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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/105

10:00 a.m., July 15, 1988

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	
F. Cassell	C. Enoch
Dai Q.	Jiang H.
	A. Rieffel, Temporary
	E. L. Walker, Temporary
	P. Péterfalvy, Temporary
A. Donoso	E. V. Feldman
	A. M. Othman
	M. B. Chatah, Temporary
G. Grosche	
J. E. Ismael	
A. Kafka	J. Hospedales
	W. N. Engert, Temporary
Mawakani Samba	
	I. A. Al-Assaf
G. Ortiz	
J. Ovi	M. Fogelholm
	D. Marcel
G. A. Posthumus	
C. R. Rye	C.-Y. Lim
G. Salehkhou	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
	S. Yoshikuni
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
M. Primorac, Assistant
R. Gaster, Assistant

Also Present

IBRD: M. Walton, Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; E. L. Bornemann, Deputy Director; D. J. S. Ballali, I. A. H. Diogo, M. E. Edo, C. Enweze, A. B. Taylor. Asian Department: M. J. Fetherston. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; H. B. Junz, Deputy Director; A. Basu, S. B. Brown, D. Burton, A. P. De La Torre, S. Kanesa-Thasan, P. Lenain, R. L. Sheehy, B. C. Stuart. Fiscal Affairs Department: R. Holzmann, C. Schiller. IMF Institute: O. B. Makalou. Legal Department: F. Gianviti, General Counsel; T. M. C. Asser, H. Elizalde, P. L. Francotte. Middle Eastern Department: B. K. Short. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; L. Alexander, D. A. DeRosa, E. Hernández-Catá, N. M. Kaibni, B. E. Rourke. Treasurer's Department: F. G. Laske, Treasurer; S. J. Fennell, Y. Ozeki, D. V. Pritchett. Western Hemisphere Department: M. Caiola, Deputy Director; H. M. Flickenschild. Personal Assistant to the Managing Director: H. J. O. Simpson. Advisors to Executive Directors: E. Ayales, A. G. A. Faria, S. M. Hassan, K.-H. Kleine, G. Pineau, N. Toé, A. Vasudevan, K. Yao, J. E. Zeas. Assistants to Executive Directors: N. Adachi, S. Appetiti, R. Comotto, E. C. Demaestri, S. K. Fayyad, V. J. Fernández, S. Guribye, M. Hepp, M. A. Kyhlberg, C. Y. Legg, V. K. Malhotra, J. A. K. Munthali, D. V. Nhien, C. Noriega, L. M. Piantini, S. Rebecchini, S. Rouai, G. Seyler, Shao Z., R. Wenzel.

1. COMPENSATORY AND CONTINGENCY FINANCING FACILITY - MODALITIES

The Executive Directors resumed from the previous meeting (EBM/88/104, 7/14/88) their consideration of the Chairman's summing up of the discussion on the compensatory and contingency financing facility at Informal Session 88/8 (7/6/88). 1/

Mr. Rye recalled that at the conclusion of the previous meeting, there had been a narrow majority in favor of a proposed amendment to the text of Section 5 of the Chairman's summing up that would allow for a 10 percent threshold subject to possible variation in relatively few cases, combined with a 5 percent fixed deductible. As a result of informal exchanges following that meeting, it appeared that a 4 percent fixed deductible would achieve a considerably broader consensus. On that basis, he and other Directors would be prepared to support such an amendment. He proposed that the second sentence of Section 5 read: "4 percent of quota would be deducted before calculating the financing to be made available or before applying the symmetry procedures." As had been agreed at the previous meeting, the remaining two sentences would be deleted.

Mr. Grosche expressed his support for Mr. Rye's suggestion. He asked whether it would still be possible to add a few words explaining why such an amount should be deducted. Perhaps one could insert, after the words "4 percent of quota would be deducted," an explanation reading: "an amount that is assumed to be covered as a minimum in all basic programs through appropriate flexible policies and/or financing."

The Chairman indicated his concern that such a phrase would lead to a debate in the Board on margins each time a basic program was adopted. The focus might then shift from policies to margins. Perhaps Mr. Grosche could agree that it be stated in the record that, in joining the consensus for a 4 percent deductible, he had done so with the understanding that the 4 percent represented a margin to be included in all programs.

Mr. Sengupta remarked that if such a definition were not included in the decision, it should at least be part of the summing up.

The Chairman said that if the Executive Board wanted the inclusion of such a phrase in his summing up, he would not oppose that, as long as the addition was not interpreted to mean that the Board had decided to change the practices of the Fund as far as margin building was concerned. Rather, it was confirmation of the present policies of the Fund.

Mr. Grosche indicated his agreement with the Chairman.

Mr. Sengupta said that Mr. Grosche's formulation gave Directors the full freedom to interpret it in the way they wished.

1/ Reproduced in Annex of EBM/88/104, 7/14/88.

Mr. Péterfalvy indicated that if the Chairman's interpretation prevailed, he would change his vote on Section 5 to support the Chairman's summing up.

Mr. Grosche remarked that the language in the last sentence of Section 7, stating that "the member would generally be expected to make a prompt repurchase...," was not clear enough. In cases in which purchases had been made clearly on the basis of wrong information, there should be an expectation of repurchase by the member. Accordingly, he suggested that the words "would generally be expected" be strengthened to read "is expected."

Mr. Posthumus indicated that he supported Mr. Grosche's proposal.

Mrs. Walker said that she would prefer that the sentence remain as it was. Her chair's original position had been that there would be no expectation of repurchase; the inclusion of the word "generally" had been perceived as a compromise.

The Chairman proposed that the text read "would be expected."

Mr. Kafka remarked that "would be expected" was too firm a wording; it was not practical to demand that a repurchase be made because of an earlier mistake. A country might not have sufficient reserves available to do so. It should, at least, be made very clear that exceptions were possible.

The General Counsel indicated that the expectation to repurchase was a term of art in the Fund. When a member was expected to repurchase but did not do so, it was not allowed to use Fund resources. The nonfulfillment of an expectation was similar in its effect to the nonfulfillment of an obligation to repurchase. Therefore, it was extremely important that the staff know exactly whether or not there was an expectation. A term such as "generally" was too ambiguous to be used in the decision.

The final decision taken by the Board, the General Counsel continued, would have to state either that "the member will be expected," in which case the expectation was automatic, or that "the Fund will decide whether the member is expected," in which case the Fund would determine, in view of all the circumstances, whether or not there was an expectation. Either the expectation was automatic or it was established by the Fund; it could not be left to some undefined circumstances, such as "generally." In the draft decision, the latter version had been taken.

In response to a question from Mr. Al-Assaf, the General Counsel said that that decision on whether or not a member was expected to make a prompt repurchase would be submitted to the Board when the staff received the actual data necessary to determine whether or not the purchases that had been made had been justified.

Mr. Kafka commented that that appeared to be a complicated procedure, which did not correspond to his understanding of the agreement on Section 7. As he saw it, the Board had in mind that there would be a hope that the country would repurchase, but no obligation. An expectation, as the General Counsel had reminded the Board, was an obligation. Nor could the decision be left entirely to the Fund, because that would give it too much discretion as to whether or not there should be a repurchase. He asked the General Counsel to suggest a less stringent formulation.

Mr. Cassell proposed that the text should read: "The Fund will decide whether the member should make a prompt repurchase," thus avoiding the word "expected," which had a stronger meaning legally than in lay English.

The General Counsel pointed out that, in the decision, the word "should" might become "shall," which would then represent an obligation of a higher degree of intensity than "expectation." When there was an expectation to repurchase, the member had no access to the Fund's general resources until that expectation had been fulfilled. If there was an obligation to repurchase, not only was the member deprived of access to general resources, but in addition, it would have to pay special charges because the repurchase would be overdue.

The Chairman remarked that the word "should" opened up a number of possibilities, including "shall," which he considered would be acceptable.

Mr. Rye remarked that the discussion was successively watering down the original text. The summing up was not a legal text, and he did not see why legal language had to be incorporated into it. It was the responsibility of the Legal Department to transcribe the summing up into legal text in the light of the discussion. If a discussion of legal points had to be held at a later stage, that would be acceptable, but he did not see a need to enter into that discussion at the current meeting. There should be a presumption that the member would make a prompt repurchase, without closing off the possibility of alternatives.

The General Counsel, in response to a question from Mr. Kafka, indicated that "presumption" meant expectation in a nonlegal sense.

Mr. Sengupta pointed out that the General Counsel's formulation was in accordance with the Fund's practice; therefore, that was the formulation that he would support.

Mr. Fogelholm asked whether the Fund had any rules with respect to overcompensation.

The Economic Counsellor and Director of the Research Department indicated that, in cases of overcompensation, paragraph 7 of the decision on the compensatory financing of export fluctuations (Decision No. 6224-(79/135), adopted August 2, 1979, stated that: "A member requesting a drawing under the proviso in paragraph 5 above will be expected to represent that, if the amount drawn on the basis of estimated data exceeds the amount that could have been drawn on the basis of actual data for the full 12-month period under paragraph 6 above, the member will make a prompt repurchase in respect of the outstanding drawing, in an amount equivalent to the excess."

The General Counsel remarked that paragraph 7 of that decision indicated an expectation to repurchase, but not an obligation. A member that did not fulfill that expectation no longer had access to general resources, but since it was not a breach of obligation there were no special charges.

Mrs. Walker pointed out that the current rules for the compensatory financing facility had not been preserved in the new facility, so that there was not necessarily a correlation between paragraph 7 of the old decision and the current discussion.

The Chairman noted that the Board was simply searching for a solution. One choice was to take the language of the compensatory financing decision, which stated that the member would be expected to make a repurchase. The second possibility was to state that there was a presumption that the member would make a repurchase. The third choice was the language of Mr. Cassell, that the Fund would decide whether the member should make a prompt repurchase. He asked Directors to express their preference.

