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Minutes of Executive Board Meeting 87/36

10:00 a.m., March 3, 1987

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

Executive Directors	Alternate Executive Directors
A. Abdallah	
	Song G., Temporary
C. H. Dallara	M. K. Bush
	L. K. Hubloue, Temporary
	E. Feldman
M. Finaish	T. Alhaimus
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	
T. P. Lankester	
	H. Fugmann
	D. McCormack
Mawakani Samba	
Y. A. Nimatallah	I. A. Al-Assaf
G. Ortiz	L. Filardo
H. Ploix	S. de Forges
G. A. Posthumus	
	C.-Y. Lim
	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	

L. Van Houtven, Secretary
A. Akanda, Assistant

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Also Present

African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director. Asian Department: A. K. McGuirk, H. L. Mendis, D. M. Ripley, W. M. Tilakaratna. European Department: N. Happe. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; J. T. Boorman, E. Brau, E. M. Zervoudakis. External Relations Department: J. E. McEuen. Fiscal Affairs Department: A. Cheasty. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, Director; R. H. Munzberg, A. O. Liuksila, S. A. Silard. Middle Eastern Department: P. L. Joyce, K. Nashashibi. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; L. Alexander, N. M. Kaibni, H.-C. Kim, E. C. Meldau-Womack, A. Muttardy, R. Pownall, B. E. Rourke. Treasurer's Department: K. Boese, M. A. Lumsden. Western Hemisphere Department: S. T. Beza, Associate Director; P. C. Leme. Bureau of Language Services: R. L. Renfield. Bureau of Statistics: J. V. Carter. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, S. M. Hassan, G. D. Hodgson, J. Hospedales, Khong K. N., K. Murakami, A. Ouanes, I. Puro, N. Toé, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, J. de la Herrán, F. Di Mauro, V. J. Fernandez, G. K. Hodges, A. Iljas, S. King, M. Lundsager, V. K. Malhotra, S. Rebecchini, C. A. Salinas, R. Manfredi Selvaggi, G. Seyler, H. van der Burg, E. L. Walker.

1. COMPENSATORY FINANCING FACILITY - RECENT EXPERIENCE AND ISSUES FOR CONSIDERATION

The Executive Directors considered a staff paper on recent experience with the compensatory financing facility and issues for consideration (EBS/87/13, 1/26/87).

Mrs. Ploix made the following statement:

We welcome this opportunity to review recent experience with the compensatory financing facility. Indeed, as we have all noticed recently, each discussion by the Board of a request for compensatory financing has given rise to various criticisms, including some from this chair. Thus, it was essential for the Board to review the aims, rules, and applications of the facility.

Since my statement stresses the need for protecting the major characteristics of the compensatory financing facility, my answers to the issues raised in the staff paper will be based on the premise of preserving those characteristics. I shall also make some proposals to enable the facility to provide the type of assistance that will complement better the profound structural changes required by small monoproduct economies.

The implementation of the compensatory financing facility must respect the unique features of the facility. In that connection, we would like to stress that we are in complete agreement with the first paragraph on page 2 of the staff paper, which summarizes the reasons for the creation of the compensatory financing facility. In our opinion, those reasons are still valid. Thus, we support fully the existing guidelines derived from the facility's main features: if the test of cooperation--conditionality--is met, then the provision of compensatory financing is automatic and simple.

Two weeks ago, on the occasion of the Board discussion of Argentina's request for compensatory financing (EBM/87/28 and EBM/87/29, 2/18/87), the staff recalled that conditionality associated with compensatory financing was related to a member's current and prospective difficulties. The authorities must devise appropriate solutions for a country's balance of payments difficulties. In such a difficult exercise, it is necessary to appraise both the short-term and medium-term sustainability of the adopted policies.

Obviously, the existence of a Fund-supported adjustment program is in itself a sufficient safeguard for access to the compensatory financing facility. Nevertheless, it is clearly not a prerequisite, and the increasing practice of associating requests for drawings under the facility with requests for stand-by arrangements should not be taken as a rule. The increasing number of cases in which this practice has been followed reflects perhaps the interest rate charged for the use of Fund resources, which often deters countries not requiring a stand-by arrangement from requesting the use of the Fund's other main facility. In our opinion, a positive judgment by the staff and the Board on a country's prospects of a satisfactory balance of payments position, whether or not in conjunction with a stand-by arrangement, does meet the test of cooperation.

We will not comment on the recent issue of approving requests for use of the compensatory financing facility in principle because we will soon have the opportunity to discuss this question in the more general framework of the comprehensive review of the facility.

Two points have been raised by the staff that concern automaticity, an essential feature of the compensatory financing facility: possible limitations in the disbursement of funds, and responsibility for the export shortfall. We are clearly opposed to introducing new limits on drawings under the facility through phasing of purchases or annual limits. Shortfalls as calculated under the facility are not phased, and compensable shortfalls are regarded as having taken place prior to financing. The staff paper indicates that members using the compensatory financing facility have, on average, not allowed their adjustment efforts to weaken. Furthermore, experience has proven that without an adequate financial package, some countries would not have been able to overcome temporary problems. In our opinion, it is necessary to maintain the automaticity and the immediacy of drawings under the facility. The reinforcement of incentives to adjust is a different aspect that should be addressed through other channels.

As to responsibility for the shortfall, I recall that my authorities have always attached great importance to the requirement that any compensable shortfall must be "largely beyond the control of the member." The determination that this requirement has been met is once again a matter of judgment. Therefore, the analysis must be made on a case-by-case basis, taking into account, as recalled by the Managing Director in 1983, "the behavior of each country requesting a drawing, covering such matters as output, stockpiling, and price policies" (EBM/83/80, 6/2/83).

There are a number of practical questions, such as the use of projections, consideration of trends, coverage of the compensatory financing facility, and early repurchase of overcompensation, that are straightforward. We have no strong opinions on these points, because they seem to be questions of judgment, and our concern is to keep the facility fair and easy to implement.

Past results do not indicate that radical changes in the calculation of the shortfall are necessary. We do not see any need for introducing references to the trend, since its direction is obviously already taken into account in evaluating the future development of the member's external trade. We have no objection to the idea of compensating the excess in the cost of imports, or of taking into account fluctuations in the cost of imports to the extent that it does not excessively burden the entire process.

As for the contingencies included in the current Mexican stand-by arrangement, and the possibility of compensation of sudden interest rate movements, those questions have been taken up recently, and it is not necessary to reopen the debate today.

In line with some of our earlier comments, we consider that two of the points raised by the staff in connection with access limits are not relevant: the question of combined access limits; and the idea of differentiating access on the basis of debt servicing capacity. Those points are taken into account when assessing the sustainability of a member's current and prospective policies, and should not be introduced as new limits on access.

Another issue that constitutes a real source of concern for my authorities is whether the financial characteristics of the compensatory financing facility are designed efficiently enough to help the low-income member countries tackle their problems. In raising this point, we do not intend to bring up a general issue, because we have confirmed the usefulness of the facility and the need to retain its main characteristics. We would simply like to focus on those less-developed countries that have little or no borrowing capacity and are dependent on one or two commodities. The Fund recognizes that these countries should not borrow at market conditions, and goes so far as to introduce criteria into the design of its programs to limit a country's external borrowing capacity under nonconcessional terms. Unfortunately, such countries are almost always monoproducers. Thus, they are exposed to massive recurring risks associated with dependence on one erratic factor that can be lessened only through adjustment and diversification.

Our proposal is a very simple one--a slight variation on general compensatory financing in favor of less developed countries in the siutation that I have described. We would like these less developed countries that have embarked on a long process of adjustment and diversification with the assistance of the Fund and the World Bank to be able to make drawings under the compensatory financing facility on concessional terms. The concessionality could take two different and cumulative forms: an increase in maturity; and a lowering of the interest rate. The increase in maturity should allow the diversification effort to be sustained. Three to five years of compensatory financing is clearly not commensurate with the time needed for economic policies to be successful. Lowering the interest rate for the drawings would overcome the drawback of the Fund's rate of charge: that it is too market oriented for these countries to be able to afford such costly financing. Such concessional compensatory financing could be granted to countries that are eligible for assistance under the structural adjustment facility and that have committed themselves to a medium-term policy of adjustment and diversification. This commitment could be shown by the existence of an agreed policy framework paper, which would have to address the issue of the diversification of a country's exports and include adjustment policies, as is only to be expected for such countries. We believe that coordinated assistance by the World Bank would contribute to the adequacy of the adjustment and development programs of those countries.

