his comments on independent improvements that the Executive Board could make to the facility. First, his authorities would welcome a relaxation of the quota limitation so that access to the facility could be expanded to at least 100 per cent of quota, assuming that such an increase did not unduly impair the Fund's liquidity. Given the growth of export earnings and fluctuations in relation to quota, an expansion of the quota limit was clearly warranted. His authorities also favored the inclusion of services in the calculation of export earnings, at the option of members, for members that could provide adequate data. As the staff had demonstrated, the inclusion of services reduced the index of fluctuations but did not reduce drawings. In that connection, he wondered why the index had been constructed as the sum of shortfalls over the sum of export earnings. Would it not have been preferable to use the concept of variance, which more adequately reflected what it was intended to measure?

With regard to the computation of the shortfall, Mr. Garcés said that he could go along with the maintenance of the arithmetic average. If it was agreed to change to a geometric average, the calculation should be made in real terms. On the question of the 2 per cent deductible, he would prefer to see the 2 per cent used as a trigger for compensation and then compensate for the full shortfall, as suggested by Mr. Pieske.

The issue of conditionality had been raised in the previous meeting, Mr. Garcés recalled. As the compensatory financing decision specified that resources could be used only in cases where the shortfall was temporary and beyond the control of the authorities, he saw no need to make access to the facility conditional on a program that was not required by the underlying economic conditions. Liberalizing the facility by removing conditionality and by adopting the measures he had mentioned previously would go a long way toward meeting the needs of members. If the German proposal was nonetheless considered, any new facility established in connection with stabilization of export earnings should be nondiscriminatory, both toward individual countries and with respect to commodity coverage; and its resources should be available in addition to compensation provided under the compensatory financing facility.

Mr. Samuel-Lajeunesse, recalling the general position of France on the primary commodities question, remarked that efforts should be mainly directed toward the conclusion of individual commodity agreements and toward the setting up of the Common Fund. It was the opinion of his authorities, therefore, that other mechanisms--including those designed to provide compensatory financing--should complement and enhance that primary goal. His authorities had always been openminded on the possibility of improving existing mechanisms in the field of primary commodities--such as the compensatory financing facility and STABEX--and such an effort seemed

more appropriate at the moment than any suggestion for setting up new mechanisms. The staff study of the German proposal demonstrated that a new commodity window was probably not desirable, as it would entail additional administrative costs and raise various problems, including that of double compensation. A facility based on the German proposal would have meant at least a doubling of the amounts provided in past years to the beneficiaries of the compensatory financing facility, and according to staff estimates those costs would be even higher during the next ten years than the \$5 billion estimated in the German proposal. Such new expenditures might create liquidity problems for the Fund. Moreover, if the Fund was to borrow in order to finance the facility, it would encounter difficulties with respect to eligibility criteria, a subsidy account, and conditionality. It would thus be preferable to work toward adaptations of the compensatory financing facility of the sort mentioned in the staff paper.

One of the improvements favored by his authorities was a widening of the availability of drawings under the present compensatory financing facility, Mr. Samuel-Lajeunesse continued. He found merit in the idea of calculating drawings on the basis of both total merchandise and primary commodity shortfalls. While his authorities had no strong opinions on the method of calculation, they did find the geometric average logical. They could also accept the inclusion of services in the calculation of merchandise shortfalls.

In general, Mr. Samuel-Lajeunesse felt, most of the proposals suggested by the staff could be useful as a means of adjusting the compensatory financing facility in order to meet the real balance of payments needs of primary product exporters and to take more fully into consideration the needs of the poorest among them. Having said that, however, he did wish to express doubts about two of the suggested measures. First, he questioned the idea of the 2 per cent deductible, the arguments for which were unconvincing; moreover, the figure of 2 per cent seemed arbitrary and could appear high in certain cases. He also had serious doubts about the concept of opening a second window of compensatory financing without any quota limitations, because that would run counter to principles maintained by the Fund with respect to drawings. Moreover, without quota limitations, the financial equilibrium of the Fund might be placed in jeopardy over the long term. On the other hand, his authorities might be willing to accept an increase from the present 50/75 per cent limit.

Mr. Matsunaga stated that his authorities placed great importance on the necessity of stabilizing export earnings and providing sufficient assistance to countries encountering a shortfall in those earnings. It was in that spirit that Japan had taken a positive attitude toward the question of the Common Fund, which was being discussed in the UNCTAD. In a like manner, he welcomed the initiative of Germany in presenting a proposal to give further assistance for the shortfalls that would be faced by primary producing countries.