Mr. Grosche, Mr. Ismael, Mr. Posthumus, Mr. Rye, Mr. Al-Assaf, Mr. Fogelholm, and Mr. Marcel indicated that they were in favor of the language of the compensatory financing facility decision.

Mr. Kafka and Mrs. Walker indicated that they could not support that language.

Mr. Zecchini said that he supported the original language proposed by the Chairman; he did not share the point of view expressed by the staff. The term "generally" implied that the Board could decide otherwise. Therefore, he preferred the original wording.

Mr. Grosche remarked that the current debate had been useful, since it prepared the way for the General Counsel to draft the legal text. Having listened to the debate, he himself could go along with the words "would generally be expected," given that the General Counsel would translate them into legal language as he had previously indicated.

The General Counsel proposed the following wording: "The member would be expected, unless otherwise decided by the Fund, to make a prompt repurchase."

Mrs. Walker said that her chair's goal on the point under discussion was to have the options of repurchasing or not repurchasing being equally possible. The formulation presented by the General Counsel appeared to assume an expectation of repurchase, with a possibility of no repurchase. She had wanted the two options to be on equal footing.

The Chairman said that the discussion did not seem to indicate a majority in favor of such equal footing. The presumption was that there would be a repurchase, unless otherwise decided.

Mr. Cassell recalled that, on Section 11 which dealt with coverage, he had suggested that the reference to "officially owned foreign assets" in the penultimate line of the third paragraph would be too narrow since foreign assets could be official but be owned by the commercial banks, for example. In such cases, the compensation of interest receipts might be too small. He had suggested referring to "relevant foreign assets" to give the staff the opportunity to decide which assets went along with the liabilities on which they were calculating interest.

The Economic Counsellor said that while the staff understood Mr. Cassell's difficulties with the lack of symmetry between assets and liabilities in the paragraph under question, the term "relevant" would lead to substantial complications in negotiations. He proposed a slightly modified wording, reading: "Fund financing of interest rate contingencies would apply to the member's net external debt, which would generally be defined as the public and publicly guaranteed gross external debt minus official external assets." The word "generally" could be interpreted as meaning that when the authorities and the staff agreed that there were substantial private external liabilities and claims for which adequate statistical data were available on a timely basis, such liabilities and claims could be included in the definition of net external debt.

Mr. Cassell remarked that he found that wording helpful.

Mr. Kafka asked whether the new wording would oblige a country to go to great expense and effort to investigate the assets held by its citizens or residents abroad.

The Economic Counsellor said that it was to avoid such problems that the words "in general" had been used.

The Deputy Director of the Exchange and Trade Relations Department observed that the assets of the private sector would not be investigated. Rather, the investigation would concentrate on the external assets that might be owned or controlled by the authorities.

Mr. Kafka said that, in that case, he could go along with the new language.

Mr. Fogelholm recalled that at the previous meeting he had requested that the reference to parallel contingency financing in the last paragraph of Section 11 be turned around to form a positive rather than negative statement. However, the text as it currently stood was longer and contained two problems, as he saw it. First, it was stated that

"...generally, such [parallel] financing would not be a prerequisite"--an assertion that the Fund could not currently make. There might be a situation in which quite a few cases needed parallel financing owing to the inadequacy of financing. Second, the reference to "other contingencies" in the last line was tied to "changes in international interest rates," which made the whole sentence illogical. He proposed that a return be made to the original language of the Chairman's summing up, since he had been the only Director to oppose that language in the first place.

Mr. Ortiz expressed his reservation regarding the 35 percent limit on the contingency financing of interest costs. He wondered whether some wording could be devised that would allow for exceptions to that limit.

The Chairman noted that if that aspect of the compromise were challenged, discussion on other issues would also be opened. He suggested that the full package be adopted with the understanding that Mr. Ortiz's chair had a reservation on that point.

Mr. Sengupta noted that the Articles of Agreement used the term "normally" rather than "generally." Perhaps it could be stated that "contingency financing of interest costs would normally be subject to a cumulative limit of 35 percent." That would meet, to some extent, the point of Mr. Ortiz, while being in accordance with the Articles of Agreement.

Mr. Feldman observed that Mr. Sengupta's proposal allowed for the very slight flexibility that Mr. Ortiz was asking for, thus achieving complete consensus on that issue. Accordingly, he strongly supported Mr. Sengupta's proposal to use the word "normally."

Mr. Grosche said that if the language were softened in that manner, he might have to oppose the total package.

The Chairman noted that the new facility was being implemented on an experimental basis. He asked that the package as it stood be supported to the extent possible with the understanding that staff and management would have the necessary leeway when applying the guidelines as they currently stood. In that way, the concerns that Directors had on various issues would properly be dealt with.

Mr. Grosche suggested that it be agreed that the facility be put into place for only one year. A thorough examination of all the facility's features could be held at that time.

The Chairman said that flexibility during the experimental period would be preferable to reopening a full debate after one year.

Mr. Kafka said that he was not in favor of Mr. Grosche's suggestion that the decision expire after one year. The Board could take action to terminate the decision whenever it saw fit, but it was not necessary to prejudge such a step.

Mr. Ortiz noted that the Board had been careful to select language that gave sufficient flexibility to management, and his proposal to change the wording on the 35 percent limit was to that end. He simply wanted the same degree of flexibility that had been given to other aspects of the management and operation of the new facility to be given to the question of interest rate coverage. If the language remained as it currently stood, management would not be able to propose to the Board that funding beyond 35 percent of the deviation be provided in individual cases.

Interest rate coverage was one of the major aspects of the whole package, Mr. Ortiz observed, and one of the reasons that his chair had gone along with the modification of the compensatory financing facility in the first place. While he recognized that there were equally strong feelings at the opposite end of the spectrum, he did not consider his request to be very controversial. His chair could not go along with the 35 percent limit as it stood.

Mr. Posthumus asked what exactly the Chairman meant by "the minimum flexibility which the management and staff needs."

The Chairman said that management and staff would apply fairly the guidelines given to them by the Board, keeping in mind that among those guidelines was the fact that the first year would be experimental in character. If they encountered cases that, in full fairness, did not fit exactly the guidelines, management and staff would make proposals to the Executive Board that were fully in the spirit of the agreement and of the guidelines. Whether that would occur after the negotiations with the country concerned had been completed or even after the drawing had been made would depend on the circumstances.

The General Counsel, in response to a question by Mr. Chatah, said that there would be no difference in the majority vote required to finance more than the 35 percent limit if the word "normally" were used.

Mr. Al-Assaf said that he would prefer that there be a strict limit of 35 percent for the first year, after which, on the basis of experience, it could be altered.

Mr. Posthumus said that the review of the facility should not only be a review of the way in which it functioned, but also of whether or not it should continue to exist.

The Chairman remarked that the facility should be adopted in a positive spirit and reviewed after one year.

The General Counsel indicated that the facility could be established in two ways. The Board could adopt a permanent decision, which would continue to apply for an indefinite period and would be subject to periodic review. Whether or not a review was completed, and regardless of the date of that review, the decision would continue to apply unless it was amended or abrogated. On the other hand, the Executive Board could adopt a decision for a temporary period of time. In that case, a decision would have to be taken at the time of the review on whether or not to renew the decision for a further period of time. That was the case, for example, for the enlarged access policy, under which decisions were taken for one year and lapsed at the end of the year unless they were readopted by the Board.

Mr. Posthumus said that a temporary decision would prejudge the fate of the facility, and therefore went one step too far. He did, however, wish to preserve the possibility of discussing the very existence of the facility at the time of the review.

Mr. Al-Assaf asked about the legal implications of the possibility of not renewing the compensatory and contingency financing facility. Would that result in the elimination of the compensatory financing facility as well?

The General Counsel said that the decision on the compensatory financing facility was a permanent one, which the Board could, however, decide to terminate. But the other part of the decision--on cereal imports--was temporary, and would expire in 1989. Accordingly, the Board would have to decide whether to retain that cut-off date for that particular part of the facility, or make it permanent along with the rest of the new facility.

The Chairman remarked that perhaps the situation should remain as it was, with the Board making a decision on or before the May 13, 1989 expiration date of the decision on compensatory financing of cereal imports.

The General Counsel observed that, in that case, one part of the decision would be temporary, while the rest would be permanent.

Mr. Grosche said that he shared the feeling of Mr. Posthumus that if substantial problems were encountered with the contingency element, it should be possible to modify or even eliminate that element at the time of the review.

The Chairman remarked that a review would take place, as indicated in the summing up, before the 1989 Annual Meetings. That would be a general review of the compensatory and contingency financing facility based on the Fund's experience with its operations.

Mr. Yoshikuni said that he fully supported the summing up as amended, but proposed that the staff take specific measures to help member countries understand the complex modalities of the new facility.

Mrs. Walker remarked that it was important to leave the current discussion in a positive spirit. The development of the new facility was a desirable step which, while involving compromises by all Directors, represented significant progress. She sympathized with Mr. Ortiz's concerns because her chair was also interested in the interest rate component of the facility. However, in light of the fact that many compromises had been made, she hoped that the facility could be supported by all Directors.

Mr. Ortiz noted that paragraph 1 of the summing up read: "Contingent financing would not generally exceed 70 percent of access under the associated arrangement." Could the same language not be used for the last paragraph of Section 11?

Mr. Grosche said that he could not accept such language, since it was far from the understanding agreed to by the Board.