My authorities would like to see the staff undertake a study focusing on this issue. Concessional compensatory financing could be implemented either through subsidies or through special funding. My authorities find the second means simpler, and thus tend to favor such a scheme. In our opinion, the funding could come from supplementary contributions. Developed countries could contribute, depending on their capacity to do so. My authorities are ready to contribute their share to such a scheme.

Mr. Kafka made the following statement:

The description of the origin of the compensatory financing facility in Section I of the staff paper requires some supplementation, at least for the purposes of comprehensiveness. Initially, the establishment of the facility had the possible effect of heading off a compensatory financing scheme that might have been established directly under the United Nations. Subsequently, the liberalization of the facility coincided with the discussion of a World Bank supplementary financing scheme for export fluctuations and led to the withdrawal of this scheme--two "victories" for the Fund.

The discussion in Section II of the staff paper also requires supplementation. The paper states on page 5 that the major concerns about the compensatory financing facility and the resulting modifications to it have reflected the need to reconcile the facility with changes in the global environment. It seems that this is only partly correct unless one attaches a particular and, indeed, peculiar meaning to the term "global environment," namely, the attitude to the facility of members with the majority of the voting power in the Fund. An increasing abhorrence of unconditionality or low conditionality by the voting majority, because of the fear that it might discourage needed adjustment efforts, has indeed been mentioned frequently during discussions at the Board. When creditors and debtors are roughly stable groups in terms of other criteria, such an approach cannot fail to polarize the financial community in line with these other criteria. Until at least the mid-1970s, or even later, such dangerous polarization had been avoided.

Another point that should be mentioned concerns the relationship between self-reversible export shortfalls, the type contemplated by the compensatory financing facility, and other causes of balance of payments difficulties. To call all the latter causes "structural" seems imprecise. The existence of such export shortfalls, together with other balance of payments difficulties, justifies only the type of conditionality that has always existed under the facility, but no more. The attempt to equate the upper credit tranche test of cooperation--in the absence of a balance of payments situation that is judged satisfactory, apart from an export shortfall--with performance under a stand-by or other financing arrangement or its adoption at the same time as compensatory financing implies a fundamental change of the 1983 decision on compensatory financing. That decision authorizes a drawing under the facility also if, in the absence of a financial arrangement, current and prospective policies meet the test of the use of Fund resources in the credit tranches. It is curious that this condition for drawings under the facility should somehow have failed to have been reproduced in its proper place in the staff paper, in this case at the end of page 7. This clause of the decision certainly implies that a country whose program has been accepted by the Fund--even if only in principle--has "current and prospective" policies that justify access to Fund resources in the credit tranches.

It is entirely artificial to limit drawings under the compensatory financing facility to cases where approval in principle has been superseded by the effectiveness of the arrangement. What does approval in principle imply? It does not even imply that there is genuine uncertainty about the availability of financing adequate to ensure the implementation of the formulated program. The Fund uses approval in principle as a means of applying pressure on the cofinancers of its programs. To my knowledge, there is not a single case in which a program that has been accepted in principle has failed to attract the critical mass of non-Fund financial support within the short time initially foreseen, and there has been only one case in which the time period has had to be extended. Therefore, the uncertainty that a financial arrangement that has been approved in principle will not become effective is minimal. In other words, that uncertainty is at best virtually nonexistent, and at worst, considerably lower than other uncertainties that may be present in an arrangement that has entered into effect. Cooperation does not mean that the member provides an unconditional guarantee to the Fund that all conditions of an arrangement will be fulfilled. It means that the member, in the face of unforeseen events, will reinforce its policies. But we have no greater right to assume that this reinforcement will take place if needed in the event of, for example, some natural catastrophe or a change in the terms of trade, than that it will take place, if needed, in the case of the failure of other financial support to materialize.

The fact that there have already been cases in which an erroneous interpretation of the decision has made is beside the point; such a misinterpretation should not be allowed to create a precedent.

We have so far spoken essentially in terms of the upper tranche of the compensatory financing facility. The conditionality associated with the lower tranche--which originally consisted purely of a credible promise to cooperate--has also been tightened radically so that prior action can now be required. The staff claims in Table 2 of EBS/87/13 that in 1985/86, only one out of six countries requesting a lower tranche drawing under the facility had had a request for a financial arrangement "discussed"; but that word is used in a peculiar sense, namely, "approval by the Executive Board." In fact, Madagascar's stand-by arrangement was approved three months after its drawing under the compensatory financing facility, and that of Bangladesh seven months after its drawing. Thus, it appears likely that three out of six drawings had recently had some relationship to the prospect of a stand-by arrangement.

As to phasing, the staff notes on page 12 that phasing would, in effect, be in contradiction to the facility's purpose of compensating past shortfalls of export revenue. The staff also mentions on page 13 that drawings under the facility do not appear to have impeded adjustment efforts relative to those cases where no recourse had been made to the facility. We look forward to the staff's study regarding the potential costs of phasing.

It should be noted that without either phasing or conditionality of the type currently applied to compensatory financing, the facility can, as it often has done in the past, serve the highly useful function of being the Fund's bridging credit facility.

There is no question that current maximum access to the facility in terms of quota is low relative to access in the early 1980s. It is also low compared with cumulative access limits under the tranche policy for drawings under the special facilities and use of ordinary resources since the mid-1970s, as shown in Table 1 on page 4 of the staff paper. In judging the adequacy of access, it should also be noted that the data on average compensation shown in Table 3 on page 11 do not consider those cases in which access under the facility was exhausted owing to earlier drawings under the facility.

As to the need for a method to protect a country against prospective contingencies, the staff paper contains enough material to stimulate thought. Of course, it should be remembered that the concept of a stand-by arrangement as such originated as a protection against contingencies foreseen with less certainty than those for which stand-by arrangements have been granted during the past 30 years. It would certainly be a mistake to replace the compensatory financing facility by a compensatory mechanism addressed exclusively to other contingencies. We encourage the staff to study such a contingency mechanism addressed not only to oil or other export receipts, but also to interest payments. It is quite likely that 1987 will be a year in which, without a generous mechanism of this kind, many programs will be in dire trouble.

As for the issues raised in Section III on entitlements to draw, with one exception, we oppose any change in present practices. That exception concerns overcompensation due to errors in projection; in that situation, we would be prepared to consider an adjustment of subsequent drawings.

We are somewhat reassured by the data and analysis regarding the accuracy of projections. However, the built-in limitations of excessive undercompensation in particular should be examined by the staff with a view to devising some protection, at the least in extreme cases of export shortfalls.

We are similarly reassured by the paucity of cases in which compensation was made available in connection with lower average exports in the postshortfall period than in the shortfall year. In principle, we see nothing wrong in the prudent use of the facility to ease the structural change that might be required in such cases of an affected economy; nevertheless, there might be cases in which the tranche policy should bear the principal burden.

On the point of responsibility for the shortfall, we reaffirm the position of this chair that the present interpretation of the decision should prevail. In the same vein, we consider that adjusting the calculated shortfall for the import content of exports would not be justified by the frequency of the cases in which the problem might be important and would mean insuperable difficulties in practice. Similarly, we agree for the time being with what we understand to be the inclination of the staff not to adjust the facility's mechanism for calculating fluctuations in import costs, irrespective of whether final imports or inputs into exports are concerned.

The question of introducing an early repurchase provision for overcompensation due to errors in projections poses difficult problems, and we would be more inclined to favor an adjustment of subsequent drawings in cases of overcompensation due to such an error.

As is evident, we cannot agree to any increase in conditionality associated with drawings under the compensatory financing facility. In fact, we oppose the present interpretation of the rules on cooperation, which virtually excludes access in the upper tranche of the facility in the absence of an effective financial arrangement. The fulfillment of the requirement under the 1983 compensatory financing decision of current and prospective policies that would entitle a member to access to the Fund's resources in the higher credit tranches can be evidenced in other ways, as the 1983 decision clearly states. Indeed, we find this decision excessively demanding. Certainly, the approval, even in principle, of a financial arrangement should be taken to imply that a member's current and prospective policies entitle that member to compensatory financing and its immediate disbursement.

