INTERNATIONAL MONETARY FUND

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Informal Session 88/8

3:00 p.m., July 6, 1988

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

Executive Directors	Alternate Executive Directors
	S. M. Hassan, Temporary
F. Cassell	
Dai Q.	
	D. C. Templeman, Temporary
J. de Groote	J. Prader
A. Donoso	E. V. Feldman
	S. K. Fayyad, Temporary
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	J. Hospedales
	W. N. Engert, Temporary
	N. Toé, Temporary
Y. A. Nimatallah	
	L. Filardo
	M. Fogelholm
	D. Marcel
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
G. Salehkhou	
	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	

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

Also Present
Asian Department: R. J. Hides. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; D. Burton, C. Puckahtikom, B. C. Stuart. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, General Counsel; P. L. Francotte. 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: H. C. Kim, Y. Ozeki. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, A. G. A. Faria, Khong K. N., K.-H. Kleine, P. Péterfalvy, G. Pineau, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: N. Adachi, J. R. N. Almeida, R. Comotto, V. J. Fernández, B. R. Fuleihan, S. Guribye, M. Hepp, C. Y. Legg, S. Rebecchini, S. Rouai, Shao Z., C. S. A. van den Berg, R. Wenzel.

1. COMPENSATORY AND CONTINGENCY FINANCING FACILITY - MODALITIES

The Executive Directors resumed from the previous meeting (Informal Session 88/7, 7/6/88) their consideration of a staff statement on understandings related to the compensatory and contingency financing facility made at that meeting. They also had before them a staff paper on modalities for the compensatory and contingency financing facility (EBS/88/100, 5/24/88; and Cor. 1, 5/25/88); a statement by the staff representative from the Exchange and Trade Relations Department on issues related to modalities for the compensatory and contingency financing facility, made at EBM/88/100 (6/27/88); and a draft decision relating to compensatory and contingency financing (EBS/88/128, 7/6/88).

The Director of the Exchange and Trade Relations Department suggested that the sentence currently in brackets in Section 7 could be reworded to read: "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 might be requested to make a prompt repurchase." The staff would consider the ease with which a member could make a prompt repurchase when deciding whether or not to request a member to make such a repurchase. Mr. Kafka had raised the point that a member might have already used its contingency financing and would not be able to make a repurchase.

Mr. Cassell noted that the new wording was a considerably watered-down version of the first draft, and went too far for his preference. He would suggest using the term "would normally be expected."

Mr. Grosche said that he would have to consult with his authorities on any dilution of the existing language.

Mr. Posthumus indicated that the new language did not satisfy him either.

The Director of the Exchange and Trade Relations Department then turned to the last paragraph of Section 9, which the staff suggested replacing with a new paragraph that would read: "The principle of uniformity precludes a differentiated overall ceiling on access to the Fund's general resources and, therefore, care will be taken to ensure that a structural adjustment arrangement/enhanced structural adjustment facility-eligible member should 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 that is not eligible for the structural adjustment arrangement and enhanced structural adjustment facility." That wording could be adjusted somewhat, but the idea was to replace the existing language with a general statement.

Mr. Posthumus asked that the staff explain the relationship between structural adjustment facility conditionality and upper credit tranche conditionality.

The General Counsel said that there was a difference between structural adjustment facility and enhanced structural adjustment facility conditionality. The structural adjustment facility was based on first credit tranche conditionality, with the concept of "reasonable effort" being used. Moreover, there were no performance criteria and no phasing, so that conditionality was very much like a first credit tranche purchase in the General Resources Account. A higher degree of effort was required for access to the resources of the enhanced structural adjustment facility. Phasing and performance criteria did exist for that facility. Accordingly, there was no substantive problem with respect to the enhanced structural adjustment facility, but there might be a problem in granting access to the structural adjustment facility unless the member was willing to propose a stricter program when it was seeking both an arrangement under the structural adjustment facility and an upper credit tranche stand-by arrangement. It was for the Fund to decide whether the level of conditionality was sufficient for the current decision.

Mr. Templeman remarked that the absence of monitoring in the structural and enhanced structural adjustment facilities would have to be corrected, which would allay concerns about conditionality.

Mr. Hassan commented that, in trying to make it possible for structural adjustment facility-eligible countries to benefit from external contingency financing, the Fund might be changing the nature of structural and enhanced structural adjustment facility arrangements, in effect converting them into stand-by arrangements. If performance criteria on quarterly benchmarks and monitoring were introduced into the structural adjustment facility, there would be little difference between that facility and a stand-by arrangement. It might be preferable to use ad hoc reviews to activate the external contingency mechanism.