The Chairman noted that the text of the summing up as amended was agreed, with the reservation of Mr. Ortiz, which he hoped would be temporary. The revised text of the draft decision would be circulated as soon as possible, for Board consideration on August 1. A revised text of the summing up would also be circulated immediately. 1/

The Executive Directors then adjourned their discussion of the modalities of the compensatory and contingency financing facility.

2. GROUP OF TEN - DEPUTIES' MEETING - REPORT BY STAFF

The Economic Counsellor and Director of the Research Department said that he had attended a meeting of OECD Working Party No. 3 in Paris on June 13, chaired by Sir Geoffrey Littler. The OECD Secretariat had suggested that the very rapid growth of the industrial countries might introduce some fears about inflation, along the lines discussed in the Board during the recent informal session on exchange rate developments (IS/88/6, 7/8/88). Most delegates had emphasized that there were as yet no actual signs in current statistics of an acceleration of inflation, thereby somewhat mitigating the overall concerns raised.

The afternoon meeting had been devoted to a discussion of financing imbalances, the Director continued. The focus was on the U.S. external imbalance, and the discussion was relatively abstract, seeking, for instance, to envisage a situation in which perhaps an external deficit of $100 billion could perhaps be financed over the medium term. Participants particularly emphasized the uses to which the imbalance was put. The imbalance could be used, for instance, to finance investment or, alternatively, to finance consumption, options which had different implications for the future capacity of the economy to service debt accumulating from

1/ Reproduced in Annex.

the present imbalance. In addition, there had been a strong feeling that whatever the technical possibilities of continuing to finance such an imbalance, it was most important that adjustment take place and that corrective policies be implemented. Hence, it might be concluded that the imbalance could continue to be financed as long as there were clear signs that credible policies were in place and at work.

Immediately following the conclusion of that meeting, the G-10 Deputies had met to consider ways of examining the role of the Fund and the World Bank in the context of the debt strategy, the Economic Counsellor noted. The discussion had been very brief and had been concerned with procedural questions. There had, however, been a clear consensus that the focus should be not on the broad discussion of the debt strategy, but on a specific discussion of the roles of the Fund and the World Bank. Any discussion had to be narrow in scope, well focused, and with the aim of finalizing a report by the time of the April 1989 meeting of the Interim Committee, focusing in particular on the areas of collaboration between the two institutions. The staffs of the institutions would be requested to submit some information to the G-10 Deputies, but it was clearly understood that whatever information was submitted should be narrowly focused on factual information, such as descriptions of existing facilities. Evaluation of the information would be left strictly to the Deputies.

Mr. Zecchini asked whether, during the discussion in Working Party No. 3 on inflation, there had been any debate on the use of the commodity indicator.

The Economic Counsellor commented that while there might not have been direct references to the commodity price indicator, events in the commodities market had of course been discussed. However, the general feeling had been that the danger of an acceleration of inflation should not be exaggerated at the present time. Certainly, the cost of not addressing the issue of inflation could be very serious indeed, so not surprisingly the possibility of higher inflation had indeed generated concern.

3. MALAWI - REVIEW UNDER STAND-BY ARRANGEMENT, AND REQUEST FOR ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered a staff paper on the first review under the stand-by arrangement for Malawi approved on March 2, 1988, and on Malawi's request for a three-year arrangement under the enhanced structural adjustment facility in an amount equivalent to SDR 55.8 million, to be disbursed in six semiannual amounts each equal to 25 percent of quota (EBS/88/118, 6/17/88; and Sup. 1, 7/8/88). They also had before them a policy framework paper on Malawi (EBD/88/155, 6/7/88).

The Managing Director made the following statement:

There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their June 14, 1988 discussion in Committee of the Whole of a paper entitled "Malawi: Policy Framework Paper, 1988/89-1990/91."

1. The Committee of the Whole discussed the policy framework paper for Malawi and commended the Government for its continuing commitment to structural adjustment. It was noted that Malawi traditionally has made substantial efforts to implement a comprehensive structural adjustment program. The speakers commented in particular on the recent efforts to maintain fiscal discipline, phase in the restoration of an open trade regime, and strengthen the traditionally important role of the private sector. The Executive Directors noted the commitment of the Government to continue to undertake measures to cope with difficult external circumstances.

2. Concern was expressed about the impact and sustainability of the difficult fiscal program--some speakers noting the significant cuts proposed, though others noted the continuing rather high level of the deficit. Staff described the progress in expenditure control and improved allocation. Some speakers felt there might be some scope for accelerating the pace of import liberalization. In both these areas the key issue was sustainability, and the Executive Directors welcomed the joint efforts of Bank, Fund, and Government staff to ensure this.

3. The Executive Directors recognized the hardships facing Malawi due to the disruption of traditional transport routes. The importance of diversifying these routes, in particular, the Northern Transport Corridor through Tanzania, was recognized. The Directors stressed the importance of greater regional integration in Southern Africa and in Africa in general. Speakers expressed concern regarding the growing influx of refugees. A significant strain has been placed on Malawi, although a number of international donor agencies and private relief groups have stepped up their emergency assistance significantly.

4. The Executive Directors commended the Government for its continuing emphasis on the agricultural sector. The need to continue policy reform and institutional strengthening was emphasized. The Executive Directors recognized the very low income levels in Malawi and stressed the social dimensions of the program. In particular, speakers mentioned the importance

of the measures to address the problems of malnutrition, continued low educational levels, school-leaver unemployment, and population pressure. Efforts to reorient the research, extension, and credit systems to make them more appropriate for smallholders were noted and their intensification urged. Expansion and quality enhancement of primary education and strengthening the primary health care facilities which manage Malawi's "child-spacing" program are high priorities in the Government's expenditure program. The Integrated Human Resources Study and Social Dimensions of Adjustment Program will mark further steps in these areas.

5. Some speakers noted the presence of two scenarios and expressed concern that while the lower growth scenario was clearly inadequate, the Government could have difficulty implementing the measures necessary to achieve the higher targets. Support was expressed for vigorous efforts to attain the resources required for the second scenario. Enhanced external support in the next few years was important, given the time required for a greater export supply response, the difficult external situation, and the low-income levels of the majority of the population.

Mr. Abdallah made the following statement:

When the Executive Board considered the current stand-by arrangement with Malawi on March 2, 1988, there was broad recognition that the economic difficulties being tackled were mainly rooted in the country's vulnerability to, and persistence of, external shocks. In particular, the declining terms of trade, intermittent unfavorable weather conditions that occasionally caused food shortages, together with transportation bottlenecks, contributed substantially to the overall poor economic performance in the 1980s. The rate of economic growth, which averaged about 2 percent annually in this decade, was considerably lower than that achieved in the 1970s and was well below the estimated rate of population growth. At the same time, inflationary pressures intensified, exacerbated by weaknesses in domestic financial policies. For example, the fiscal deficit widened to a peak of 12.5 percent of GDP in 1986/87; as a result, the balance of payments weakened and the debt burden rose sharply.

In the event, Directors agreed with the authorities that the latter's ongoing adjustment efforts should be pursued within a medium-term perspective. A policy framework paper has now been prepared in full consultation with the staffs of the Fund and the World Bank. The request for Fund assistance under the enhanced structural adjustment facility is a logical conclusion of a process that began with a shadow program in August 1987, formalized in March 1988 with the approval of the stand-by arrangement. The authorities took note of the advice of the Board calling for stronger action in the fiscal and other areas including the reform of parastatals, particularly the Agricultural Development and Marketing Board (ADMARC). These reforms were highlighted in my introductory statement to the Board in March.

I should stress that available evidence indicates that performance under the current stand-by arrangement is broadly in line with the objectives of the program. All quantitative performance criteria have been met for end-March 1988 and the end-June criteria are also likely to be satisfied. Real GDP declined by 0.2 percent in 1987 compared with the projected 0.4 percent. The rate of inflation increased somewhat in 1987 to 27 percent, and remained rather high in the first quarter of 1988. The stubbornness of inflationary pressures reflected, inter alia, the tight food supply situation, liquidity expansion, and the effects of devaluation. Nevertheless, the authorities are hopeful that inflation will be reduced to the program target as the supply situation improves and firm financial policies are implemented as specified under the program.

The budgetary outturn for 1987/88 indicates a better than projected performance, with the overall deficit being reduced to 10.2 percent of GDP instead of the original 10.7 percent, representing a reduction equivalent to 2.3 percentage points from its level in 1986/87. As discussed in March, the 1988/89 budget deficit target is estimated to be reduced to 8.1 percent of GDP. In the budget, the authorities announced specific policies intended to achieve that objective and the emphasis of adjustment falls on expenditures, in recognition of the narrow tax base and the need to avoid raising the tax burden unduly. Accordingly, although expenditure has been allowed to increase by 11 percent in nominal terms, this represents a significant decline relative to GDP from 29.1 percent in 1987/88 to 27 percent in 1988/89; moreover, it represents a more substantial decline in real terms. The Government does not intend to raise wage rates or to increase civil service employment. In addition to overall restraint, the composition of expenditure is better attuned to government priorities, with development outlays and other nonwage recurrent spending being raised by 30 percent and 13.2 percent, respectively. The development budget emphasizes completion of ongoing projects, in particular the construction of the Northern Corridor network which is designed to ease prevailing transportation difficulties.

On the revenue side, the budget is expected to benefit from the expansion of the tax base which involves, inter alia, the conversion of excise tax rates from a specific to an ad valorem basis, the expansion of the domestic surtax base and the transformation of the luxury tax from an import base to a consumption base in order to capture both imported and domestically produced commodities. These tax reform measures are considered to be a first step in a medium-term tax reform program designed to increase revenue yield, while at the same time improving allocative efficiency and incentives for export promotion and import substitution.