We consider that the present maximum access limits of the compensatory financing facility, as of those of the tranche policy, are inadequate. Combined access limits, including ordinary and special facilities, would not be acceptable to us unless they implied an effective liberalization of access.

We oppose the reintroduction of phasing into the facility.

Mr. Ismael made the following statement:

I welcome this opportunity to discuss recent experience with the compensatory financing facility and how it should be changed to meet better the needs of members with volatile exports, while preserving the revolving nature of Fund resources. This review is timely, because the administration of the facility in recent years has satisfied neither the users--especially the large number of potential users who have shied away from the increased stringency of access--nor the major countries, which see conditionality and other terms as being too lax.

A majority of members in my constituency are primary commodity producers and exporters. Some of them account together for the bulk of several major non-oil commodities entering world trade--namely, rubber, palm oil, tin, tropical timber, and pepper--while also being net energy exporters. They have a vital interest in an effective compensatory financing facility that meets the needs of members requiring compensatory financing of export fluctuations. They have also been increasingly frustrated by the growing conditionality associated with the facility, which used to be a relatively simple special facility providing quick assistance to members facing temporary export shortfalls.

I would like to highlight briefly some of the views of my constituency about the facility as it is presently administered, in order to provide another perspective to that of the staff paper, which is inclined--too much, I think--in favor of even more conditionality and stringency of access. In this connection, this chair has had the benefit of direct consultations with our authorities at the 22nd Conference of Governors of Southeast Asian Central Banks held in Nepal in January 1987. At this conference, Governors deplored:

- The change in character of the facility since the 1980s, making it in practice a supplementary facility to stand-by or extended arrangements, rather than a special independent facility as originally intended.

- The interpretation of the phrase "beyond the control of the authorities" to exclude certain commodities, such as oil, in calculating export shortfalls.

- The stricter interpretation of the requirement of cooperation to include meeting conditions prior to management approval of compensatory financing, thereby reducing the facility's flexibility in responding quickly to the needs of members for timely relief.

These perceptions are not wrong. The record speaks for itself. As shown in the staff paper, there were 106 potential users of the facility--and 30 inquiries about drawings--in 1986, but only eight managed to gain access. Six of those eight drawings were accompanied by stand-by or extended arrangements. Since the revised guidelines of September 1983, only six out of 33 drawings under the facility were provided separately from use of other Fund facilities.

In short, many potential users are already highly dissatisfied with the current facility. In these circumstances, it is not surprising that my authorities, like many others from the developing world, have reacted rather strongly to the staff paper. In general, they are alarmed at the tone of the paper in leaning toward a further tightening of conditionality and more stringent access. They also feel that the timing of such a stance appears especially insensitive to the needs of developing countries, coming just after the most dramatic decline in commodity prices and terms of trade, caused by factors beyond their control, since World War II.

The compensatory financing facility should remain a special facility that is quick disbursing, with relatively liberal conditionality in order to compensate members as closely as possible in time to the export shortfalls that they may experience. My authorities feel that these key features of the facility cannot be changed without destroying its compensatory nature, thereby making this special facility no different in practice from a stand-by arrangement. They urge strongly that the facility should continue to compensate promptly for past shortfalls in export earnings, and that the present links to stand-by arrangements should be reduced as far as possible.

My authorities are of the view that any further tightening of conditionality, access, and phasing would make the facility too rigid, thereby depriving the Fund of the flexibility required to be able to respond quickly to the needs of its members and to changes in the international monetary system. The present guidelines, and the operation of the facility, are adequate to ensure the revolving character of the use of Fund resources. Indeed, the effective degree of conditionality has been excessive, as reflected in the greater restriction on access since September 1983. In retrospect, this tightening of conditionality has not been justified, given the evidence that members using the facility have not weakened their adjustment efforts relative to those that have not used the facility. Moreover, strictly speaking, the present guidelines have not required linking the facility to stand-by arrangements.

My authorities, therefore, oppose strongly any further formal linkage of the compensatory financing facility with stand-by arrangements, especially by the use of performance criteria and phasing. Any move in this direction would be contrary to the central feature of prompt compensation, thereby making the facility less effective for its intended purpose. In the same vein, explicit account of "special factors" should be taken only in a few selected cases, as at present. Even so, the benefit of the doubt should always be given to the member because the evaluation of debt servicing capacity and uncertainty of exports is highly judgmental. My authorities also feel that limits on access to compensatory financing should continue to be considered separately, because the purpose of the facility is different from that of other facilities. In addition, the compensatory financing limit should not be reduced, because it is already inadequate relative to members' needs. I would be interested in seeing a staff evaluation of whether the size of access has kept pace with the growth of world trade and members' reserves.

Some of the attractive features of the compensatory financing facility are its relative simplicity and accuracy in determining the amount of compensable shortfalls, although these elements have been eroded in recent years. This chair prefers that the facility continues to be kept as simple as possible, given that unnecessary complications and refinements can only contribute to delays and uncertainty in access. Hence, my reaction to the issues related to the implementation of the facility is as follows:

- The underlying trend in exports should not be relevant in determining access, since a member should in principle be compensated also for a deviation in exports on a declining trend to provide more room for an orderly adjustment. Moreover, there are very few instances in which average exports in the postshortfall period are lower than in the shortfall year. These should be treated as special cases in which adjustment under stand-by or extended arrangements should be encouraged strongly by the Fund.

- The present guidelines for determining the responsibility for the shortfall are adequate. So long as a member meets the test that the shortfall is largely attributable to factors beyond its control, the total shortfall should continue to be compensable. Any attempt to determine precisely that only part of the shortfall is beyond the control of a member will entail tremendous practical difficulties and make access more uncertain.

- Refinements such as adjustment for the import component of exports and changes in import prices will also present practical difficulties, although I am not opposed in principle to the latter. Similarly, I would welcome compensation for other contingencies, but would agree with the staff that this may be outside the scope of the facility.

Finally, my authorities would prefer to restore the flexibility that the facility had during the 1970s, given the continuing large needs of members for financing, the difficulty in access to private markets, and prospects for a large negative flow of resources to the Fund over the next few years.

Mr. Sengupta made the following statement:

This discussion on the compensatory financing facility is taking place at a time when most primary commodity producing nations are in an extremely unfavorable position. In recent years, the current account deficits of developing countries have increased, their terms of trade have deteriorated, their access to external borrowing from private sources has been curtailed, and they have had to reduce their imports sharply, both in terms of value and volume. In these circumstances, export shortfalls that occurred owing to circumstances beyond the control of a member would impede its ability to import, and thus create constraints on development.

The staff paper notes that the facility was widely used during the late 1960s and early 1970s. Since the mid-1970s, the periods of use of this facility reflected, in the main, the cyclical pattern of economic activity in the major industrial countries. This experience was in line with the expected nature of the facility as a self-correcting mechanism to help countries tide over temporary shortfalls.

Let us note again the basic logic underlying the compensatory financing facility. The facility was created to assist members facing balance of payments difficulties arising from a temporary shortfall in export earnings. The effects of such shortfalls on the balance of payments are by their very nature expected to be reversible. Only such a temporary imbalance needs to be financed, so that the country can withstand its effects without being forced to adopt policies that have the long-term effect of disrupting the structure of production. This is the logic that differentiates the compensatory financing facility from stand-by arrangements. A staff paper on "Adjustment and Economic Growth--Their Fundamental Complementarity" submitted to the Bank-Fund Symposium on Growth-Oriented Adjustment Programs, states: "A transitory and reversible imbalance does not generally call for policy action if resources exist (reserves) or can be found (borrowing) to finance it for the duration or if the distortions (restrictions, price and output variations) to which it can otherwise give rise are considered acceptable." In other words, policy action is not necessary if these deficits can be financed or if distortions that would be introduced without financing are acceptable. Financing has to be provided to avoid introducing unacceptable distortions; it does not call for any special policy action.

The argument that export shortfalls that qualify for compensatory financing usually come in addition to other forms of balance of payments problems, which require corrective policies, does not mean that the release of compensatory financing should be made conditional on the introduction of those corrective policies.