Nevertheless, Mr. Matsunaga continued, the adequacy of the existing compensatory financing facility should be reviewed before any serious study was taken up on the new proposal. Were the resources available under the compensatory financing facility adequate to meet the needs of members? And was there a need to improve any aspects of the administration of the facility? Only after those issues had been studied would it be appropriate to look in any detail at new proposals, although his preliminary reaction was that a scheme like the German proposal would be better operated outside the Fund, particularly since it contained certain elements of a discriminatory nature that were in opposition to Fund principles. If it was the wish of the international community to have a special commodity window outside the Fund, whether administered by the Fund or not, the advantages and disadvantages should be carefully considered. The major advantage of a separate commodity window outside the Fund was that there would be no limitation based on balance of payments need, and emphasis could be placed on giving assistance to certain groups of countries, particularly the poorest. The disadvantages included the difficulties involved in financing the scheme--including the increases in administrative costs--and the problem of double compensation.

On the possibility of improving the existing compensatory financing facility, Mr. Matsunaga stated that it might be appropriate to raise the quota limitations, although any thought of doing so should take into account the Seventh Quota Review increases. One should also look closely at the proportion of assistance given under strict conditionality to any assistance given under less strict conditionality. On the matter of the method used for calculating the shortfall he, like others, had observed some logic in the geometric approach; on the other hand, it was important to be aware of the implications such a formula would have for individual countries, and it might take more than logic alone to justify a change from the arithmetic approach.

The 2 per cent deductible concept should certainly be examined as part of a package of other potential improvements being considered for the compensatory financing facility, Mr. Matsunaga said, although the impact of such a measure on the liquidity position of the Fund should carry some weight in the decision whether or not to implement it. He had no difficulty with the inclusion of services in the list of compensable items, particularly since in most cases a shortfall in earnings from services was beyond the control of the authorities. Nonetheless, the question of including services in the calculation did involve certain technical questions--including whether or not the inclusion should be at the option of individual members--and more study of the matter was needed before he could take a position on it. Finally, he agreed with Mr. Kharmawan that, since the question of the stabilization of export earnings was being discussed in several international fora, any review by the Executive Directors of the compensatory financing facility should pay due attention to the work being carried out elsewhere.

Mr. Finaish remarked that his task had been made considerably easier by earlier speakers who had expressed views on a number of points that were broadly similar to his own. In particular, he wished to thank Mr. Whitelaw, who, in his excellent presentation, had made reference to Pakistan as a member country that would be one of the biggest losers under the new arrangements suggested in the staff paper. In fact, all the countries in his constituency that had made use of resources under the compensatory financing facility would be worse off under the suggested arrangements.

He supported a liberalization of the compensatory financing facility, Mr. Finaish continued. Resources under the facility had been available for a number of years, but only a small part of the resources available had been utilized. The underutilization was largely attributable to the conditionality in the use of such resources, including the quota limits on drawings. The liberalization of the compensatory financing facility in 1975 had led to greater utilization of resources. The need for further liberalization of the facility and hence greater utilization of those resources might be seen as a part of overall pressures on the balance of payments of developing countries and on the means of financing such deficits. The oil facility had served a useful purpose, but it had ceased to exist. Since access to borrowing from market sources was limited for a large number of countries for one reason or another, some arrangement should perhaps be made for allowing those countries greater access to the compensatory financing facility.

Assuming the case for a further liberalization of the facility was prima facie genuine, the suggestions for the use of the geometric average and a 2 per cent deductible would not be helpful, Mr. Finaish considered; both changes would lead to a reduction in access to resources under the compensatory financing facility. The geometric average had merits as a theoretical approach but was at variance with the actual behavior of exports of developing countries, and the 2 per cent deductible was designed primarily to safeguard the use of Fund resources. Those suggestions stemmed from the somewhat arbitrary assumptions that countries making use of the facility had comfortable foreign exchange reserves and that the effects of the changes would not constitute any constraint on the policies of those countries. While such changes might make it easier to define countries that were more clearly deserving of additional resources, they would at the same time reduce the amount of resources available under the facility and thus be counterproductive. A more useful change would be a liberalization of the quota limits to the maximum extent possible. That would benefit developing countries, particularly those in the Trust Fund groups. His chair supported raising the quota limits to the maximum extent possible. The fact was that the shortfall as a part of the trend constituted a limit by itself.

