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Statement by Mr. de Groote on
Review of the Compensatory Financing Facility
Executive Board Meeting 87/156
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The CFF was added to the Fund's arsenal of financial facilities specifically to assist members with external shortfalls stemming from events beyond their control rather than from weaknesses of domestic policy. Not all the various events outside a member's control which lead to current account shortfalls are covered by the CFF, however. CFF coverage has been limited to the compensation of shortfalls which are reversible in nature. Current account shortfalls not related to exports, and external disturbances of an irreversible nature, both fall outside the scope of the CFF. This limitation of coverage will not surprise us if we reflect that during the early 1960s, cyclic shortfalls in commodity markets were in fact the only major factor disturbing countries' development and adjustment processes.

In today's very different external environment, countries' balance of payments positions are exposed to a great variety of external disturbances, many of which can affect a country's payments position for a long time. It is in relation to these prolonged disturbances that the shortcomings of the present CFF mechanism are most clearly evident: unlike quickly reversible shortfalls, prolonged weaknesses in export markets or shortfalls related to interest rate increases in general, need to be addressed with appropriate adjustment measures. The needed response to shortfalls resulting from prolonged exogenous disturbances does not, however, differ from the response to more general balance-of-payments difficulties resulting from the inappropriateness of a member's policies: both call for corrective policy measures. But the CFF provides no mechanism for financing or assisting the implementation of the appropriate adjustment when a country experiences a non-reversible external shock. And although this gap can to some extent be filled by the negotiation of a stand-by arrangement, major problems arise when, for exogenous reasons, an export weakness emerges or suddenly gets worse after a Fund arrangement has entered into force. The staff has estimated that as many as half of the stand-by arrangements which have been interrupted since 1982 might have had a better chance of survival with support from some form of additional financing to protect the program against external shocks. This surmise powerfully suggests that there exists an important gap in the Fund's present lending policies.

Efforts to close this gap by establishing more formal linkages between CFF access and Fund conditionality have so far contributed more to confusion over the CFF's true nature and less to progress toward solving the problem. In some cases CFF purchases have been authorized without appropriate safeguards. In others, CFF access may have been needlessly restricted by linkage to adjustment programs. Contradictory proposals have been put forward for increasing the automatic and quick-disbursing nature of the CFF, for phasing CFF disbursements, or for imposing more stringent access conditions. These varied responses all reflect a common uneasiness with the shortcomings of the mechanism as it stands now.

The U. S. proposal to create a contingency mechanism represents a stimulating and constructive response to the general concerns expressed during earlier discussions on the need for explicitly addressing situations which today's CFF does not cover. Like Mr. Enoch, I therefore regard this proposal as an element completing the CFF mechanism, rather than as a radical departure from the present policy. Incorporation of the contingency notion into the CFF would permit this mechanism to perform its legitimate function of protecting adjustment programs against all unforeseen disruptions of those programs' underlying assumptions, whether these are reversible or irreversible in nature.

The contingency notion is not a substitute for the present CFF principle, but rather its necessary complement, because it extends the CFF mechanism to those members who are actively involved in the process of current account correction, and who cannot achieve their external objectives due to unforeseen developments of an irreversible nature. The probability of program slippages and interruptions caused by deviations from the program's original assumptions about export market, import price and interest rate behavior could thus be greatly decreased, because as soon as such deviations begin to exert current account effects above a certain threshold, they would trigger a discussion on additional financing and adjustment measures. The question of what deviations are covered by the proposed scheme should not require lengthy negotiations between Fund and member, as the staff seems to imply. All that is needed for the scheme to work smoothly is a clear understanding, and agreement, at the beginning of the program, concerning the general assumptions on which the planned current account correction is based. These can normally be derived from the Fund's World Economic Outlook exercise. Likewise, the inclusion in the proposed scheme of interest rate deviations is neither a revolutionary idea, nor especially complex: the compensation of interest rate shortfalls would involve no judgment about what interest rates are to be considered normal or excessive, but would instead be based on a presumably sustained deviation from the interest rate assumptions accepted at the beginning of the program.

Although technically it is conceivable to incorporate the proposed compensation scheme into the stand-by arrangement itself, by building in some flexibility in access to the stand-by financing, there are strong arguments for introducing it through the CFF mechanism. This would create, in effect, an External Shock Facility with two components: a CFF window to compensate purely reversible shortfalls, and a contingency window to address irreversible situations. Use of the CFF framework would eliminate any possible confusion by clearly spelling out that the compensation measures are triggered solely by exogenous developments beyond the member's control, and not by any weaknesses in the program's policy implementation. The clear perception of this fact would encourage other creditors to assess the member's adjustment process favorably, and to relax, over time, the rigor of their own lending practices in favor of a more flexible approach to financing responses to exogenous factors affecting the country's adjustment process. And vis-a-vis the overall debt strategy, the CFF approach would have the additional advantage of symmetry: adverse deviations would trigger the release of additional financing: conversely, a performance which was better than expected would be absorbed, by increasing the program's targets with respect to official reserve holdings: this would both strengthen the member's external creditworthiness and ensure that the adjustment process would not be relaxed.