Monetary and credit ceilings have been formulated in line with the need to contain the inflation rate to about 20 percent in 1988 and to attain the balance of payments objective. Meanwhile, both lending and deposit rates have been freed so that a market-clearing level of interest rates can emerge. Since then, deposit and base lending rates of commercial banks have fallen by 3 percentage points. Meanwhile, the Reserve Bank will review its policies with respect to credit and monetary control in order to introduce appropriate changes that would promote effectiveness and prompt response. Accordingly, a study on monetary policy instruments is being undertaken with Fund technical assistance and will be completed in September 1988.

The centerpiece of external policies is the liberalization of the exchange and payments system, and that is being undertaken in phases during the three-year program period. The policy will be supported by the implementation of a flexible exchange rate policy through appropriate adjustments to maintain Malawi's external competitiveness. Furthermore, in order to further stimulate production of nontraditional exports, the 1988/89 budget announced other incentives, including the introduction of changes to the export duty drawback system to make it more effective and the setting up of a foreign exchange revolving fund to meet the need for imported inputs for exporters. The Fund will be financed initially through external assistance. Other institutional measures involve the strengthening of the Malawi export promotion council as well as a further reduction in the few export commodities requiring export licensing.

In April 1988, the authorities concluded agreements with the London and Paris Clubs to reschedule outstanding debts including some of the arrears that had arisen due to the suspension of payments effected after notification to creditors. The authorities are grateful to the creditors for providing substantial relief amounting to an estimated SDR 39.7 million on terms that are comparatively more favorable than those granted in the 1983/84 rescheduling exercise. For the medium term, the authorities are hopeful that the need for rescheduling will not arise as they intend to pursue a cautious borrowing policy. The main concern has been with repurchases to the Fund which reached a peak of SDR 30.3 million in 1987, representing about 13 percent of Malawi's exports of goods and services. Obligations to the Fund are significant and it is for this reason that the authorities have decided not to make further drawings under the current stand-by arrangement, and opted instead for an arrangement under the enhanced structural adjustment facility because of its concessionary character. As a result, the profile of repurchases improves over the medium term, and are projected to be reduced to SDR 18.2 million, equivalent to only 6.3 percent of projected exports of goods and services.

Malawi urgently needs growth, which under the medium-term strategy, is projected to average between 3.0 percent and 3.5 percent annually between 1989 and 1991 while inflation is estimated to fall to about 5 percent by 1991-92, and financing gaps to be eliminated by the end of the program period. Meanwhile, the authorities are hopeful that they could do slightly better with growth averaging about 4-5 percent annually in order to allow for a perceptible increase in per capita income, thus reversing the erosion in the standard of living that has taken place over the decade. The higher growth expectation is contained in the second medium-term scenario whose realization depends crucially on securing additional concessional financing through the Consultative Group and a careful selection of quality projects.

In conclusion, the Malawian authorities have implemented strong and comprehensive measures since July 1987, and the first arrangement of the three-year program constitutes a further strengthening of the adjustment process. The stabilization and structural reforms to be implemented under the program are comprehensive and the Fund could have been slightly more generous; but it is realized that this is the first arrangement under the enhanced structural adjustment facility and that management preferred to err on the side of caution. Malawi deserves stronger support from the international community and sincerely hopes that it will be forthcoming.

Mr. Enoch made the following statement:

I am pleased to open the discussion of the first arrangement under the enhanced structural adjustment facility to come to the Board. I am especially pleased that this is to be for Malawi, which is an especially appropriate candidate. There is a clear prospect of medium-term viability by the end of the program period, and reasonably firm financing assurances have been established for the whole period. The program will also achieve the complete elimination of external restrictions, and Malawi should be able to avoid further resort to rescheduling and exceptional financing. Moreover, we have seen a convincing track record established, first under a shadow program, and then under a stand-by arrangement. The shadow program included a number of institutional reforms vital to the effective implementation of financial policies, and the stand-by arrangement was preceded by several significant prior actions, including a start to import liberalization and early clearance of arrears. This sequence has helped build a secure foundation of confidence in Malawi's commitment to strong adjustment, and has allowed the Board to guide, at an early stage, the adjustment strategy that would eventually form the basis of the enhanced structural adjustment arrangement. I hope that this approach will provide a blueprint for future arrangements under the enhanced structural adjustment facility.

The actual substance of the program supported by the enhanced structural adjustment arrangement reflects a strong and comprehensive set of policies. The core of any credible adjustment program for Malawi must be fiscal restraint, and it is reassuring to see the successful implementation of expenditure monitoring and control procedures under the stand-by arrangement. On the revenue side, the proposed major reform of the tax system will be vital in ensuring that revenues can be maintained at current levels improving domestic resource allocation. And, while the performance of the major parastatals in 1987/88 was weaker than expected, important restructuring is in hand, and it is most welcome that no transfers will be made to the parastatals from the budget for this new financial year. Further progress will, I hope, be made with the completion of the World Bank's review of public expenditure. On the other hand, I am not convinced that enough urgency is being attached to the question of the fertilizer subsidy, and I also have some concerns over the continued expansion in the civil service. Given the overall constraint to be imposed on government salaries, I wonder whether the projected rate of recruitment will unduly dilute the incentives that underpin the efficiency of administration.

The staff paper before us presents two alternative scenarios for Malawi's prospects, with the difference arising from different external inflows. Reports from last month's meeting of the Consultative Group for Malawi indicate that commitments were greater than projected. This is clearly a helpful development, and I would welcome staff comments as to how far the result of this Consultative Group meeting makes the achievement of the second scenario more likely.

This high level of donor commitments will of course affect the budget. Presumably, if the more generous level of aid commitments is to be fully taken up, the overall budget deficit will widen. I see no problem here, provided that underlying fiscal performance is maintained. Broadly speaking, this balance will be reflected in terms of domestic bank financing of the budget. I therefore am substantially reassured by the net repayments from the Government to the banking sector that are projected under the program.

There is a further paradox in the program, apparent in the external accounts. The current account path projected under the enhanced structural adjustment arrangement envisages a series of wider deficits than were envisaged at the time of the request for a stand-by arrangement. I presume, however, that this apparent relaxation, and the stronger buildup of reserves, largely reflect the use of additional financing from the enhanced structural adjustment arrangement to continue releasing the compression of imports that occurred in 1986 and 1987, as well as the welcome acceleration that is projected in the liberalization of the trade and foreign exchange systems. I think that it might be helpful in future if, in situations in which the fiscal and current accounts are driven by the capital account of the balance of payments, these seemingly paradoxical effects might be more clearly identified and quantified by the staff, so that we can more fully assess the net contribution made by the enhanced structural adjustment facility to overall economic performance.

I do have one question in this area. Table 8 on page 21 of the staff paper shows that a significantly faster import volume growth is assumed--of 5.3 percent in 1988, 8 percent in 1989, falling to 3.6 percent in 1992--compared with the projections in the staff paper for the March 2, 1988 Board discussion of the stand-by arrangement, in which 4.5 percent growth in 1988 and 3 percent thereafter were assumed. Yet GDP growth assumptions are identical, and terms of trade and export growth figures little changed. Is this because the import liberalization does not have any positive impact on growth in the program period, or is it because the positive impact on growth is offset by additional adjustment measures to counter domestic imbalances? I would be interested in staff comments.

One further paradox is that despite the enhanced structural adjustment arrangement, the projected price path is the same as that given in the staff paper for Malawi's requested stand-by arrangement. I would have thought that the strong fiscal policy to be pursued by Malawi, combined with the expected impact on prices of accelerated import liberalization, the fading of the devaluation effect, and a recovery from last year's drought-induced shortfall in food production, might all have been reflected in a faster deceleration in projected inflation. I therefore look toward an explanation on the monetary side, in the form of the excessive liquidity of the banking system and negative real interest rates. However, given the net reduction projected in the stock of bank credit to the Government, and the lower targets now set for the expansion of net domestic assets and domestic credit compared with those envisaged under the original stand-by arrangement, ov rall the monetary impact on inflation seems rather unclear. But it would certainly seem prudent to pay particular attention to this monetary sector, and I strongly endorse the staff in recommending the urgent introduction of an enhanced system of monetary and credit control by the end of 1988. I also hope that the next review of Malawi's adjustment program could offer a closer analysis of monetary and credit policy, drawing on the work currently being done by the staff in this area with respect to technical assistance.

On the whole, however, there are good reasons to be confident about Malawi's policy performance under the enhanced structural adjustment arrangement. As I noted when the Board considered Malawi's request for a stand-by arrangement (EBM/88/28, 3/2/88), the most serious problems probably lie in Malawi's continuing vulnerability to the extraordinary external developments that have beset the country in recent years. Regional political instability and the resulting transport and refugee problems place severe constraints on the country, particularly given its very limited resources and dependence on tenuous lines of communication. As the staff paper reminds us, Malawi is a desperately poor country, with a per capita income below the average even for sub-Saharan Africa. Per capita income has also been falling for four years in succession. The authorities should be commended for coping as well as they have in the face of these difficult conditions. Unfortunately, some of the external problems seem unlikely to be eased significantly in the foreseeable future, and there is little room for maneuver. The cautious assumptions which seem to have been incorporated into the enhanced structural adjustment arrangement are therefore wise. But the implementation of the program supported by the enhanced structural adjustment arrangement should place Malawi in a much stronger position to respond to any future shocks, and will be a key element in maintaining the full support of the donor community.

I support the proposed decisions.

Mr. Mawakani made the following statement:

When the Board considered Malawi's request for a stand-by arrangement, it was recognized that the structural difficulties facing Malawi could best be addressed in the context of a comprehensive medium-term adjustment program. I therefore welcome the authorities' request for an arrangement under the enhanced structural adjustment facility, especially since this is the first such request to come to the Board.