The staff suggestion that some aspects of the German proposal be combined with the compensatory financing facility would be favorable to countries heavily dependent on commodity exports, Mr. Finaish felt,

although those with broad-based export structures would be penalized. Hence, he would support the idea that the compensatory financing facility should be expanded and liberalized and that the German proposal should be taken up independently.

Conceptually, Mr. Finaish continued, there were three types of short-fall: in commodity exports, in total merchandise exports, and in the total exports of merchandise plus services. In recent years, invisible earnings had become an important part of the total foreign exchange earnings of a number of countries, and any fluctuations in those earnings--which at times could be beyond the control of the authorities--could become a major policy constraint. Since the calculations in the staff paper suggested that quota liberalization alone would be insufficient to allow member countries full access to the resources under the facility, his authorities suggested that the list of export items be expanded and that services be included at the option of the member concerned.

A number of Executive Directors had made references to the question of oil, Mr. Finaish recalled. It would be helpful to know for what substantive reasons oil had been excluded from different proposals. The export of oil was vulnerable to various hazards beyond the control of a member. It would have been better to expand commodity coverage under the various proposals without creating any impression that discriminatory treatment was being accorded. In general, he found the staff paper to be somewhat limiting in its approach to a review of the compensatory financing facility; if only those proposals put forth in the paper were followed, access to the Fund's resources would be made more restrictive rather than liberal. Various other suggestions for liberalizing the facility and making it more accessible to deserving countries had been discussed in other fora, and he was somewhat surprised that those suggestions had not been taken into account in the staff paper. For example, export shortfalls should be calculated taking account of changes in import prices and various growth factors; moreover, increased import volumes resulting from factors beyond the control of a member should also be included in the calculation of shortfalls. If the intention was indeed to make improvements in the compensatory financing facility, suggestions such as those he had mentioned should be given due consideration.

Mr. Caranicas, speaking personally, agreed with Mr. Schneider that the Fund had been the most effective among the international agencies in helping developing countries to overcome export shortfalls. That did not, of course, mean that the facility could not be improved, although it was difficult to know what direction to take when the question was being discussed so often in so many different fora.

In principle, his authorities were not against including services--particularly tourism and workers' remittances--in the list of compensable items, Mr. Caranicas continued. In one country in his constituency,

tourism in some years accounted for more than \$1.5 billion in earnings, but it was subject to violent fluctuations, as had been seen in 1974 when receipts had decreased by some 50 per cent. Similar unpredictable fluctuations occurred with respect to workers' remittances. Hence, the possibility of including services under the compensatory financing facility should be seriously studied.

With respect to the calculation of the shortfall, Mr. Caranicas commented that two aspects should be given consideration. First, because it was on the classification of countries that the calculations by the staff were based, the method chosen to classify countries was important. The classification of countries as defined in the Fund's Annual Report would be more useful than the one currently employed that did not make clear distinctions between or among the so-called developed countries and the primary producing countries. Second, his authorities were in favor of using the geometric average rather than the arithmetic average to calculate the trend value, for reasons explained by the staff in its paper. On the question of the 2 per cent deductible, he did not wish to comment without further elaboration by the staff; some speakers had suggested that the proposal was arbitrary, and he would welcome staff explanations of why the 2 per cent figure had been chosen.

On the German proposal, Mr. Caranicas agreed with the staff that it might be wise to integrate some of the features of the scheme into the existing compensatory financing facility, rather than to consider a separate commodity window in the Fund. While he was not averse to studying the proposal and would welcome further clarification, he tended to feel that the possibility of improving the compensatory financing facility should be looked at first.

One point that had not been touched upon by other speakers was the question of alleviating the effects of medium-term export problems of developing countries, Mr. Caranicas observed. The staff had mentioned the matter by alluding to the expansion of program lending in the World Bank, and it might be useful for the Fund to pay attention to that operation and its limitations in considering its own lending.

Mr. Bouchard said that his authorities would be in agreement with any suggestions that might improve access to the compensatory financing facility, whether by easing conditionality, raising quota limits, including services, changing the computation of the shortfall, or expanding the coverage of commodities. Moreover, they were inclined to agree with the suggestion by the staff that the compensatory financing facility might be amended to include some of the elements contained in the proposal put forward by the German authorities. To the extent that such changes would have the effect of reducing drawings by more developed countries while increasing purchases by developing countries--especially those deriving most of their earnings from primary commodities--his authorities would have no hesitation in going along with them,

particularly since they believed that the benefits of the compensatory financing facility should accrue first and foremost to the developing countries.