Of course, this proposed enhancement of the CFF framework would have to be supported by adequate access to the Fund's resources, to reflect both the Facility's enlarged coverage and the incentive it is intended to provide for the pursuit of sound adjustment. The provision of up to three access tranches, of 25 percent of quota each, seems about the least which could be expected to ensure the effectiveness of the scheme. This access would be additional to any access to CFF purchases which the member might have obtained for compensating a purely reversible situation prior to acceptance of an IMF arrangement.

In fact, the proposed enhancement of the CFF would have no effect on members' access to CFF purchases prior to any Fund arrangement. Members who had suffered a temporary shortfall under otherwise satisfactory balance-of-payments conditions would have a given access to the CFF, and so would members whose shortfall came on top of a pre-existing overall payments problem addressable in the context of a stand-by or SAF arrangement. I would expect that we could find an agreement on the level of this access in the range of 30 to 50 percent of a member's quota. For consistency's sake, we should also consider the possibility of extending the broad coverage of external disturbances proposed under the U. S. scheme to these lower tranche purchases, provided their temporary and reversible character can be properly demonstrated. A baseline scenario would be required in all cases, as the broad reference against which to assess the presence of reversible or non-reversible factors.

To summarize, the enhanced CFF could be worked out with the following access scheme:

- a range to be agreed on, between 30 and 50 percent of a member's quota, to compensate payments problems which are solely due to reversible shortfalls.

- an additional 75 percent of quota, phased into three tranches of 25 percent each, for compensating external disturbances which may arise during the implementation of Fund arrangements.

Access to the 30 to 50 percent segment of the Facility, which corresponds to the present CFF mechanism, would be provided to members whose current account shortfalls are of a purely reversible nature. This proposal does not exclude the possibility that countries could obtain access to this segment of the Facility at the beginning of a Fund arrangement, with the opportunity, as suggested by the staff, of an advance purchase of 25 percent of quota at the beginning of their negotiations with the Fund provided that the reversibility of the shortfall can be clearly isolated from the country's broader payments difficulties. In sum, this segment of the Facility would be a floating tranche in the sense that it could be activated independently of or prior to any Fund arrangement, or at any stage of implementation of Fund programs, even if the country had already obtained access to the contingency scheme. Global access to the enhanced shock facility would thus amount to 105 to 125 percent of a member's quota.

As to the more operational issues discussed in the staff paper, I can support the proposed introduction, into the formula for calculating shortfalls, of a ceiling on export projections in order to contain the amounts of compensation associated with rapid export growth. As to overcompensation in the case of successive CFF purchases, I agree with the staff that we should consider deducting any overcompensation produced by the first purchase from the amount to be compensated by the second CFF purchase. And as to commodities the fluctuations of which would entitle a member to use both segments of the external shock facility, I do not see any reason for excluding oil any more than any other commodity. Gold could also motivate access to the facility, since compensation for its fluctuations cannot be regarded as an intervention in its price, prohibited by Article V, section 12(a). As to the income level of countries which would be entitled to access to the renovated facility, I do not recognize any useful reason for preventing high income countries, such as Australia, from calling once again on the facility if all conditions are present entitling them to do so.

In conclusion, Mr. Chairman, let me summarize my views on today's policy issues as follows: The question whether it is preferable to continue the present CFF or replace it with a contingency mechanism is, in my view, based on an articifial perception of opposition between the notions we are dealing with today. Both approaches are partial aspects of a single basic idea: that the Fund should protect its members against external shocks to their balance-of-payments positions, whether these shocks are reversible or not. It is within this basic framework that issues related to the temporariness or permanence of the shortfalls, to the nature of the deviations to be covered, and to symmetry between positive and negative deviations, can be more easily understood and accommodated. Beyond those technicalities, what is important is to ensure that the Fund has an adequate array of instruments, and sufficient resources at its disposal, to fulfill its compensatory function. I am convinced that further elaboration of the CFF framework, along the lines which I have just suggested, could greatly improve its effectiveness and its attractiveness to members, thereby making the proposals for concessional compensatory financing a much less pressing matter.