Achieving the objectives of the program described in the policy framework paper before us will require the effective implementation of appropriate and well-balanced supply-side and demand-management policies focusing on the agricultural, industrial, and transport sectors.

In the agricultural sector, the policies that are aimed at improving productivity and expanding output seem appropriate. In addition to encouraging the use of efficient agricultural techniques through improved extension and research services, the authorities should place greater emphasis on streamlining the pricing and marketing system and providing ample credit to farmers, particularly the smallholders. As part of the efforts to provide incentives to smallholders and to increase agricultural yield, the authorities intend to continue to subsidize fertilizer. This is understandable in view of the prospective shortfall in domestic production of maize. The removal of this subsidy should therefore not be given high priority, since its cost is relatively low compared to the benefit of a substantial increase in agricultural output.

In the industrial sector, I welcome the emphasis being placed on private sector activity and on the maintenance of a liberal pricing system. These measures seem appropriate and go in the right direction for the development of this sector. In the energy sector, I support the policies aimed at protecting the environment. However, the rates of increase in electricity tariffs as well as their levels seem too high, and could have a potentially adverse impact on the industrial sector's profitability and competitiveness. Any short-term budgetary gains deriving from such rapid and substantial price increases may be at the expense of long-term industrial output growth.

The authorities have appropriately given top priority to diversifying transport routes. The adverse impact on the external accounts of the disruption of the traditional trade routes to Mozambique's ocean ports are still being felt. The authorities appear to have taken the right step in focusing their efforts and resources on reopening the Nacala rail line and on implementing the Northern Corridor Project. Every effort should be made to improve the transportation network, given its importance for economic development in Malawi.

The authorities have already implemented a series of measures in the fiscal sector that have brought government expenditure under control. However, as the authorities themselves recognize, much needs to be done to bring the fiscal deficit to a more sustainable level. In that respect, I welcome the measures envisaged under the program. On the revenue side, I agree with the authorities that the tax burden is relatively high and that a complete reform of the tax system with a view to broadening the tax base is needed to enhance revenue performance. The measures to be taken with regard to the public enterprises, and especially those regarding the Agricultural Development and Marketing Board, should help to turn around the financial position of the major parastatals, thereby contributing to an improved budgetary outlook.

I endorse the measures aimed at improving export competitiveness and promoting nontraditional exports. However, while such an outward-looking policy can generally be profitable, I wonder whether it is really appropriate in view of the severe external constraints facing Malawi in general and its landlocked position and vulnerability with respect to transportation problems in particular. Until the problems related to the availability of external transportation routes are resolved, an outward-looking strategy may run into serious difficulties.

As requested by some members of the Board during our discussion on Malawi's stand-by arrangement last March, the policy framework paper presents two medium-term scenarios. Given the low income level in Malawi, I urge the international community to provide Malawi with the additional external financial resources required under the second scenario. In view of the good track record established under the stand-by arrangement and the upgrading of the adjustment program with the addition of structural reforms, the Malawi authorities deserve the international community's support through concessional financial assistance on the scale contemplated under the second scenario. I support the proposed decisions.

Mr. Rieffel made the following statement:

The Malawi authorities have responded courageously to the challenge of being the first candidate for arrangements under the enhanced structural adjustment facility. The large resources to be provided under the proposed arrangement, which will be matched by augmented resources from other multilateral and bilateral sources, will not, however, make the road ahead an easy one. In our enthusiasm, we should not forget that the World Bank made a series of structural adjustment loans to Malawi not too long ago that did not succeed--to the extent envisioned--in strengthening the foundations for growth, and the authorities decided to resort to administrative controls to contain the strains that emerged.

Thus, as my principal message, I must urge the authorities to keep in mind the need for persistence in the pursuit of their medium-term objectives. In the period immediately ahead, they will need persistence to restore the degree of price stability that they have historically maintained. Over the medium term, they will need persistence to diminish their reliance on controls and to create a dynamic private sector capable of bringing enduring prosperity to the country.

With regard to the medium-term policy framework, my authorities were surprised to see two scenarios of adjustment and financing presented in the policy framework paper. In the process of developing the policy framework paper as a planning instrument, we have always emphasized the objective of presenting a coherent and consistent set of policies that reconcile inherent differences in view among the borrowing country, the Fund staff, and the World Bank staff.

From this perspective, the presentation of two scenarios can only complicate efforts to reach agreement on specific policies at the beginning of a medium-term program. More external financing will, of course, make the adjustment process easier. But we know relatively little about how to ensure that these resources will have more than a momentary benefit. I hope that the substantial commitments of assistance made at the Consultative Group meeting last month reflected satisfaction with the quality of Malawi's reform efforts and not a blind response to a request for more financing. And indeed we believe that this was the case. At the same time, we caution the authorities against interpreting these commitments as a basis for relaxing their reform efforts. If they do, as we have seen in other cases, the commitments will tend to evaporate and Malawi will be back where it started.

By contrast, there is another feature of Malawi's policy framework paper which I would like to commend. The objectives appear to have been set conservatively, leaving room for overperformance. For example, the deadline for full liberalization of import restrictions was set for March 1991 in the policy framework paper, and has been advanced to March 1990 under the enhanced structural adjustment arrangement. In addition, while the policy framework paper mentions that civil service employment will not increase by more than 2 percent annually, the 1988/89 program envisions no increase in civil service employment.

We urge the authorities to seek other opportunities for overperformance, especially with regard to the budget. There is no better way to attract the support of external donors, and overperformance can often have a dramatic impact on economic activity domestically. We also encourage the staff to adopt this approach to other cases.

I was also pleased to see the importance given in the policy framework paper to rationalizing the operations of the Agricultural Development and Marketing Board (ADMARC).

Finally, my counterpart in the World Bank has provided me with a staff report to Executive Directors of the Bank on the June Consultative Group meeting, which might have been of interest to Fund Directors in preparing for today's discussion. I was struck by the importance given at that meeting to reducing the rate of population growth as a means of improving Malawi's economic prospects. This report underscores my earlier point about using the policy framework paper to focus attention on key structural problems rather than on some arbitrary levels of external assistance.

Turning to the 1988/89 program, I have four brief comments. The scope of export licensing is being progressively reduced. I hope that by the end of the first-year program, the licensing requirements for gemstones, scrap metal, and most food products will have been eliminated. Given the potential for negative interest rates, the authorities will need to monitor credit trends very closely. The staff paper indicates that some price controls remain in the industrial sector. While these cover only five products, it would perhaps be appropriate to eliminate the controls relating to meat and vehicle spare parts during the adjustment process. Given the importance of the budget objectives, I strongly endorse the use of indicative targets for expenditures and the overall deficit.

We consider the level of access proposed under the enhanced structural adjustment facility arrangement to be appropriate. We commend the authorities for their decision not to make further drawings under the stand-by arrangement, and commend the staff for recommending that the second review of the stand-by arrangement be combined with the midyear review of the enhanced structural adjustment arrangement.

We are especially pleased that the arrangement contains a quantitative benchmark for ADMARC's net profit. In Malawi's particular circumstances, however, it would be more appropriate to give this test of progress the status of a performance criterion. In turn, the external borrowing limits seem less vulnerable to slippage and might therefore be given the status of quantitative benchmarks.

Finally, I would hope that the views of the Board on Malawi's policy framework paper could be transmitted to the World Bank in some fashion. At our Board discussion of policy framework papers in early May, there was a general feeling that such a gesture would be useful.

Mr. Marcel said that his authorities attached great importance to the timely implementation of arrangements under the enhanced structural adjustment facility, and he was therefore pleased that Malawi was able to take advantage of the new facility by embarking on a strong structural adjustment program. In general, he shared the views of previous speakers on the excellent quality of Malawi's adjustment program.

However, he remained concerned at the presentation of two different scenarios in a policy framework paper, Mr. Marcel observed. The two-scenario approach was confusing since it could be difficult to know which scenario had been chosen by each of the three parties involved in preparing the policy framework paper. It could also lead to the conclusion that no common position had been reached between the parties. That, of course, would be inconsistent with one of the goals of the policy framework paper exercise, which was to deepen the collaboration between the Fund and the World Bank.

In Malawi's case, for instance, the Fund used the low scenario for its first arrangement under the enhanced structural adjustment facility, while the World Bank used the high scenario in its industrial and trade policy adjustment credit, Mr. Marcel commented. Such a situation could be puzzling for external donors or creditors, and should therefore be avoided in the future.

He agreed with the staff proposal to establish the level of access at 150 percent and with the schedule for disbursements, Mr. Marcel remarked. He also supported the selection of quantitative and structural benchmarks. The focus on the performance of the agricultural and development banks seemed quite appropriate, in view of the potential for slippages.

He was somewhat concerned about the projected decline in the use of Fund resources in the coming years, Mr. Marcel concluded. While he understood the authorities' wish to borrow from the cheapest sources possible, and hence to limit their purchases under the stand-by arrangement, he feared that the Fund might withdraw its own resources from the poorest countries. In cases like that of Malawi, his chair preferred the Fund either to withdraw its resources more slowly or not at all. He fully supported the proposed decisions.

Mr. Fernando made the following statement:

> We have no difficulty in completing the review under the stand-by arrangement. The authorities have used only the first credit tranche, and have prudently decided to avoid further drawings. Performance criteria have been met, some ahead of schedule. The authorities should be commended for the resolute manner in which they have adjusted the fiscal balance. The fiscal adjustment in 1987/88 was not merely large, in a deteriorating environment, but it was also high quality, as a current expenditure overrun largely caused by interest on debt has been recouped through higher revenues. Bank financing of the deficit, originally targeted at 2.5 percent of GDP, has been contained at 1.5 percent, and is striking evidence of the authorities' commitment to fighting inflation.