We are aware that, over time, the Fund has introduced conditionality in terms of a test of cooperation for drawings in the upper tranche of the compensatory financing facility. We do not agree that the test of cooperation must be met before such drawings can be made under the facility, because of the logic underlying the facility. But even if that issue is ignored at this time, the way in which the test of cooperation has actually evolved is very questionable. The staff argues that the test of cooperation is satisfied only if the request for compensatory financing is accompanied by an arrangement either already in place or adopted simultaneously. The staff had clearly made this test a necessary condition for the Board's approval of Argentina's request for compensatory financing (EBM/87/28 and EBM/87/29, 2/18/87). But this represents a misinterpretation of the 1983 decision on compensatory financing. The part of that decision that the staff has chosen not to quote in EBS/87/13 is very relevant: "However, the existence or the adoption of an arrangement is not a prerequisite. If a member's current and prospective policies were such as would, in the Fund's view, meet the criteria of the use of resources in the credit tranches, the member would be deemed to have been satisfactorily cooperating with the Fund, even though such use was not contemplated at the time of the CFF request." This shows that the existence of a concurrent arrangement is, as Mrs. Ploix noted, clearly not a prerequisite.

The case of Argentina shows that countries satisfying all the requirements for the use of the facility cannot get compensatory financing, even if they follow necessary adjustment policies, so long as a concurrent arrangement is not in effective operation. Thus, the approval in principle of a concurrent arrangement is not taken as sufficient reason for compensatory financing to be provided. The argument is that if the arrangement did not materialize, its policies would not qualify the country to meet the criteria for the use of Fund resources, which meant that it could not obtain compensatory financing unless a program was actually in effect. If this was the intention behind the 1983 decision on compensatory financing, then why was it that the sentence used in that decision was "that the existence...not prerequisite." I do not want to reopen the discussion on the decision on compensatory financing for Argentina, but it should be noted that that decision was based, as Mr. Kafka says, on a misinterpretation of the 1983 decision. I join Mr. Kafka in noting that such a misinterpretation should not be made in applying the decision to future requests for compensatory financing.

The staff paper mentions that some members who met the test of cooperation did not make drawings under the compensatory financing facility because of concerns about their capacity to service a large increment in outstanding debt, and future uncertainties about their reserve needs. Those concerns should not lead to discouraging drawings by a member that could use the proceeds to compensate for past shortfalls in export receipts that might have been financed initially by running down reserves or postponing import purchases. It is for this reason that the drawing should be quick and should not be tied to phasing or performance criteria.

As to access to the facility, the existing limit of 83 percent of quota has been a serious constraint to the continuation of development processes in member countries faced by sharp declines in export earnings. The average rate of compensation, however, has been much lower. In 1986, the simple average of drawings as a percentage of shortfalls was about 75 percent, while the weighted average--which represents a sum of drawings as a percentage of the sum of shortfalls--was about 60 percent.

Access should be determined with reference to the actual and prospective circumstances facing members, which is particularly relevant for low-income and small countries. With private credit markets being inaccessible, and with primary commodity prices declining, these countries have no other source of finance than the Fund. Access to the facility should be need based rather than quota based. We do not think that there is any point in considering the access limits of all the Fund's facilities together, since the purpose of each of the facilities is distinct and defensible. I agree with the staff's description of the original reasons for one-time drawings under the facility, immediately after the shortfall period. The suggestion to introduce phasing on the grounds that it is difficult to distinguish the sources of export variability has no basis in fact. The suggestion that a one-time drawing undermines members' incentives to carry out their adjustment programs also has no basis in fact. On page 13, the staff notes that the evidence in recent years suggests that "members using the CFF have, on average, not allowed their adjustment efforts to weaken relative to the efforts of those members that did not have recourse to the compensatory financing facility."

I am not in favor of reintroducing the annual access limits under the facility. A member should be allowed to draw the entire amount after the Board's approval of the request, as has been the practice until now.

I am in favor of continuing the present procedures for the determination of members' shortfalls and drawings. Whatever the methodology adopted for the calculation of export shortfalls, the bias should be in favor of the member. It would be more appropriate to calculate shortfalls based on total export earnings, with compensation for the deterioration in terms of trade.

In regard to the commodity coverage of compensable shortfalls, we feel that the net export approach would not be practical or feasible. Also, netting off variations in import costs from export shortfalls would not be feasible. We believe that export shortfalls could be adjusted by an import price index. As footnote 1 on page 23 of the staff paper notes, the use of real rather than nominal values would over time result in broadly similar levels of compensation, which might not raise the amount of compensatory financing, but would surely enhance the quality of the facility.

The scope of the facility should be extended to provide coverage for contingencies such as increases in interest payments. Also, efforts might be made to see how other contingencies, such as those included under the current Mexican program, namely, the oil price contingency mechanism, could be incorporated in the facility.

In our view, it is not necessary to widen the scope of the provision for early repurchase of overcompensation of export shortfalls. Such an extension would inhibit members' use of drawings under the facility because it would increase the uncertainty about the use of the funds; they would not know the final amount of compensation for about two and a half years after the drawing because it would more often than not take that long for final data on exports to become available.

Finally, as to Mrs. Ploix's suggestion for concessional compensatory financing, I feel that low-income countries and those eligible for structural adjustment arrangements would benefit from lower costs on compensatory financing disbursements. But, as I have stated earlier, the compensatory financing facility should not be burdened with conditionality, such as the existence of concurrent arrangements or a policy framework paper, in view of the logic underlying the facility and because the temporary nature of the facility warrants quick disbursement. The facility proposed by Mrs. Ploix should be available to all countries eligible for structural adjustment arrangements, whether or not they actually draw on the structural adjustment facility, based on a policy framework paper or a stand-by arrangement. If they draw on the structural adjustment facility or a stand-by arrangement, that would of course be sufficient to establish the test of cooperation, if such a test is necessary. If they do not draw on such facilities, the test of cooperation should be based on a judgment of the policies adopted.

Mr. Nimatallah made the following statement:

It is a fact that the compensatory financing facility has served its purpose very well. But it is also a fact that the facility has been abused at times, and that the repayment of its resources was overdue at other times. I am thus inclined to believe that to secure the revolving character of Fund resources, including compensatory financing facility resources, members must make sure that they find durable solutions to their imbalances, domestic and external, so that they can repay the Fund on time.

Whatever the outcome of this discussion by the Board, I would like to emphasize that requests to make purchases under the facility must continue to be treated on a case-by-case basis. Experience shows beyond any doubt that each case differs in characteristics and circumstances, and therefore should be treated on its own merits. The Fund will do well to avoid rigid guidelines, and I am sure that the Board will be fair in exercising judgment in each case.

As far as conditionality is concerned, I certainly want to make sure that for a country to benefit from the facility, it must show clearly that there is an adjustment effort in progress, which need not be in association with the Fund. If, however, there is no such adjustment effort in place, I think the member should show clear intentions to the Fund of making that effort through a planned program of adjustment to be supported, at least in principle, by the Executive Board.

In principle, I support the continuation of the current level of access. However, I agree that in order to reduce potential abuse of the facility and to secure the revolving character of Fund resources, there can be, in rare cases, some deviation from the rule. I am also in favor of widening the use of contingent financing with stand-by arrangements for possible future shortfalls to prevent potential interruptions to programs and growth.

As to phasing, I have no difficulty in leaving this matter to the circumstances of each case. There might be cases where early and total disbursement is helpful and necessary, while in other very special cases, it may be prudent to introduce some phasing.

On issues related to the determination of members' shortfalls, I suggest, first, that the staff combines its judgmental projections, to the extent possible, with an extrapolative method.

Second, concerning the use of the underlying trend, I support the current method of calculating the shortfall through assessing deviations from that trend, irrespective of its direction. The purpose of the facility is to prevent any potential interruptions to a course of adjustment by compensating members for reversible shortfalls in their export revenues within a trend, which could be rising, steady, or falling. The important point is that compensatory financing is provided to prevent any interruption in that trend. There can be cases where members are adjusting gradually to their declining export revenue over time, and therefore that adjustment should continue without interruption. The recent behavior of the price of crude oil is a good case in point. While countries have been adjusting gradually to a decline from a price of about \$30 a barrel to one of above \$15, there has been a large dip in that price all the way down to about \$8 a barrel. The difference between a price slightly below \$20 and that of \$8 cannot be considered but as a sharp deviation from a declining trend. Moreover, the Fund is usually concerned with trends in export revenues in general, and not just those related to one commodity. Naturally, I do not object to making sure that a country would take measures to diversify its exports, if industrial countries would let it do so. Therefore, I reiterate my support for the continuation of the current method of computing the shortfall by assessing deviations from the trend, irrespective of its direction.