The Chairman observed that the possibility was being offered for countries to adopt features that would entitle them to benefit from contingency financing when they were negotiating an arrangement under the structural or enhanced structural adjustment facilities. It would be in the interest of a country if it chose to do so. However, that was the choice of the country in question, and if it did not elect to make those changes, it could use the structural adjustment facility as it stood.

Mr. Templeman said that he had understood the agreement to be that the question of conditionality would be studied further, including the possibility of making contingency financing of the structural and enhanced structural adjustment facilities concessional. The current wording appeared to preclude such a possibility.

The Director of the Exchange and Trade Relations Department remarked that concessional contingency financing could be studied, but it would be difficult for structural adjustment facility resources to be used for such a purpose given the current modalities of the facility. There had to be uniformity between members who attached contingency mechanisms to arrangements under the structural adjustment facility and those that did not.

Accordingly, the staff considered that if there was to be concessional contingency financing in conjunction with the structural adjustment facility, additional resources would have to be found. There was somewhat more latitude in the case of the enhanced structural adjustment facility, and the staff would certainly be studying that question.

Mr. Grosche said that his chair's position was that the resources of the structural and enhanced structural adjustment facilities clearly could not be used for financing external contingency mechanisms.

Mr. Cassell suggested that the first paragraph of Section 9 end after the phrase "at a later date," deleting the phrase "...on the basis of experience with contingency mechanisms and an assessment of the prospects of obtaining additional concessional resources."

The Chairman said that he could go along with Mr. Cassell's suggestion if there were no objections.

The Economic Counsellor and Director of the Research Department indicated that Section 11, on coverage, was very similar to the presentation in previous documents, except for a specific paragraph and an appendix that had been added concerning the 35 percent sublimit on interest rate coverage. While the staff had anticipated difficulties arising from the introduction of additional sublimits, the Board discussion of June 17 (EBM/88/95) resulted in the understanding that a 35 percent quota sublimit on interest rate coverage should be introduced. The key difficulty in computation arose from a desire to combine a mechanism with a sublimit of 35 percent while adhering to the principle of symmetry. When those two features were combined, there was a possibility of triggering the symmetry provision for repurchases while, in the absence of such a sublimit, the country would have experienced a contingency shortfall. The mechanism that the staff proposed in order to resolve that anomaly was outlined in Appendix C. It was a complex mechanism, designed to allow unfavorable interest rate deviations that involved Fund financing in excess of 35 percent of quota to be used to offset net favorable deviations in other variables.

Mr. Kafka indicated that if the 35 percent limit on contingency financing of interest rates remained, his chair would have to vote against the new facility in its entirety.

Mrs. Filardo said that she agreed with Mr. Kafka in not supporting a 35 percent limit. The current compensatory financing access of 83 percent of quota was being replaced by a facility that limited access to 65 percent of quota; the added constraint of a 35 percent limit on interest rate financing was not acceptable.

Mr. Donoso said that he, too, was opposed to the notion of such a sublimit.

Mr. Nimatallah noted that it had been agreed that the new facility would be experimental for the first year. The modalities as they stood were the basis of a good compromise, which could be changed upon the facility's review.

Mr. Posthumus indicated that he could go along with Mr. Nimatallah's points, but wished to note that the staff's calculation had established that a 35 percent limit on interest rate contingencies was equivalent to SDR 5.2 billion of total quotas, which might not be enough of a limit.

Mr. Templeman asked Mr. Kafka and Mrs. Filardo to reconsider their position and to inform the Board if they found an acceptable compromise. It would be regrettable if two important chairs were not included in the final agreement.

The Chairman reminded the Board that the new facility would be reviewed after one year, at which time the decision could be amended.

Mr. Zecchini asked what the position of the German chair was with respect to the compromise text.

Mr. Grosche said that he was basically opposed to having any interest contingency introduced into the new facility, but because of the revised text he was willing to go along with it. However, his chair's position had moved considerably and he still had doubts about accepting the coverage of interest rate contingencies.

Mr. Cassell said that he, too, would go along with the compromise solution reluctantly; however, in his case that was because he did want to see interest rates covered.

Mr. Grosche said that he was not opposed to interest rate coverage only because of the implication for the Fund's liquidity. As he had said at the previous meeting, the repercussions on the behavior of debtors and creditors and the possibility of bailing out the banks were serious problems. Despite those serious reservations, he was willing to go along with the coverage because of the safeguards that had been introduced--the 35 percent sublimit, and the fact that parallel financing was being rigorously sought. In addition, because the facility would be experimental for one year, his chair hoped that the interest rate coverage could be done away with after the review.