Strategies to combat inflation have been impeded by constrictions on the supply situation arising from several years of import compression, compounded by transport bottlenecks, the refugee problem, and drought. The situation facing monetary policy is also far from ideal. There is excess liquidity in the banking system, to the point where banks are reported to be refusing deposits. Further mobilization of private savings is not envisaged through the interest rate instrument, and interest rates continue to be negative in real terms. Private sector demand for credit is sluggish. The anticipated increase in private demand as activity picks up is to be met from government repayments to the banking system as fiscal adjustment proceeds. In this situation, the short-term goal of monetary policy--stabilization--should be carefully screened off from growth-promoting initiatives. Direct monetary controls for a temporary period and supply-side measures may have to be relied on to a greater extent to curb inflation.

We underscore the need for steady export growth. While rescheduling would provide financing support to the balance of payments during the program period, the postponement of debt repayments and the additional repayments arising from the increased financing during the program period make the objectives of steady export growth and a reserve buildup as vital as growth. We welcome the staff's attempt to focus on this issue through the ten-year overview of the balance of payments given on page 21 of the staff paper. We recall that at the recently concluded Toronto summit, expectations were raised about exceptional debt relief on lines originally proposed by Chancellor Lawson. Translated into operational reality, these initiatives would exert a further positive influence on these financing projections. Staff comments on how this extra financing would support Malawi's adjustment effort would be appreciated.

On the export front, much of the expected gain is from the agricultural sector, where smallholders predominate. While we welcome the price incentives introduced to encourage production, an export effort requires support beyond the farm gate to bring about the product quality required to make exports competitive. This is an area for close and continuing attention, as increased production is not synonymous with increased exports.

Our attention was drawn to the alternative scenarios for financing and their implications for growth laid out in the policy framework paper. For the third year running--during which an extended arrangement has run out and a successful shadow adjustment program has been merged into a stand-by arrangement--real per capita income has declined. Stronger international support can accelerate by two years the beginning of a restoration of per capita incomes in the context of adequate growth. Malawi has demonstrated its commitment to strong and comprehensive adjustment through a good track record and prior actions. In this context, we join Mr. Enoch in asking whether the authorities successfully received financing of the scale suggested by the higher growth scenario at the June meeting of the Consultative Group. While the speed with which the economy's response to adjustment can be markedly influenced by external financing support, we may have to review the level of access under the enhanced structural adjustment facility in subsequent arrangements, if the marginal financing is not forthcoming from external sources. I also note that Malawi's policy measures in the area of trade liberalization and exchange reform involve high short-term external costs.

Finally, with respect to the social impact of sustained adjustment, we note from the policy framework paper that programs targeting specific groups are under study, many with World Bank collaboration. We would urge speedy action on these studies. We support the proposed decisions.

Mr. Lim said that he broadly agreed with the staff paper, and thus readily supported the proposed decision regarding the review under the stand-by arrangement. He also endorsed the request for a three-year arrangement under the enhanced structural adjustment facility.

Malawi's economy had been confronted by a series of significant external challenges in recent years, culminating in significant fiscal and external imbalances in 1985/86, and the emergence of arrears in external trade payments, Mr. Lim remarked. That had necessitated the imposition of exchange controls and the rescheduling of external debt. The authorities had demonstrated a clear commitment to address those problems through an appropriate package of financial and structural policy reform. The stand-by arrangement approved in March 1988 had built on the early financial measures initiated in 1987, and the authorities were to be commended for successfully meeting all performance criteria.

The authorities had also acknowledged that the advances achieved to date in reducing the domestic deficit, expanding the tax base, and liberalizing the financial and foreign exchange systems needed to be reinforced over the medium term by a comprehensive program of structural reform, Mr. Lim concluded. He particularly welcomed the emphasis to be placed on the primary role of the private sector and on parastatal reform, and the acknowledgment that structural reform would need to be supported by appropriate fiscal, monetary, and external policies aimed at containing domestic demand and significantly reducing the rate of inflation. The conservative external funding assumptions were also notable.

Mr. Yoshikuni made the following statement:

I welcome the opportunity to discuss Malawi's economic program under the stand-by arrangement and, more importantly, the first request made to the Fund for arrangements under the enhanced structural adjustment facility. As one of the major contributors to enhanced structural adjustment facility resources, my Japanese authorities have awaited the successful launching of the first program under the facility since the basic outline of the facility was agreed late last year. At the same time, however, we have stressed from the outset that a strong adjustment program within a comprehensive medium-term framework should be a prerequisite for access to the new facility.

Malawi has been faced with severe strains on its economy despite cautious and effective management by the authorities. In addition to the unfavorable external environment--reflected, for instance, in oil price increases and high interest rates--the relationship with Mozambique exacerbated the situation. Against this background, the budget and current deficits widened, the inflation rate accelerated, and real GDP growth turned negative.

The authorities, with the assistance of the Fund, have addressed these problems vigorously, and developed the current program supported by the stand-by arrangement approved in March. It is encouraging that all the performance criteria have so far been met, and there have recently been some favorable developments--such as the reduction in the budget deficit in fiscal 1987/88 and the elimination of external arrears to private banks faster than scheduled. Furthermore, the medium-term structural adjustment program includes sufficient reforms aimed at restoring economic balance through liberal economic policies.

Nonetheless, I share the concerns of other Directors regarding the existence of two scenarios in the policy framework paper, and would appreciate staff comments on this point. It is encouraging that some important measures have already been implemented since July 1987, and these can be regarded as successful prior actions for the medium-term program. There is no room for complacency, however, given the continuing severe external circumstances still facing the country. After all, as Malawi has a per capita income below the average for sub-Saharan Africa, the three-year program is far from sufficient to realize and maintain sufficient economic growth while restoring external viability. To this end, the authorities must incorporate the three-year program efficiently into the longer-term development policies referred to in the policy framework paper. They should proceed with the proposed far-reaching structural reform program without any delay.

In view of the current severe difficulties facing Malawi's economy, it is also essential to support the authorities' efforts with sufficient financial aid, preferably on concessional terms, in order to promote the program efficiently in the medium term. With these considerations in mind, I fully support the proposed decisions.

As this will be the first program supported by arrangements under enhanced structural adjustment facility, the staff and the authorities should make the utmost effort to keep the economy on track as a good precedent for other countries seeking such arrangements.

Mr. Grosche made the following statement:

Economic developments and growth over the past few years were increasingly hampered by growing domestic and external imbalances, owing to weaknesses in macroeconomic policy and to widespread and deep-seated structural deficiencies which need to be comprehensively addressed. Malawi is thus an appropriate candidate for the Fund's first arrangement under the enhanced structural adjustment facility, especially as the country has demonstrated its willingness and ability to adjust by performing well under the stand-by arrangement. It is reassuring to see that despite the difficult situation facing the country, the stand-by arrangement is broadly on track, and I have no difficulty in endorsing the proposed decision on the first review, and welcome the fact that no further drawings are expected to be made under that arrangement.

This first arrangement under the enhanced structural adjustment facility will set the pace for future cases. Therefore, my comments should be taken as a small contribution to the Board's guidance for the staff in framing future and perhaps more difficult cases. In general, I am content that the measures already taken and agreed to by the authorities are adequate, and that the three-year program deserves the support of the Fund under the enhanced structural adjustment facility. I also share the staff's judgment that the program should lead to a viable balance of payments position at the end of the program period. This is, of course, the major objective of such arrangements and a prerequisite for timely repurchases. Moreover, while I appreciate that Malawi already has a fairly open trade and payments system, I hope that the remaining restrictions are removed, preferably before the end of the program period.

Notwithstanding my general support, I wonder whether the need criterion has been fully met at this juncture. There may be problems looming ahead in terms of balance of payments financing, but at this stage the current account deficits are expected to be broadly financed through external assistance, and they do not constitute a protracted balance of payments problem. After all, it is quite normal and appropriate that a developing country runs current account deficits, provided, of course, that they are soundly financed. I would be grateful to the staff for any comments that they may have on this issue, and on the question of the different scenarios in the policy framework paper and whether a higher growth scenario would be achievable in terms of financing and its repercussions on the balance of payments.

I certainly agree with the access limit of 150 percent of quota and the even distribution of purchases during the program period. The overall balance of payments outlook and the existing high Fund exposure warrant such a phased approach. The mix between structural and macroeconomic policies is also quite adequate. The contemplated structural measures appear comprehensive and far reaching. The authorities correctly concentrate their efforts on agriculture, which will remain the key sector of the economy. And I agree that producer incentives and productivity have to be improved to increase agricultural production and thereby reduce dependence on food imports. In this context, the future role of the Agricultural Distribution and Marketing Corporation (ADMARC) is quite important. I certainly welcome the measures already taken to reduce ADMARC's monopolistic position. However, I am somewhat disappointed that further measures appear to have been postponed until the completion of a study reviewing ADMARC's functions; but I noted that the completion of this study had been formulated as a structural benchmark. I also note that the staff--in its guidelines on the development of enhanced structural adjustment arrangements--consider that studies are not an acceptable substitute for actions.

Given ADMARC's crucial importance for fiscal performance, I would have expected somewhat more extensive, concrete, and earlier actions. At any rate, I hope that the recommendations of the study are translated into immediate and concrete action. Similarly, quite a number of the structural measures contained in the policy framework paper seem to lack specification. I would thus urge the authorities to put them into concrete form when the policy framework paper is updated prior to the second annual arrangement under the enhanced structural adjustment facility.