Third, as to responsibility for the shortfall, I also support the present practice. I believe that in most cases, it is complex and difficult to decide with certainty who is responsible for a shortfall. Due to increasing interrelationships and interdependence among countries and groups of countries, it is extremely difficult to pin down causes for a shortfall that are within or outside an individual country's responsibility. After all, the Fund should give the benefit of the doubt to the member. Fourth, I have no hesitation in cases of overcompensation to require that there be an early repurchase by the member, and I would welcome the introduction of measures to make current procedures more comprehensive in this respect.

In conclusion, I strongly believe that the compensatory financing facility is useful and should be retained. It has been a growth-inducing facility that in many cases has helped to prevent any interruption in the course of growth and adjustment. However, there have been cases in which the facility has been abused, and in which it was clear that some countries had relaxed their adjustment efforts because they had received compensation early and in full. I hope, therefore, that today's discussion will eventually help find ways to minimize those problems. I also hope that the facility will continue to play its basic role.

Mr. Dallara made the following statement:

We welcome today's discussion as an important first step in the comprehensive review of the compensatory financing facility. We attach particular importance and priority to such a review at the current juncture; it has been a number of years since the most recent major review of the facility, and significant changes have taken place in the world economy since that time. It is important that the facility be adapted to reflect the evolving global environment and the circumstances of the Fund's members. In recent years, there have been a number of changes in the world economy that we believe are particularly relevant to this review of the facility. First, there is the fact that reductions in export earnings have been increasingly associated with broader structural balance of payments problems. Although I agree with Mr. Kafka that the phrase "structural payments problems" may not capture the exact character of the balance of payments problems experienced by some members, the fact is nevertheless clear that "shortfalls" in export earnings in recent years generally have occurred within the context of broader balance of payments problems.

Second, certain primary commodity markets have exhibited persistent weaknesses, reflecting, inter alia, macroeconomic developments, surplus global production, technological innovation and substitution, and in some cases stockpiling policies. These developments raise important questions about the prospects for a significant recovery in a number of commodity markets, thus casting doubt as to whether shortfalls based in large part on developments in such markets are in fact temporary.

Third, we have witnessed substantial growth in arrearages to the Fund, a phenomenon virtually nonexistent at the time of the previous review of the facility.

Fourth, and related to these factors, there has been the emergence of serious, even critical, problems of international indebtedness for many Fund members.

These developments suggest that the following should be among the objectives of this review:

- First, to ensure that compensatory financing is associated with effective measures to strengthen the member's underlying payments position, as stressed on page 6 of the staff paper.

- Second, to ensure that the facility does not support artificial export dependence on commodities which may be moving toward a secular decline.

- Third, to ensure that the criteria and guidelines for use of the facility are fully consistent with our obligations under the Articles to safeguard the temporary use of Fund resources.

- Fourth, to preserve flexibility in the use of the facility in order that it can facilitate orderly adjustment in a variety of situations.

With these developments and objectives in mind, I offer the following observations on specific issues. In doing so, however, I would like to make clear that these comments are preliminary--an initial set of thoughts that together with those of my colleagues will hopefully help lay the groundwork for further reflection and work, and eventually pave the way for the adaptation, modification, and strengthening of this facility.

The use of the compensatory financing facility has increasingly been associated with the adoption of comprehensive economic programs. We view this as an appropriate, and indeed necessary, development, in the light of the deep-seated nature of members' balance of payments problems over the last decade. I have listened with interest to Mr. Sengupta's comments this morning, quoting the staff. It is indeed difficult to argue with the logic that transitory and reversible payments problems require primarily, if not exclusively, financing rather than adjustment. However, the applicability of that logic to today's balance of payments problems is highly questionable.

The application of the guidelines on cooperation with respect to the use of the upper tranche of the facility has provided a means of integrating the facility somewhat into the overall debt strategy. We are not inclined at this time to believe that a more formal linkage between initial approval of compensatory financing in the upper tranche and the existence of stand-by or extended arrangements is necessary. With respect to the test of cooperation in the upper tranche of the facility, Mr. Kafka brought up the issue of the degree of uncertainty associated with the availability of needed financing. As Fund policies and practices have evolved, we seem to require a somewhat different degree of the certainty of financing for those members dependent largely on private capital markets than for those dependent primarily on official sources of financing. We should look into this further in our review of the facility, although it could also be considered in the context of our review of the practice of "approval in principle."

The test of cooperation in the lower tranche provides little in the way of a genuine safeguard for the Fund's resources, thereby raising fundamental questions as to whether our policies for the disbursement of the lower tranche of compensatory financing are consistent with our obligations under Article V, Section 3(a) of the Fund's Articles of Agreement. This problem could be addressed, at least in part, through a lowering of the 50 percent threshold. Alternatively, the Fund could, in circumstances in which a member had serious balance of payments difficulties and was requesting a drawing in the lower tranche, look to the adoption of a comprehensive economic program, preferably--although not necessarily--within the context of a Fund arrangement. This would in effect leave the test of cooperation for the lower tranche unchanged in cases in which there are no serious balance of payments problems, but strengthen that test when there are such difficulties. This notion is, to some degree, already embodied in the guidelines of 1983--which, as Mr. Kafka indicated this morning, now points to the need in such cases for prior actions. Almost by definition, prior actions imply "subsequent action," thus suggesting the need for a comprehensive program. We would welcome consideration of these options by the staff in its forthcoming review of the facility.

Regardless of how appropriate the test of cooperation might be at the time of the approval of compensatory financing, there remains the problem--with respect to both the upper and lower tranches of the facility--that the test is currently applied only at the time that a drawing under the facility is initially approved, and the entire amount of compensatory financing is disbursed at that point. We recognize that there are some valid considerations that necessitate early and full disbursement of drawings under the facility. Over the past few years, one can recall a number of cases involving both low-income debtors with protracted balance of payments problems and middle-income debtors with immediate liquidity needs, in which the facility provided useful flexibility in facilitating the adjustment process.

At the same time, it should be recognized that complete disbursement of compensatory financing at the outset of an adjustment program might, in some cases, not only undermine the incentives to follow through on a program, but might actually make the adjustment process and medium-term debt management more difficult for the member. Recently, there have been cases in which compensatory financing has exceeded the total size of a stand-by arrangement, not to mention the quarterly drawings available under the arrangement. One means of dealing with this problem would be to implement a flexible policy of phasing, possibly for both the upper and lower tranches of the facility. Another option would be to reinstitute the policy of annual ceilings. Under either approach, it would be important to avoid rigid guidelines in order that early substantial disbursement could be made in special cases in which it was felt that such an approach would clearly support orderly adjustment.

If the Board's view was that phasing was not clearly warranted in all cases of compensatory financing, one could imagine an approach involving phasing only in certain cases of compensatory financing. One possibility would be to introduce phasing when total outstanding use of credit exceeded a certain amount, such as 200 percent of quota, the rationale being that, with increasing amounts of exposure by the Fund to a member, it might become increasingly necessary for the Fund to take additional steps to safeguard its resources. This rationale would appear to have particular merit in the light of the sharp growth of arrears to the Fund in recent years.

Under the enlarged access policy, the guidelines on access within the limits explicitly provide for consideration to be given to a member's ability to repay the Fund on schedule. Therefore, access would be adjusted appropriately in accordance with the debt service capabilities of the member, an approach that has been broadly endorsed by the Board in its guidelines on access. It strikes me as odd, and anachronistic, that no similar provision exists in Fund policies on use of the compensatory financing facility. Surely we have an obligation to the Fund and to each member to ensure that, regardless of the extent of a member's export earnings shortfall, the Fund does not provide credit to the extent that it imposes an excessive debt burden on that member, thereby raising the specter of repayment problems in the future--problems both for the member and the Fund.