Mr. Zecchini said that, in a spirit of compromise and with the understanding that the provision was experimental, he could go along with the text.

Mr. Fogelholm suggested that the reference to parallel contingent financing from commercial banks in the last paragraph of Section 11 be adjusted to make the statement positive rather than negative. He proposed that the third sentence read: "In order to assure adequate financing of the program, there would, in general, be a formal requirement for advance coverage of interest rates and other contingencies by mechanisms established with commercial banks."

Mr. Posthumus noted that the second paragraph of Section 11 stated that the subset of variables would remain unchanged throughout the life of the associated arrangement. It was his impression that the Board had not intended for a country to be committed to the same variables in different arrangements.

The Economic Counsellor responded that the list of variables would be expected to remain fixed unless the structure of the country's economy had changed.

Mr. Cassell asked whether the two sentences on parallel financing, in the last paragraph of Section 11, could be placed after the reference to hedging, since parallel financing applied to interest rates, but at the same time was a wider issue. Also, in the previous paragraph, which dealt with deviation in net interest payments, the definition of "payments on the gross external debt minus receipts on officially owned foreign assets" seemed to be too narrow; he would suggest that the term "officially owned" be replaced by "relevant."

The Economic Counsellor agreed that the language as it stood reflected an intrinsic asymmetry between the asset and liability sides. However, the main argument for the language was the lack of alternatives. There were two extreme options: one would be to include only the public sector, in which case there would be a problem because some countries had a substantial private debt, while others did not. The other option would be to include the entire private and public sectors, which would be difficult because of large unrecorded private sector assets. The Fund would probably not be able to obtain accurate statistics on countries' private assets held abroad. It seemed reasonable to accept the term "relevant," which would leave the definition to the staff without tying down the definition too much, since the first year of the facility would be experimental.

Mr. Reddy asked whether it was possible for members to exclude export earnings from contingency coverage, or whether they had to accept the standard selection of key external variables.

Mr. Fogelholm said that, as he understood it, it had been agreed that the variables chosen would have a netting out effect; one could not hedge against the Fund.

Mr. Reddy noted that, if that were the case, the compensatory financing element would not be usable if a country decided to make use of the contingency element.

The Economic Counsellor said that the choice of variables had to cover a substantial part of the country's current account transactions.

As he saw it, the country would be given the option to choose whether to debit the compensatory or the contingency window, subject to the overall access requirements.

Mr. Kafka noted that, in Section 12 on the calculation of contingent deviations, it was stated that: "The staff will estimate the impact of unforeseen changes in external demand on export earnings." Could the staff expand on how it would make such estimates?

The Economic Counsellor said that, for countries with a diversified export base, specific import and export prices would not provide the staff with a clear basis for the calculation of contingent deviations. A broader concept was necessary in such cases, which had been the rationale for using the impact of unforeseen changes in external demand on export earnings. The way in which that would be calculated had been described in some detail in EBS/88/100. The unforeseen deviation in foreign demand would be multiplied by the relevant elasticities.

Mr. Kafka remarked that that method did not give consideration to trends in market penetration, which were an important element in the recent development of many less developed countries. Such trends should be taken into account.

The Economic Counsellor remarked that those trends should be incorporated in the computation of the baseline itself; he had been describing the computation of the contingent deviations from the baseline.

Mr. Marcel, in reference to Section 13, stated that his authorities would have strongly preferred a higher access for the first compensatory tranche in order to make drawings on that element more attractive. Given the considerable reduction in compensatory access and the substantial tightening of conditionality, such a decision would have been fair and would not have been likely to call into question the spirit of the April 7 compromise.

Mr. Posthumus asked whether baselines of 18 months would be revised on the occasion of the annual world economic outlook projections. He could go along with baselines that were longer than 12 months when the program in question was longer, but they should be updated annually.

The Economic Counsellor said that the staff would draw on the World Economic Outlook, rather than the world economic outlook forecast. The baseline would then have to be supplemented as appropriate by country-specific variables. Furthermore, when information was provided on a regular basis, such as the London inter-bank offered rate (LIBOR), the baseline could be updated frequently. Accordingly, the methodology of the world economic outlook forecasts would be adapted in order to achieve more current results. Not only would the baseline be updated after twelve months, but there would even be further refinements within the life of the baseline.

Mr. Rye suggested that the first sentence of the last paragraph on Section 12 be adjusted to read: "...the staff will adhere to the principle of exogeneity," rather than the more flexible "be guided by."