Mr. Cross commented that the staff paper raised a great many questions, some of which might best be considered in discussions on other topics. Where the paper did concentrate on the review of the compensatory financing facility, it tended to presume that the current export stabilization system and Fund facility were inadequate and that the need for modification was self-evident. He agreed with Mr. Matsunaga that the question of the adequacy of the compensatory financing facility had not yet been properly addressed and that the Fund should perhaps analyze more fully the impact of the changes in the facility that had been made in 1975 before looking at the possibilities for further changes. If, after a thorough review, it could be shown that the existing facility was inadequate, he would certainly be prepared to consider appropriate modifications.

The review should examine the experience of conditionality, particularly with regard to drawings in the first 50 per cent of quota, Mr. Cross felt; it should encompass the nature of the shortfall, including its "temporariness" and whether or not it was beyond the control of the authorities; and it should look closely at the policy responses of the authorities. Another question to consider was the possibility of eliminating shortfalls that arose from a new discovery or product. If a country discovered some exportable item that led in two years' time to a substantial rise in exports, it then had a prima facie shortfall for which it could seek financing, but he continued to wonder whether it was appropriate for the Fund to finance such shortfalls. Another question concerned the financing of buffer stocks by the compensatory financing facility, a theoretical possibility of which the appropriateness should be closely examined. Some modifications designed to prevent double compensation or reduce drawings against "unconvincing arithmetic shortfalls" should certainly be discussed.

With respect to the issue of the best method for calculating shortfalls, Mr. Cross considered that the geometric average would probably have been preferred if the Fund were beginning the compensatory financing facility afresh. However, whether it was appropriate at the present stage to make the change from the arithmetic to the geometric average was open to question. Proposals to include certain imports in the calculations or to consider shortfalls in real rather than nominal terms had not been argued convincingly. In general, all the suggested modifications raised complicated issues that would require much more analysis and discussion than had thus far been attempted, and while he appreciated the staff's effort to present a wide range of possibilities in a single paper, Executive Directors should narrow the focus and concentrate over the next few weeks on examining the adequacy of existing facilities and, if necessary, possible ways of improving them.

The Economic Counsellor observed that the purpose of the staff paper had been to give Executive Directors a variety of possible changes without attempting to promote or oppose any of them. The discussion seemed to suggest that there was little desire to have a new commodity window as part of the Fund's compensatory financing facility. That view had been shared by various Executive Directors with differing attitudes toward the facility. In any event, as Mr. Whitelaw had noted, similar results could be obtained by an appropriate increase in quota limits. The German proposal could, of course, be considered on its own, without prejudice to the question whether the Fund might be the manager or trustee of any such operation if it came into being.

Several Executive Directors had raised the question of discrimination, the Economic Counsellor recalled. He did not feel that any measures in the paper were discriminatory in the sense of applying different rules for different sets of countries. It was true that the geometric average and the 2 per cent deductible had differential effects on different groups of countries, but those measures had merits on their own and would have been supported by the staff independent of the differential effects on different groups of countries. Certainly the deductible was superior to the concept of a threshold, under which a country just below the threshold level had to pay for its shortfall entirely by itself, while one just above the threshold qualified for outside financing for the full amount.

Various aspects of conditionality and the question whether or not shortfalls were temporary or beyond the control of the member were perhaps best taken up during the review of the compensatory financing facility, the Economic Counsellor considered. However, he believed that no firm solutions would ever be found to such questions and that the case-by-case approach currently employed would continue to be the most useful. Mr. Drabble had questioned whether a numerical approach was possible in determining whether a shortfall was truly beyond the control of the member or whether further policy changes were required. He was inclined to believe that the application of degrees of conditionality based on percentages of quota was the only workable way to ensure that the Fund did not make too much money available with light conditionality in situations in which policy changes were clearly necessary.