One way of approaching this problem would be to place a global ceiling on outstanding credit from all Fund facilities. Another approach would be for the Fund to provide, under the compensatory financing decision, for consideration to be given explicitly to the question of debt service capacity, and for actual access in individual cases to be adjusted in the light of this factor. We would welcome future staff work on this aspect. In this connection, we would also appreciate quantitative analysis of whether there is any connection between purchases under the facility and repurchases and arrears to the Fund.

As Executive Directors are aware, my authorities have in the past supported reductions in access under the compensatory financing facility. Given our current policies with regard to cooperation in the lower tranche, phasing, and repayment prospects, we believe that there remain arguments in support of a reduction in the compensatory financing access limits. However, with changes along the lines I have suggested, we would not be inclined to seek a reduction in access limits.

It has become increasingly clear in recent years that declines in export earnings relating to certain commodities may not be "temporary" shortfalls. If there are structural changes in the market for a particular commodity, treating a decline in earnings as a "temporary shortfall" does not serve a member well. As the staff points out, the formula should "not work against the incentive to adjust to what is expected to be a permanent change in the environment facing a member."

It is in this context that we have serious reservations regarding one particular pattern of export performance that currently qualifies as a "shortfall": the situation in which there is little nominal recovery in export earnings in the postshortfall years, following a decline in exports in the shortfall period. Recently, in several cases, we have provided compensatory financing even though the requests incorporated negative export growth in the first postshortfall year and very little export growth, if any, on average in the two postshortfall years taken together. For example, in one case, in the first postshortfall year exports declined in nominal terms by 7 percent, and the average level of export earnings in the two postshortfall years was 1.8 percent lower than the level in the shortfall year itself. In another case, the average level of export earnings in the two postshortfall years was 2.7 percent lower than in the shortfall year. The disbursement of compensatory financing in such cases has the potential to discourage appropriate sectoral adjustment even if broad adjustment policies were put in place, thereby raising questions about the credibility of a facility designed to compensate for temporary shortfalls.

We believe that this problem requires our attention. In other words, we should take into account not only deviations in trend in the calculation of shortfalls, but directions in trend as well. One possible way of accomplishing this would be to refine the formula for compensatory financing so as to require that average annual exports in the two postshortfall years recover at least one half of the decline in average exports between the preshortfall years and the shortfall year. We would appreciate further staff work on this technique as well as other possible techniques to deal with this particular problem.

There is another pattern of export performance which currently qualifies a member for a drawing under the facility, but which we believe may well be inconsistent with the spirit, if not the current letter, of this facility, namely substantial, positive export growth in the shortfall year. In 1984 and 1985, for example, there were three requests for compensatory financing involving positive growth in export earnings in the shortfall year--over 12 percent in one case, and over 20 percent in the other two cases. We do not question the validity of these drawings under the current formula, but the application of the formula produces a result that seems illogical. Do we really believe the compensatory financing facility should be used to compensate a member whose earnings continue to grow at a double-digit pace in the "shortfall" years, even in a low inflationary world, and whose only claim to the resources of the facility is that export earnings grew somewhat less in the "shortfall" year than the trend might point toward? My authorities believe firmly that the answer to that question is no. Perhaps we should preclude compensatory financing in circumstances where there is positive growth in export earnings in the shortfall year, or where growth in export earnings exceeds 5 percent.

The staff has also sought our views on a number of other important issues relating to entitlements to draw. I will comment on only one of those issues, that of the circumstances underlying the shortfall being "beyond the control" of the member, which we continue to believe to be an important issue with respect to the operation of the facility. We note with interest Table 7 of the staff paper, which demonstrates that it is possible, although difficult, to reach judgments on and make calculations concerning the extent to which shortfalls are beyond the control of the authorities. This issue may be worthy of further consideration and study.

Let me make clear that our comments and suggestions today relate to the current basic structure of the compensatory financing facility. A more fundamental reformulation of the facility could be envisaged, as a possible means of using the facility to address more directly the problems of implementing comprehensive growth-oriented economic progress in an environment characterized by adverse, and in some cases rather unpredictable, exogenous developments, such as declines in key commodity prices relating to weather conditions. Perhaps one could imagine a conversion of the facility, building on the "contingency" mechanisms that have been embodied in some arrangements in recent years. It would be premature at this time to give detailed consideration to such a formulation, but it is an idea perhaps worth revisiting in the future. I noted with interest, and some disappointment, Mr. Kafka's view that he would not favor exploring this option as a substitute for the facility, because I believe it represents the only feasible way to consider a broad and general availability of contingency arrangements.

In conclusion, we welcome today's preliminary discussion. We believe that we must move ahead in adapting the facility to current global economic realities, to modify it in a manner that preserves its usefulness and flexibility in this environment, and to strengthen its role in promoting adjustment and growth. We hope that the Board will be able to continue its review of the facility not too long after the spring Interim Committee meetings.

Mr. Ortiz made the following statement:

Let me say at the outset that the countries in my constituency did not request this review of the compensatory financing facility. Let me also say that we support the proposal made by Mrs. Ploix regarding the provision of interest rate subsidies to low-income countries. We welcome her initiative in requesting a study that would examine this question in more detail. The major policy issues that need to be addressed in the forthcoming comprehensive review of the facility are clearly brought out in the staff paper.

There are two basic issues concerning conditionality. First, whether the current degree of conditionality remains appropriate in view of the evolution of world trade and the current situation of the actual and potential users of the compensatory financing facility. Second, whether the principles of conditionality contained in the decisions of the Board relating to the facility have been faithfully interpreted and effectively applied by the staff.

The procedures that govern the implementation of the compensatory financing facility have been adapted through the years in the effort to make it more effective in meeting the purposes for which it was created, namely, to finance deficits arising out of export shortfalls so that members could "continue their efforts to adopt adequate measures toward the solution of their financial problems." As noted in the staff paper, the major reviews of the facility have generally resulted in a positive response to changing circumstances and to the needs of Fund members. The validity and desirability of the purposes and objectives of this facility have thus been reaffirmed, and we believe that under the present circumstances, the continued existence and adequate functioning of the facility is all the more significant.

As noted by previous speakers, economic conditions have worsened dramatically for member countries in the developing world since the early part of this decade. In the circumstances, both macroeconomic stabilization efforts and structural policies oriented toward improving resource allocation acquire a new significance. But this situation also points to the need for widening the scope and access of the various financing mechanisms available, particularly the compensatory financing facility, in order to facilitate the adjustment process, especially in view of the abrupt reduction of financing from external sources since 1982. This chair is of the view that the tightening of conditionality that has effectively taken place over the past few years is not the appropriate response to changing circumstances. In previous discussions, we have noted that it is more important to improve program design than to tighten conditionality.

We agree with Mrs. Ploix that the current requirements for access to the compensatory financing facility--that the export shortfall be of a short-term character and attributable to circumstances beyond the control of the member, and that the member cooperate with the Fund to find, when required, appropriate solutions for its balance of payments difficulties--remain broadly adequate.

The recent discussion on Argentina's request for compensatory financing (EBM/87/28 and EBM/87/29, 2/18/87) has raised some questions relating to the interpretation of the existing principles of conditionality, which deserve our attention. Specifically, these refer to the test of cooperation for access to upper tranche drawings. The 1983 decision that established the guidelines on cooperation under the facility mentions four explicit criteria to assess cooperation, three of which are mentioned on page 7 of the staff paper: the existence of a satisfactory balance of payments position, apart from the effects of the shortfall; the existence of broadly satisfactory performance under an arrangement with the Fund; or the adoption of such an arrangement at the time that the request for compensatory financing is made. The fourth provision, omitted from the staff paper, establishes that "the existence or the adoption of an arrangement is not a prerequisite. If a member's current and prospective policies were such as would, in the Fund's view, meet the criteria of the use of resources in the credit tranches, the member would be deemed to have been satisfactorily cooperating with the Fund, even though such use was not contemplated at the time of the CFF request."