Mr. Templeman said that his chair's original proposal to allow baseline periods of as long as 18 months had been made with the intention that 18-month baselines would be an exception for cases in which a stand-by arrangement was for 18 months. It would be helpful if the possibility of an 18-month baseline was qualified by the phrase: "where the program itself is 18 months long." On the principle of exogeneity, he was willing to consider some alternate language to "guided by"; however, "adhere to" was rather strong. His intention was to retain the fundamental principle that exogeneity depended on whether a contingency was outside the control of a member country, but he wished to avoid fine tuning variables to the extent that had been experienced with the compensatory financing facility.

On the question of compensatory financing, there was no reference in the staff statement to the specific conditionality attached to the two tranches, Mr. Templeman noted. However, the conditionality was set out in the draft decision, and it was important that it remain at least in that text.

Mr. Cassell suggested that the paragraph on approval in principle would benefit from the addition of a sentence reading: "As with the use of all Fund resources, any access must be conditional on the ability of the member to repay the Fund." Such a qualification would eliminate the sense of automaticity that the paragraph currently conveyed.

Mr. Kafka remarked that the Fund would not approve an arrangement even in principle if it considered that the member did not have the capacity to repay.

The Chairman commented that Mr. Cassell's suggestion was a reiteration of a legal point that applied to all Fund arrangements. Possibly, an overall paragraph reminding readers of general points could be placed at the beginning of the statement.

Mr. Grosche said that he fully supported the drafting of a general proviso paragraph.

Mr. Cassell said that he could go along with such a general paragraph. It was not clear to him that approval in principle guaranteed the ability of a member to repay the Fund, since the fact that the approval was only in principle meant that some uncertainty was involved.

Mr. Templeman recalled that EBS/88/100 had referred to a case in which a compensatory financing proposal was presented jointly with a stand-by arrangement. Such a case was evidence in itself that a major balance of payments problem existed and therefore the risk involved in the Fund's proceeding with approval in principle took on a different aspect.

The Fund had suggested a compromise whereby approval in principle and release of Fund financing would only take place "where the necessary additional financing which had not been assured was sufficiently small that failure to secure that financing could reasonably be accommodated through additional adjustment during the program period." The sense of that agreement did not seem to be reflected in Section 14.

The Economic Counsellor said that the staff considered Section 14 to reflect the agreement reached at the Executive Directors' working lunch to allow full contingency financing regardless of the size of the financing gap. The agreement reflected in Section 14 would release the compensatory drawing on approval in principle of a Fund arrangement; that was in line with the guidelines for use of the lower compensatory tranche, which stipulated prior actions that would give reasonable assurance that policies corrective of the member's balance of payments problems would be adopted. In effect, the Fund would not only be making a judgment that the corrective policies would be adopted, but also that the necessary financing would be forthcoming.

Mr. Templeman said that, by definition, if a stand-by arrangement was approved in principle, the necessary financing for the program had not been assured.

The General Counsel said that the relationship between the cereal decision and the compensatory financing facility, as covered in Section 15, had not yet been discussed by the Board. However, under the existing decisions of the Fund, a very close relationship existed, which it was not possible to break unless the Executive Board decided to abrogate the cereal decision. The proposal of the staff was to incorporate into the new decision taken by the Executive Board a section dealing with the problem of cereal imports, maintaining the current relationship between that aspect of the decision and the combined facility. The only change would be that conditionality for access under the cereal imports decision would be aligned to the conditionality for the compensatory financing element. The May 1989 review of the cereal facility would take place as planned.

Mr. Fogelholm asked whether cereal prices would then be excluded from general price increases on imports that would be covered under the external contingency mechanism.

The Economic Counsellor stated that, as with the compensatory financing facility, the key constraint was to avoid double compensation. Once that had been satisfied, import prices could include cereal prices in a similar way as had been done with the compensatory financing facility. Some export shortfalls provided a country with an opportunity to draw through either the compensatory or the contingency window, subject to the overall constraints.

Mr. Templeman said that he assumed the temporary access to 40 percent contingency financing regardless of a member's compensatory drawings would gradually ratchet down to the 105 percent global standard limit as repurchases were being made.

The Economic Counsellor confirmed that after the transition period a member would have reached a limit of 105 percent.

Mr. Posthumus asked whether, in the transitional arrangement, it would be possible for a country to draw on the compensatory financing element during the first three months after the decision on the new facility had been taken, and then immediately after that draw under the contingency element, resulting in a limit of more than 105 percent.

The Economic Counsellor said that the overall limit of 105 percent would still apply in such a case.