We have some reservations about the appropriateness of the contemplated macroeconomic adjustment efforts, both domestic and external. Specifically, the program envisages a significant expansion of investment and a growing gap between investment and savings. And although the current account deficit currently seems to be covered, financing will remain at a high level. Given Malawi's stage of development, it is quite understandable, and even absolutely necessary, that the authorities should strive for increased external assistance to promote investment and growth. On the other hand, however, dependence on external assistance carries the risk of unexpected delays or shortfalls in disbursements which would tend to hamper investment activity. Moreover, concerns may arise as to the administrative capacity of the authorities. As far as the shortfalls are concerned, that is perhaps already a part of the answer to one of my earlier questions to the staff. To be sure, I do not want to question the authorities' investment objectives, particularly since the investment program has in the past and will in the future be continuously reviewed by the staffs of the World Bank and the Fund. That should ensure that the resources flow into productive projects and strengthen the country's debt servicing capacity. However, only a moderate effort appears under way to mobilize domestic savings. Government revenues will be stagnant at best over the program period, and the share of domestic savings in GDP is projected to rise only moderately. Moreover, interest rates are negative in real terms, and hence are not yet an effective instrument for mobilizing domestic savings and allocating resources. Nonetheless, I welcome the removal of controls on the interest rate structure and the intended close monitoring of interest rate developments. Even more important is the improved control of liquidity in the banking sector. I hope that the recommendations in the technical study prepared by the authorities with the assistance of the Fund's Central Banking Department will be implemented soon, so as to ensure attainment of the monetary objectives.

Malawi has embarked on an encouraging and far-reaching adjustment course that goes a long way toward improving resource allocation and strengthening the basis for higher economic growth. Successful implementation of the program will certainly require persistence and endurance on the part of the authorities. In this regard, I am encouraged by the performance under the current stand-by arrangement, and I have no doubt about the authorities' continued commitment to adjust and to revive Malawi's economy. I approve the proposed decisions.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/104 (7/14/88) and EBM/88/105 (7/15/88).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/88/172 (7/13/88) is approved.

APPROVED: April 4, 1989

JOSEPH W. LANG, JR.
Acting Secretary

Final Version of the Chairman's Summing Up of the Discussion on the Compensatory and Contingency Financing Facility Concluded at Executive Board Meeting 88/105, July 15, 1988

These remarks summarize my understanding of the agreement that has been reached on the general principles and specific modalities for the compensatory and contingency financing facility. My informal remarks of April 7, 1988 (Informal Session 88/5, 4/7/88) on the same subject form an integral part of the understandings and are included as an Appendix to this summing up.

At the meetings that took place in March and April of this year, broad agreement was reached on general principles and a framework for the new facility. In particular, it was concluded that the essential features of the compensatory financing facility should be preserved; that contingent Fund financing could help maintain the momentum of adjustment programs against adverse external shocks; and that the basic features of contingency mechanisms should include an appropriate blend of adjustment and financing, incorporate symmetry, and involve external factors beyond the control of authorities, subject to a minimum threshold level for activation. To these principles I would add the need to pursue parallel contingent financing vigorously where necessary and to ensure that programs continue to be adequately financed when Fund resources are disbursed. It is also important to stress that purchases under this facility, as under all Fund facilities, would be subject to balance of payments need and that, in providing financing under this facility, due attention will be paid to the member's capacity to meet its obligations to the Fund.

In our meetings over the past few weeks, Directors have reached agreement on a number of operational modalities for the new facility and the features of this agreement are summarized below. Directors also concluded that in order to avoid creating an unduly rigid and complex system, many detailed operational aspects of contingency financing would have to be developed with the authorities at the time each associated arrangement is framed, on an experimental and case-by-case basis. As each case comes before the Board, and is commented on by Directors, that experience will be duly reflected in subsequent cases. Then, before the 1989 Annual Meeting, there will be a general review of the compensatory and contingency financing facility based on experience with its operations.

I will now turn to the detailed modalities for the new facility.

1. Access limits for contingency mechanisms

Contingent financing would be subject to the cumulative access limits for the facility. In addition, contingent financing would not generally exceed 70 percent of access under the associated arrangement. For multi-year arrangements there would be a flexible approach for distribution of access as between years; normally, some front-loading and carry-over of access would be provided for, but access in any one year would not generally exceed 70 percent of the access available under the associated arrangement in each 12-month period.

2. Activation

Contingency mechanisms would be attached to Fund arrangements and would be approved by the Executive Board at the time of the approval of the associated arrangement. Contingency mechanisms generally would be activated on the basis of a review by the Executive Board. Such reviews would normally be conducted within the context of a midterm program review, although in some cases it might be useful to conduct an ad hoc review. Eventually, some of these reviews might occasionally be conducted on a lapse of time basis, but it is understood that in the early experimental stage of the new facility a discussion by the Executive Board would take place in each case.

In some exceptional cases where the link between additional financing needs and the relevant contingencies and the policy actions that would need to be phased in could be specified in advance with sufficient precision, the Executive Board could give advance approval for the disbursement of contingent financing without further Executive Board review. In such cases, the staff assessment could be expedited and, after the Board has received adequate advance notification, disbursements would be made. All purchases would of course require observance of the arrangement's performance criteria, adjusted by the Executive Board as necessary to take account of the effects of the contingencies.

3. Resources for contingent financing

Purchases for contingent financing will use ordinary resources with a repurchase period of three to five years. Access would be considered separate from holdings resulting from the use of Fund resources under any other policy but not from holdings resulting from purchases on account of export shortfalls or excess cereal costs. As is the case with purchases under tranche policies, purchases for contingent financing and holdings resulting from such purchases would be excluded for the purpose of determining a member's reserve tranche position.

4. Choice of the optional tranche

The optional tranche would be divisible. Prior to activation of a contingency mechanism, members would be free to choose the application of the optional tranche, except when the member requests and the Fund agrees to specify in advance an allocation of the optional tranche; it is expected that this would mainly involve cases where parallel contingent financing was being arranged. At the time of activation of the contingency mechanism, members would commit themselves on the use of the optional tranche for the remaining period of the baseline.

5. Minimum threshold

For an experimental period until the general review of the facility has been completed, the staff would work with a threshold of 10 percent of quota, but management would have the freedom to propose a lower or higher figure in what is expected to be the relatively few cases where this was necessary. Four percent of quota--an amount that is assumed to be covered as a minimum in all basic programs through appropriately flexible policies and/or financing--would be deducted before calculating the financing to be made available or before applying the symmetry procedures.

6. Proportion of deviation to be financed

The proportion of a contingent deviation to be financed would be determined on a case-by-case basis to ensure an appropriate mix of adjustment and financing and would be established at the outset of the arrangement with a contingency mechanism. In the period immediately after an adverse shock has occurred, it would normally be expected that the Fund would finance a substantial proportion of the adverse deviation. Every effort would be made to obtain parallel contingent financing from other creditors and contingency mechanisms would not be activated unless the program continued to be adequately financed. The proportion of the deviation to be financed could be changed at the request of the member at the time of the activation of the contingency mechanism, if the program was being affected by shocks of a nature that made the originally decided split between financing and adjustment inappropriate.

7. Phasing

Contingent financing would be phased through the baseline period at the same time as purchases under the associated arrangement. The phasing would take into account the time path of the net deviation from the baseline and the timing of the implementation of additional policy measures. When a shock covered by the contingency variables had occurred the first purchase would be made available when the cumulative deviation from the baseline was projected to exceed the threshold. Subsequent purchases would be proportional to the net deviation estimated for the corresponding quarters, on the basis of shocks that had already been observed. When a member has made a purchase under a contingency mechanism on the basis of an estimated deviation which later is shown to be incorrect, the member will be expected, unless the Fund decides otherwise, to make a prompt repurchase to reverse any overcompensation.

8. Symmetry

When a favorable deviation relative to the baseline occurs, a substantial part of the favorable deviation would be used to build up reserves in cases where reserves were low. Where reserves were at a more adequate level, part of the favorable deviation would be reflected in a reduction of purchases under the basic arrangement, or, if an earlier contingency purchase had been made, the member could opt to repurchase contingency purchases.

9. Eligibility of structural and enhanced structural adjustment arrangements for contingency mechanisms

It has been agreed that it would be desirable to permit contingency mechanisms to be attached to arrangements. In view of the limited amount of resources available to the Special Disbursement Account and the ESAF Trust and the restrictions on their utilization, financing for this purpose would need to be provided from the Fund's general resources. The possibility of providing for concessionality in the resources disbursed under contingency mechanisms for low-income countries will be reviewed at a later date.

The use of the Fund's general resources for contingency financing for structural and enhanced structural adjustment facility arrangements raises issues with respect to the uniformity of treatment of Fund members. For this fundamental principle to be maintained, the conditionality attached to the use of the Fund's general resources under a contingency mechanism must be the same, whether this is in connection with a structural adjustment arrangement, an enhanced structural adjustment arrangement, or an upper credit tranche arrangement.

This does not pose difficulties with respect to the enhanced structural adjustment facility, but to enable a contingency mechanism to be activated for a structural adjustment arrangement, it would be necessary for the member concerned to agree to a program sufficiently strong to permit the Executive Board to determine that the structural adjustment arrangement in question entailed conditionality equivalent to that of an upper credit tranche arrangement. It would also, as a practical matter, be necessary for such structural adjustment arrangements (and, as relevant, for enhanced structural adjustment arrangements) to incorporate stronger provisions for monitoring, including a review to change benchmarks as necessary and to formulate them in a way that would govern the phased disbursements under the contingency mechanism, as well as to activate the mechanism.

The principle of uniformity precludes a differentiated overall ceiling on access to the Fund's general resources. Therefore, care will be taken to ensure that a member eligible for arrangements under the structural adjustment facility or the enhanced structural adjustment facility would not, by virtue of its eligibility both for arrangements under those facilities and for upper credit tranche arrangements, have higher access to the Fund's general resources under the contingency mechanism than a member who is not eligible for the structural and enhanced structural adjustment facilities.