Two fundamental issues have thus been raised. First, the question of decoupling drawings under the facility from stand-by arrangements. I would like, very emphatically, to draw attention to the fact that the guidelines explicitly state that the adoption of a stand-by arrangement is not a prerequisite for access to resources under the compensatory financing facility. The conditionality attached to the facility by the de facto coupling with stand-by or extended arrangements, as has been the normal practice for some time, blurs the intended distinctions among the Fund's various facilities. Whereas a stand-by arrangement is aimed at financing short-term adjustment programs and the extended arrangement at providing special assistance to members facing balance of payments deficits resulting from structural maladjustments in production and trade, compensatory financing is designed to assist members encountering balance of payments difficulties produced by a temporary export shortfall. Recognition of the different purposes of each facility implies the need to separate the compensatory financing facility from the conditionality associated with other arrangements if one is to preserve the nature and effectiveness of the facility.

The second issue has to do with the question of whether or not the approval in principle by the Board of a stand-by arrangement constitutes sufficient evidence of cooperation with the Fund according to the established guidelines. I do not want to restate at this time all the arguments advanced during the Board discussion on Argentina's request for compensatory financing; however, it seems appropriate to make the following remarks.

Under the guidelines, the third criterion for establishing cooperation mentions the adoption of a stand-by arrangement; there is no mention of approval by the Board, and it is clear that the spirit of the guidelines refers to the authorities' intention and purpose to adopt a set of policies. There is no better proof of intention than that of requesting a stand-by arrangement.

As to the fourth criterion for meeting the test of cooperation--the adoption of policies that would qualify the country to purchases in the credit tranches--the Legal Department holds the view that an approval in principle does not constitute sufficient evidence of cooperation because the policies contemplated could only be deemed sufficient if the financing for their implementation was assured. Several considerations are relevant in this respect. First, many arrangements have been put in place while parts of the financing package have not yet been finalized or when large financial gaps persist, even after the expiration of the arrangement, with outstanding use of Fund resources; second, the gathering of the critical mass of financing does not constitute assurance that financing will eventually be provided; third, the management submits a program for approval in principle when there is a reasonably high expectation that the financing package will be completed; and finally, various uncertainties exist regarding the assumptions under which a program is formulated, and if we require the degree of certainty implied by the interpretation of the Legal Department, the Fund would not be able to lend any money. In view of these considerations, I submit that the precedents regarding this matter were based on an incorrect interpretation of the guidelines.

Access to the compensatory financing facility is determined by projections of foreign exchange earnings. Taking into account the fact that judgmental elements necessarily enter into the computations, it becomes of paramount importance for the staff and the authorities to carry out this exercise as stipulated in paragraph 6 of the original decision on compensatory financing.

As we have stated during previous discussions by the Board on this matter, the judgment relating to the "beyond the control" requirement should continue to be made on a case-by-case basis.

It is interesting to note that according to Table 7 in Annex I of the staff paper, over 80 percent of the total value of shortfalls associated with drawings under the facility during the period 1976-86 was attributable to causes that were clearly beyond the control of the country concerned. Furthermore, even when some of the factors explaining the shortfalls were deemed to have been within the control of the authorities--especially those related to exchange rate policy--the countries concerned would have qualified for compensation on the basis of the multiplicity of other factors taken into account in assessing the causes of the shortfall. Therefore, the approach followed thus far for judging the responsibility of the shortfall does not seem to have been an obstacle to the operation of the facility.

As to contingent clauses for compensation, it is important to underscore the backward-looking nature of the facility as opposed to the forward-looking nature of the type of contingencies included under the Mexican arrangement. Contingent clauses are designed to isolate adjustment measures from foreseeable shocks, a characteristic that is well illustrated in the case of Mexico; even though the oil contingency mechanism has not been used, it has served its original purpose of consolidating confidence in the viability of the economic program. The compensatory financing facility is meant to operate when an unanticipated shortfall in foreign exchange revenues has already occurred; thus, contingent clauses would obscure somewhat the purpose of the facility.

Regarding access limits on the use of the facility, recent experience shows that members have seldom requested full use of their entitlement, which could be interpreted as a sign that the current limits are appropriate. However, it also could be a result of the effective conditionality and maturity associated with compensatory financing, and the member's own capacity to service its foreign debt, rather than the adequacy of the access limits to meet the country's needs. In any event, the existing access limits under the facility should be maintained at a minimum, and continue to be considered separately from access limits on the use of ordinary resources.

The justification of phasing in a stand-by or extended arrangement is to provide a link between adjustment and financing. However, as mentioned above, and following the reasoning of Mrs. Ploix, the different nature of the compensatory financing facility implies associating the financing to the occurrence of the export shortfall. Therefore, we believe that the shorter the lag between the shortfall of revenues and actual drawings, the more effective the use of these resources in accordance with the principles of this facility.

Mr. Grosche made the following statement:

The paper before us today provides helpful background information on the raison d'être of this facility and its role within the Fund's lending operations. The analysis of the experience in recent years is well focused to bring out the issues that need to be discussed. Today's preliminary discussion can only touch on a number of issues, but we hope it nevertheless can serve the purpose of concentrating the upcoming review on a number of desirable adaptations to the compensatory financing facility.

Before turning to the points proposed for discussion, let me briefly first address the issue from a more general viewpoint. The staff paper rightly stresses the fact that balance of payments disequilibria have increasingly become structural in nature in many commodity exporting countries, thereby requiring the implementation of corrective policies. It would seem reasonable, therefore, to ask whether the compensatory financing facility is the appropriate facility to be used in overcoming those more structural problems. Would it not be more appropriate to address those balance of payments disequilibria that are not expected to be corrected within a short period of time in the context of the Fund's regular lending programs, through either stand-by or extended arrangements? And if so, should the use of the facility then not be radically limited to those clear-cut, "self-correcting" cases in which no structural factors are involved, and in which almost no conditionality is called for?

As attractive as this approach may sound, we agree with the staff that in most cases it may be very difficult to separate structural from cyclical factors. Therefore, we think it would be appropriate to continue the current pragmatic approach and to use the facility in accordance with the practice that has evolved over many years. The basic approach is to preserve the original framework of the compensatory financing facility, but when used in cases of structural adjustment we need to see to it that it contributes fully to the effort displayed by the country concerned. In other words, the aim would remain twofold: on the one hand, the Fund should ensure the almost automatic availability of compensatory financing for countries experiencing truly temporary shortfalls beyond their authorities' control; and on the other hand, it should seek to improve the facility's complementary function in those cases in which persistent structural payments disequilibria require effective adjustment.

We consider that our 1983 guidelines on compensatory financing do ensure a reasonable degree of conditionality. The question is not so much whether the requirement of cooperation with the Fund in cases in which there is a need for adjustment makes the adoption, or existence of a regular Fund program a standard condition for the approval of a request for compensatory financing. The crucial point is that the country needs to demonstrate that it has been undertaking or will make the necessary efforts to correct its underlying balance of payments problems. In addition, an adequate degree of conditionality would be necessary to ensure the revolving nature of the Fund's resources.

We believe that, in general, determining access to the facility would require making a judgment on the member's ability to repay the Fund, as is done in determining access under regular Fund policies. We note Mr. Dallara's proposals to that effect, and would like to see them further explored by the staff.

As to access limits, we do not consider it necessary at this time to conduct another full-scale investigation into the appropriateness of access under the facility, because this has been done only recently. We should, however, point out that Table 3 of the staff paper, which shows an average compensation of 60-79 percent, does indicate that the access limits have been broadly appropriate. Nonetheless, the Board should not forget that the question of access cannot be separated from that of the availability of Fund resources. There are a number of considerations to be taken into account in this context, such as the Fund's liquidity position, which the staff paper unfortunately does not consider.

We consider it only prudent and almost self-evident that we need to think in terms of combined access limits, not least because of considerations regarding the future debt servicing capacity of members. When it comes to making choices, one would have to accord higher priority to regular tranche drawings, which does not mean that a certain additionality is not warranted and indeed intended, especially in those self-correcting cases for which the compensatory financing facility was originally created.

The question of phasing can of course hardly be separated from the issue of conditionality. There are compelling reasons for introducing the idea of phasing in cases of a clearly demonstrated need for adjustment. To be sure, it is often difficult in practice to distinguish, in a quantitative manner, between the structural and the temporary parts of a shortfall. Nevertheless, persistent balance of payments problems are usually recognized and dealt with under regular adjustment programs. When thinking in terms of combined financial support for the member's adjustment efforts, it does not appear very logical to have the Fund's regular resources made available in stages, but then to release the full amount provided under the compensatory financing facility all at once. We realize, however, that there are a number of difficult questions involved here, and welcome the analysis the staff intends to undertake in the context of the forthcoming review.