Mr. Templeman said that, on the calculation of compensable export shortfalls. his chair had had doubts about the suggestion that any under-compensation of the first purchase would be added to the subsequent shortfall when determining the size of the second purchase. Had there been a clear consensus in favor of that? Such a concept did not preserve a feature of the existing compensatory financing facility, but rather, was a new concept. To insist that a country be given take additional financing when it was not known whether the country needed that financing, or what its policies were, did not seem reasonable.

The Economic Counsellor said that paragraph b of Section 17 appeared to reflect the Board's consensus, but the staff could look into that matter further.

The Chairman noted that there was no discussion on Section 18, which dealt with avoidance of double compensation in compensatory and contingency financing. Section 19, on the review, was very important, and he suggested that it be included in the general paragraph at the beginning of the statement, since it was in light of the review that the decision had been agreed to.

The Chairman then made the following summing up:

> 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, Final Version) on the same subject form an integral part of the understandings and are included as an appendix to this summing up. 1/

1/ Reproduced in Annex.

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 multiyear 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, 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 de minimis 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. The threshold would not be deducted before calculating the financing to be made available or before applying the symmetry procedures. In order to avoid double compensation, the staff would evaluate the margin being incorporated in Fund-supported programs, and, to the extent that a quantified margin had been specified in the basic program, Fund contingency financing might not be provided for the full amount of the margin. Similarly, the symmetry provisions of the contingency mechanism might not apply until the favorable deviation exceeded a certain portion of the margin.

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 would generally be expected 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 arrangements under the structural and enhanced structural adjustment facilities for contingency mechanisms

It has been agreed that it would be desirable to permit contingency mechanisms to be attached to arrangements under the structural and enhanced structural adjustment facilities. 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 arrangements under the structural and enhanced structural adjustment facilities 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 arrangements under the structural and enhanced structural adjustment facilities, 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 an arrangement under the structural adjustment facility, 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 facility 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 facility arrangements (and, as relevant, for arrangements under the enhanced structural adjustment facility) 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 and enhanced structural adjustment facilities 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 arrangements under 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 interbank borrowed rate). 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 deviations in net interest payments (payments on the gross external debt minus receipts on officially owned foreign assets) and 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 the symmetric provisions of the mechanism in situations where the country would otherwise have experienced a contingent shortfall. Countries 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. Although parallel contingent financing from commercial banks will be pursued vigorously, generally such financing would not be a prerequisite; in cases where the contingency financing that could be made available by the Fund would be small in relation to the effects on the member's external position of changes in international interest rates and where therefore parallel financing would be necessary to ensure adequate financing of the program, there would be a requirement for advance coverage of interest rates and other contingencies by mechanisms established with commercial banks.

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 arrangements and arrangements under the enhanced structural adjustment facility (and where appropriate, those under the 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 London interbank borrowed rate (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 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 Executive Directors then adjourned their discussion of the modalities of the compensatory and contingency financing facility.

LEO VAN HOUTVEN
Secretary

Appendix to Chairman's Summing Up

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 contingency 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 a 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 midterm 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.

Application of the Guidelines on Cooperation for the Compensatory Financing Facility

I would like to elaborate on my comments on how the guidelines on the test of cooperation would relate to the compensatory financing facility, based on evolving experience. As I said, there would be no need for a change in the letter of the guidelines but we would need to interpret them in a manner that both ensures timely access for the member and provides an adequate degree of protection for the Fund's resources.

Except as provided for below, a request by a member experiencing balance of payments difficulties that go beyond the export shortfall would be presumed to satisfy the guidelines and a drawing for the full amount of the compensatory element would be available immediately if the export shortfall were temporary, largely attributable to circumstances beyond the member's control, and the member was willing to cooperate with the Fund in an effort to find an appropriate solution to its balance of payments problems. The optional tranche would become available, as appropriate, in accordance with paragraph (3) of the main text.

On the other hand, if there were substantial indications that the member's record of cooperation in recent periods had been unsatisfactory, or that its existing policies were seriously deficient in relation to the size of its existing or prospective payments imbalances, then, consistent with the guidelines, we would continue to expect prior actions that would provide "reasonable assurance" that policies corrective of the member's balance of payments problems would be adopted. In these circumstances, access to the compensatory element would be in two tranches. The first would be disbursed as soon as appropriate prior actions are taken. Disbursement of the second tranche would take place according to the present guidelines and practices relating to the upper compensatory tranche. It would generally be expected that in these cases the optional tranche would become available upon program review.

It will be important in all cases to pay due attention to the member's capacity to service its debt obligations to the Fund.