10. Eligibility of enhanced surveillance procedures for contingency mechanisms

The attachment of contingency mechanisms to the procedures for enhanced surveillance would be examined further in the context of the review of enhanced surveillance.

11. Coverage

As a general principle, contingency mechanisms would cover unanticipated changes in the exogenous components of a few key external variables: export earnings, import prices, and interest rates. Other current account transactions (such as tourist receipts and migrant workers' remittances) could also be covered where they are of particular importance. Capital movements and unanticipated shifts in the volume of imports of goods and services would not be covered. Natural disasters would not be covered by contingency mechanisms, but could give rise to assistance under the Fund's decision on emergency assistance related to natural disasters.

Coverage in the context of a particular Fund arrangement would be determined on a case-by-case basis, in discussion with the authorities. In all cases, the specific set of variables selected would need to cover a substantial proportion of the exogenous components of the country's current account. At the same time, the authorities and the staff would have sufficient flexibility in determining coverage to avoid complications in the calculations of baselines and contingencies that could substantially delay agreement on programs and activation of the contingency mechanism. The subset of variables covered would be specified at the inception of the program and would remain unchanged throughout the life of the associated arrangement.

Contingency mechanisms would cover unforeseen changes in nominal interest rates, and would be limited to changes in benchmark international interest rates, such as the London inter-bank offered rate (LIBOR). Accordingly, unexpected deviations in interest costs stemming from changes in the risk premium, exchange rates, and unanticipated external borrowing would not be covered. Fund financing of interest rate contingencies would apply to the member's net external debt, which would generally be defined as the public and publicly guaranteed gross external debt minus official external assets. Such contingencies would apply only to instruments that are affected by unforeseen changes in interest rates.

Contingent financing of interest costs would be subject to a cumulative sublimit of 35 percent of quota. When such a limitation applied, the calculation of the net aggregate contingent deviation would be modified so as to avoid triggering symmetric provisions of the mechanism in situations where the country would otherwise have experienced a contingent shortfall. Parallel contingent financing from commercial banks will be pursued vigorously. However, provided that adequate financing of the program is assured, there would not be a formal requirement for advance coverage of interest rates and other contingencies by mechanisms established with commercial banks. Countries also would be encouraged to hedge a part of their foreign debt against unforeseen rises in world interest rates, on the basis of the several instruments available in world financial markets.

12. Calculation of contingent deviations

Contingent deviations for individual current account variables would be calculated in relation to a baseline projection specified at the inception of the program. The aggregate size of the contingent deviation for a particular member would then be calculated as the net sum of deviations from baseline values for individual variables.

In preparing the baseline projections the staff would draw on world economic outlook forecasts of key variables, supplemented as appropriate by country-specific variables, and taking into consideration the country's circumstances. The key world economic outlook projections would be updated as necessary to provide an adequate basis for the calculations. The baseline normally would be specified for a period of 12 months, and in any case no longer than 18 months. Extended and enhanced structural adjustment facility (and where appropriate structural adjustment facility) arrangements would call for specification of annual baselines at the beginning of each program year.

In calculating the contingent deviations, the staff will adhere to the principle of exogeneity. Application of this principle would be straightforward for most import prices and export prices of key internationally traded commodities. For countries with a diversified export base (typically including a substantial proportion of manufactures), the staff will estimate the impact of unforeseen changes in external demand on export earnings. As regards interest rates, the contingent deviation would be calculated by multiplying the stock of net external debt specified in the baseline by the unexpected deviation in the nominal LIBOR (or the appropriate benchmark rate where liabilities are denominated in currencies other than the U.S. dollar). When necessary, the calculation of contingencies would take into account information (particularly with respect to longer-term contracts) about the lags with which changes in world prices and international interest rates have an effect on the member's current account.

13. Compensatory financing element

In situations where the member's record of cooperation in recent periods had been unsatisfactory, or where its policies were seriously deficient, the compensatory financing element is to be made available in two tranches of equal size (each 20 percent of quota), given reasonable assurance that policies corrective of the member's balance of payments problems would be adopted.

14. Approval in principle

When compensatory financing requests are accompanied by Fund arrangements approved in principle, purchase of the full compensatory financing element (40 percent of quota) would be allowed for members with a good record of cooperation, and purchase of the first tranche (20 percent of quota) of the compensatory financing element would be allowed for other members.

15. Cereal decision

Overall access under the cereal decision and the compensatory and contingency financing facility will be 122 percent of quota, as set out under alternative A in the Annex to EBS/88/100. Symmetry with the agreement to maintain access at its current level of 83 percent of quota for export shortfalls for members with a satisfactory balance of Payments position except for the effects of the export shortfall would suggest leaving in place the existing access limit of 83 percent of quota for cereal excesses and the existing joint limit of 105 percent of quota for members with a satisfactory balance of payments position except for the effects of the cereal excess/export shortfall. This approach implies a potential to include access for contingency financing up to an overall access limit of 122 percent of quota.

16. Transitional arrangements

Under transitional arrangements, (i) there would be access of 40 percent of quota for contingency financing for countries with outstanding compensatory financing purchases of more than 65 percent of quota at the time the new decision is approved; and (ii) compensatory financing requests on which discussions were initiated before the approval of the new decision would be governed by the current compensatory financing facility decision for a period of three months after the approval of the new decision.

17. Calculation of compensable export shortfalls

a. Projection limits

There would be an upper limit on the projections of export earnings to be used in the calculations of export shortfalls. The limit on the projected growth of the average level of exports in the two postshortfall years over the average level of exports in the two preshortfall years would be set at 20 percent. Periodically, this limit would be reviewed, and if necessary revised, in the light of developments with respect to world inflation.

b. Adjustment for overcompensation and undercompensation

A compensatory financing request based on a shortfall falling within or overlapping with the two-year projection period of an earlier purchase would be adjusted by the amount by which the earlier purchase may have been overcompensated. Similarly, any undercompensation of the first purchase would be added to the subsequent shortfall when determining the size of the second purchase.

18. Avoidance of double compensation in compensatory and contingency financing

In calculating compensable amounts under the new facility, the staff will apply procedures to avoid double compensation between compensatory, including with respect to cereal costs, and contingency financing along the lines outlined in EBS/88/100. Under the procedures, a member with a contingency mechanism that includes export earnings as a variable should be able to be compensated under both contingency and compensatory financing, provided the amounts compensated under one component are deducted from the amounts to be compensated under the other. The member will have the choice to classify the amount of compensation deemed common to both contingency and compensatory financing as a purchase under either component.

The Chairman's Informal Remarks on the Compensatory Financing Facility and External Contingency Mechanisms

I would intend that these informal remarks be provided to the members of the Interim Committee as background. Our recent discussions lead me to believe that there is broad agreement in the following areas:

(1) On general principles, we have agreed that the essential features of the compensatory financing facility should be preserved; that contingent Fund financing could help maintain the momentum of adjustment programs against adverse external shocks; and that the basic features of contingency mechanisms should include an appropriate blend of adjustment and financing, symmetry, and a focus on disturbances above a minimum threshold level involving external factors beyond the control of authorities.

(2) On the operational framework, there has been broad support for an approach that would combine compensatory and contingency elements into a single facility, attaching the external contingency mechanism element to Fund-supported adjustment programs. On overall access, agreement might be found on a figure of 105 percent of quota. The amount available under compensatory and contingency elements would each be 40 percent of quota and an optional tranche to supplement either element at the choice of the member would be 25 percent of quota.

(3) On the compensatory financing facility, the guidelines on cooperation approved by the Executive Board in 1983 would continue to apply to compensatory financing purchases. In applying the guidelines it would be the intention to ensure that purchases under the compensatory financing facility continue to provide timely compensation for export shortfalls while at the same time providing reasonable assurance of protection of the Fund's resources. The application of the guidelines which would govern access to the compensatory financing facility is set out in the Attachment. If a member decided also to apply the optional tranche to the compensatory financing facility, then that tranche would become available upon either approval or review of a program supported by the use of Fund resources or, in the absence of such a program, upon the Fund being satisfied that equivalent requirements had been met. It should be understood that where a member has a satisfactory balance of payments position except for the effect of the export shortfall, the member would continue to qualify for an outright purchase of 83 percent of quota.

(4) On the question of access to contingency financing, provision for such financing in a Fund arrangement would create a positive presumption of contingent financing for specified amounts which would be established on a case-by-case basis, taking into account the need for an appropriate mix of adjustment and financing and the member's capacity to meet its obligations to the Fund, and would not generally exceed 70 percent of the access under the associated basic arrangement.

After it appeared that a specified contingency was arising, a review by the staff would be carried out and Executive Directors would be asked to decide whether an external contingency mechanism purchase was justified, the amount that was justified, the extent to which existing performance criteria might need to be modified, and the understandings that might need to be reached with the authorities on adaptation of policies. Such reviews would normally be conducted within the context of a mid-term program review, although in some cases it might be useful and appropriate to conduct an ad hoc review in order to expedite the process. In some exceptional cases, an attempt would be made to specify at the outset of the program the link between additional financing needs and the relevant contingencies and the policy actions that would need to be phased in should the contingencies arise. Where this specification could be done with sufficient precision, disbursement of contingent financing could proceed once it had been ascertained that performance criteria had been observed for the relevant period of the arrangement. In such cases, the staff assessment could be expedited and, after the Board had been informed, disbursements would be made. In all cases, disbursements would of course require observance of relevant performance criteria.

There are still a number of important matters that remain to be discussed, including the mechanism for symmetry and the extent and nature of coverage for interest rate developments.

It would be my intention after the Interim Committee meeting to ask the Executive Board to consider further the modalities and operational elements of external contingency mechanisms.