The list of questions offered by Mr. Ruding provided the core of a number of matters with which the Executive Board would have to deal when it came to its complete review of the compensatory financing facility in March, the Economic Counsellor stated. The question of medium-term shortfalls was beyond the scope of the compensatory financing facility, although it certainly needed to be studied. The matter of special repurchases had been the subject of an extensive discussion in the Executive Board in June 1978, at which time it had been concluded that Executive Directors did not favor changing the provisions on repurchase. With regard to stock adjustments, it was perhaps better to continue to apply the existing policy on a case-by-case basis in view of the Board's earlier discussion on that matter. The degree of cooperation expected of a member

and the degree of conditionality required had also been fully discussed at a previous meeting. The staff had suggested that the same degree of conditionality as was applied to first credit tranche drawings be applied to third tranche drawings under the compensatory financing facility; that proposal had not met with favor, however, and it had been concluded that above 50 per cent of quota an appropriate degree of conditionality should be applied, but that general rules about what was "appropriate" could not be formulated. The matter of double compensation--which was dealt with in the Annex to the staff paper--should appear on the agenda of the review of the compensatory financing facility, as should Mr. Ruding's suggestion to drop the formula. Mr. Ruding's last point--the possibility of making calculations in real terms--had encountered much opposition when it had been considered in June, although the matter could certainly be included among those to be discussed in the March review. Most of the matters, of course, had been well argued both in staff papers and in the Executive Board, although the provision of additional information could lead to some new argumentation.

The staff representative from the Research Department, commenting on the geometric average, recalled that several Directors had asked whether the staff was not being contradictory in expressing a preference for the geometric average when random fluctuations were being dealt with. He did not believe that a contradiction existed, since the nominal value of export earnings could fluctuate randomly around an upward trend representing the combined effects of inflation and growth in real exports. With such a model, random fluctuations had to be measured as the deviation from the trend, and the measurement of the random fluctuations would be improved by improving the measurement of the trend. Whether the model provided a reasonable representation of actual export earnings, and whether the trend was arithmetic or geometric, could be tested statistically. That had been done for 71 countries for the 20-year period 1957 through 1976. The model based on a geometric trend gave a good statistical fit, which was improved when a dummy variable was introduced to take into account the acceleration of inflation after 1970. The fit was especially good for the more developed primary producing countries. For those countries, 97 per cent of the variance in export earnings was explained by the geometric trend factor when the acceleration of inflation after 1970 was taken into account by a dummy variable.

For 63 of the 71 countries, the geometric trend provided a better statistical fit than the arithmetic trend, the staff representative continued. For the eight remaining countries, the average growth rate was only 2.2 per cent per year, and the growth rate was not statistically different from zero in half those eight cases. Moreover, in the rare cases where the arithmetic average might have provided a better statistical fit, the use of a geometric average would hardly have made a difference in the calculation of the shortfall because the growth rate of export earnings was very low. The staff could easily provide the statistical background if it was considered useful by Executive Directors.

The Associate General Counsel, responding to questions on the institutional relationship between the Fund and the so-called commodity window under the German proposal, noted that the commodity window would be difficult to establish within the Fund, either as a separate facility or as a variation of the compensatory financing facility. The reasons for the difficulty were clear: the facility would make financing available without reference to balance of payments need; nonmembers would be included among the beneficiaries; and the scheme was intended to provide aid rather than balance of payments financing. Moreover, the shortfalls to be financed would be only those from a limited list of commodities. The scheme could, of course, be modified to reduce the difficulties he had mentioned, and it might then be possible to establish the commodity window within the Fund. There would be no difficulties if such a facility was set up outside the Fund but administered by the Fund, which had the authority to perform financial services, including the administration of financial resources. In that situation, there were only two limitations: first, that the scheme should be consistent with the purposes of the Fund; second, that the resources of the Fund should not be involved.

On Mr. Kharmawan's question whether, as a legal matter, the Fund could do away with the quota limitation in the case of a facility within the Fund, the Associate General Counsel responded that the compensatory financing facility itself had no quota limitation. It had been stated in the decision establishing the facility that the resources of the Fund under the facility would be available to assist members that had large balance of payments imbalances.

Mr. Drabble inquired whether the Fund had the same power when the resources to finance the facility had been borrowed, perhaps at differing rates of interest.

The Associate General Counsel commented that the fact that the Fund had borrowed the resources to finance a facility did not affect the authority of the Fund to remove quota limitations.

Mr. Kharmawan observed that the changes proposed by the staff with respect to the existing compensatory financing facility seemed to have been suggested with a view to integrating the German proposal for a commodity window into the Fund's compensatory facility. Assuming Executive Directors decided that integration was not the best course to follow, would the specific changes suggested by the staff also be abandoned? Some of those changes--including the idea of the geometric approach--had come up in other discussions, and he wished to be clear about whether or not those changes would be included in the review of the compensatory financing facility.

If it was decided that the German proposal could be implemented outside the Fund, Mr. Kharmawan continued, the way in which it would be administered raised certain procedural questions. If the commodity window was to be administered by another body, he believed that the

involvement of the Fund should cease. However, if the Fund was to administer the commodity window, there would be a certain amount of involvement and that possibility should be examined before any further analysis was undertaken with respect to the German proposal itself. Finally, if the commodity window was to be operated within the Fund or within the compensatory financing facility itself, he wondered whether it would be possible to separate the two with respect to the question of quota limitations.

The Associate General Counsel observed that Mr. Kharmawan's question could only be answered if one assumed that it was possible to implement the German proposal through the Fund. He had already indicated that the German proposal contained certain features that made it difficult or impossible to implement within the Fund; however, on the theoretical assumption that appropriate modifications to the scheme could be made, it would be possible to eliminate quota limitations with respect to the additional amounts that could be provided on a uniform basis to all members that would qualify under the facility.

The Acting Chairman, responding to Mr. Kharmawan's first question, remarked that the only feature of the German proposal that had not been discussed earlier was the proposal for a 2 per cent deductible. He saw no difficulty in abstracting that suggestion from the German proposal and considering it on its merits in the review of the compensatory financing facility.

Mr. Kharmawan stated that he found no logic in introducing a restrictive element like the 2 per cent deductible into the compensatory financing facility without at the same time integrating the German proposal in its entirety. In general, it seemed unreasonable to consider an economy measure without widening members' access to resources.

Mr. Pieske said that he saw some advantage in having a broad list of issues to be dealt with in the forthcoming review of the compensatory financing facility; hence, he would have no objection to including the 2 per cent deductible proposal among the matters to be discussed. On the financing of the German proposal, the authorities had envisaged two main forms: government contributions and funds raised on capital markets and backed by government guarantees. The hope had been that government contributions would come from member and nonmember countries alike. When he had said earlier that the scheme envisaged participation by nonmember countries, he had been referring to contributions by those countries rather than to drawings.

Several Executive Directors had asked why oil had not been included in the German proposal, Mr. Pieske recalled. The proposal had been developed in the context of other schemes designed to stabilize commodity prices, and the list of 25 commodities had been drawn from lists that had been introduced under the other schemes. As oil had not been considered a candidate for price stabilization in any of the other lists, it had not been included in the German proposal.

Mr. Ruding agreed with the staff that the paper for the March review of the compensatory financing facility should contain a full list of all the suggestions and proposals that had been raised since the previous review. It might be useful if the staff could go further and add to each aspect a summary of where the Executive Board had stood the last time it had discussed the particular suggestion or proposal, although, since Executive Directors might change their minds, matters should be included even though they had not previously received much support. In that connection, while he had previously been less opposed to a threshold than to the idea of a 2 per cent deductible, he had been impressed by the comments of the Economic Counsellor with respect to the serious disadvantages of the threshold.

The Acting Chairman, in summarizing the discussion, noted that there had been little support for the concept of attempting to integrate the German proposal into the Fund. While it might be possible for the Fund to administer such a facility if it should come into being following discussions in some other forum, there was no need to go into the matter for the time being.

As had been mentioned by Mr. Caranicas, positions had changed little since the June discussion on the compensatory financing facility, the Acting Chairman observed. At that time Executive Directors had generally favored the inclusion of services in the coverage of the facility, although it had not been clear then--as it was not at present--how the inclusion could be handled. While the geometric average had theoretical and practical merit, it had not achieved sufficient support to be put into operation, although it would be reconsidered in the review paper. He did sense that a slightly larger group of Executive Directors in the current discussion had indicated a willingness to consider expanding the quota limitations.

The Executive Board concluded for the time being its discussion of possible changes in the compensatory financing facility.

2. TONGA - MEMBERSHIP - TENTATIVE INQUIRY

The Acting Chairman informed Executive Directors that a tentative inquiry regarding membership in the Fund had recently been received from the Government of Tonga. Previously, the then Minister of Finance and Deputy Prime Minister had contacted the Fund staff to inquire about the subject of membership on September 22, 1970, during the Annual Meeting held in Copenhagen.

The Executive Board took note of the statement by the Acting Chairman.

APPROVED BY THE EXECUTIVE BOARD:
Meeting 79/81, May 23, 1979

LEO VAN HOUTVEN
Secretary