We note that there are not only the operational problems mentioned by the staff on page 15, but also considerable difficulties in ensuring that all the conditions will actually be met at the time of a drawing when the compensation has been agreed upon well in advance.

It is obvious that in the use of projections, errors are unavoidable, despite the staff's commendable efforts to improve its methods of calculating the shortfall. Overcompensation and undercompensation is therefore likely to continue to occur. It is doubtful whether the strict application of a formula would produce better results than the judgmental approach applied so far. Therefore, we consider the continuation of appropriate quota limits to be an important safeguard that should not be given up. An additional safeguard worth considering would be the introduction of a provisional reduction from the estimated shortfall.

In our view, the direction of the trend needs to be taken into account better than has been done in the past in order to avoid compensatory financing in situations when there is no recovery in the postshortfall period. As mentioned before, it should be asked whether a clearly discernible declining trend in a country's exports would not be more appropriately dealt with in the context of regular adjustment programs, and whether members should not be discouraged from drawing under the facility even if a shortfall could theoretically be calculated.

As to the responsibility for the shortfall, we would not object to a more detailed examination of the "beyond the control" requirement in the forthcoming review. In this context, it would be particularly relevant to discuss the effects of members' exchange rate policies on export performance. As to the implications of coordinated efforts by commodity exporters to regulate supplies, we would have to refer to the discussion on compensatory financing by the Board in 1983. Of course, it would be desirable to devise generally applicable guidelines indicating which part of a shortfall was attributable to the participation of a member in international commodity agreements and cartels and thus within the control of the member. But this would be extremely difficult to do, and we suggest that in practice a great deal of good judgment as well as a case-by-case approach will continue to be required.

Finally, we support the suggestion to introduce a provision for early repurchase in cases of overcompensation. It would also be desirable, in the case of consecutive drawings resulting from inaccurate export projections, that adjustments be made to subsequent drawings equivalent to the amount of prior overcompensation.

Mr. Lankester made the following statement:

The compensatory financing facility as presently constituted has its faults, some of which this chair has often pointed out in connection with specific cases. However, the facility does have important strengths. We believe that there are some modest changes here and there that are worth considering seriously, but we would not want to see radical changes in the overall shape of the facility. Like Mr. Nimatallah, I have come here to listen as much as to speak, and the thoughts I have to offer are very tentative.

The rationale for the level of conditionality currently applied is that before the Fund commits the use of its resources under the compensatory financing facility or to any other facility, it must be confident that the member will be able to repay its obligations in due course. The Fund, therefore, expects the member to achieve a viable balance of payments position over the medium term. Thus, it is inevitable that the Fund should be interested in the macroeconomic policies being followed by a member seeking compensatory financing. One way in which the Fund has sought to formalize this interest is through the test of cooperation that applies to all drawings under the compensatory financing facility, a requirement that is made very specific in cases in which countries are seeking a drawing in the upper credit tranches.

In the light of the difficulties that many members have faced in recent years, it is not surprising that an increasing number of requests for compensatory financing have been accompanied by drawings under other facilities. We do not believe that the present guidelines on cooperation should be reworded to make it a formal requirement that a stand-by arrangement accompany compensatory financing in the upper tranche. Nevertheless, it is usually the existence of these accompanying programs--provided that they are adequately designed--that gives the Fund the best prospects for repayment. We believe the need for prudence needs to be stressed. One statistic that the staff paper does not provide is the proportion of outstanding liabilities of members in arrears that is made up of drawings under the facility. I understand that all but one of the members currently ineligible to use Fund resources have outstanding compensatory financing obligations, as do most of the group of members that have incurred substantial arrears at times in the past few years, but which have so far avoided being declared ineligible. Compensatory financing must take place in an environment in which there are reasonable prospects of repayment to the Fund.

We consider that the current access limits for the facility are broadly appropriate. We also accept that the philosophy of having special facilities, such as the compensatory financing facility, requires us to consider the limit by itself and not in conjunction with that of any other facility except in the context of a member's overall repayment capacity.

We have more difficulty with the degree of front-loading that currently emerges for many stand-by arrangements combined with requests for compensatory financing in the upper credit tranche. For example, during 1986, both the Philippines and Bolivia received more funds on the first day of their program from the compensatory financing facility than from the entire stand-by arrangement endorsed by the Board at the same time.

It seems to us that there are two thoughts that emerge from this. We are not convinced of the general merits of phased drawings under the facility or of reintroducing annual limits, because the funds are meant to compensate for shortfalls that have already occurred. However, there might be scope for some limited degree of phasing when the request for compensatory financing is large relative to the funds being sought under a stand-by arrangement. There could also be additional reassurance that the Fund was committing its resources widely if the threshold for upper tranche conditionality under the facility was reduced slightly from 50 percent, which would reduce the risk of large requests for compensatory financing being accompanied by less than adequate measures to ensure medium-term viability. This threshold has been changed before, and it would be appropriate to review it again.

On the question of access, I note our continuing reservations on the use of automatic contingency financing. We think it much better that members with unused access to the facility should draw on the facility during the course of a stand-by arrangement, should there be adverse terms of trade movements during the program and if the normal performance criteria are met.

We welcome the proposal to review past forecasting errors to determine whether there is any scope for improving current practice. We also favor the continued use of cautious assumptions. It now seems fairly clear that the general environment in which commodity prices are determined has changed radically in recent years. It would be fair to say that the staff was somewhat slow to incorporate these changes, although it was understandable in the circumstances. Forecasters are naturally loathe to change practices that have served them well in the past until there is substantial evidence of a need for change, but since we are now in a world in which the outlook is less optimistic than it was during much of the facility's existence, a review of forecasting methods is appropriate.

The staff is correct in raising the question of whether the direction of trends should be taken into account in determining shortfalls and in setting the conditions for access to the compensatory financing facility. In this connection, I support to some extent the remarks of Mr. Dallara and Mr. Grosche. In a situation in which the export trend is upward, but the rate of growth of exports in the shortfall year has been less than the trend, we wonder whether consideration of the trend conforms to the spirit of the original intention of the facility that countries could have access to compensatory financing in that situation. More important, because this is a matter that relates to the Fund's concern for prudence, is the situation in which there is a structural downtrend in exports of the member. Mr. Sengupta asked us to respect the logic of the facility, but it seems to me that there is other logic that we ought to consider because when there is a situation of a shortfall with a downward trend, and the Fund is committed to providing resources, the Fund's resources are at greater risk than when there is a shortfall year with a flat trend or a fortiori with an increasing trend. In that situation, exports are not expected to return to their earlier level. At the end of the five-year period, the country's export earnings are projected to be lower than at the beginning. In that connection, it does seem to us that there would have to be more emphasis on adjustment, particularly export diversification, so that we can be confident that the funds being advanced will be repaid.

The third related issue raised by the staff is the question of what circumstances are "largely beyond the control" of the member. In individual cases, we have often argued that staff papers have been somewhat vague and uncritical on the contribution that the overvaluation of the exchange rate may have had in determining and causing the shortfall. Although we accept that quantitative work in this area is very difficult, forecasts of the effects of exchange rate changes on export performance form a critical part of stand-by arrangements. We can see no reason why a similar degree of rigor should not be applied to the past as to the future. I think we are prone to giving the member the benefit of the doubt on this question of the exchange rate without adequate prior analysis.

As to the coverage of the compensatory financing facility, members have noted that we dislike the anomaly that the present system is capable of producing in which large imports of raw or semifinished materials are processed and converted into exports, movements in the value of which are not taken into account. The staff paper notes that the existence of such imported inputs has not seriously affected the outcome of requests for compensatory financing. Even so, it does seem to me that this is somewhat of an anomaly. I believe that the difficulties of measurement are exaggerated somewhat in the staff paper, particularly when one considers that we already accept fairly rough and ready standards in the computation of shortfalls. In other words, I am not sure that the standards that we would apply if we did adjust exports for imported inputs in certain cases-and I accept that we would have to consider very carefully which cases could be considered--would necessarily be less satisfactory than those that we already apply.

We are in broad agreement with the present coverage of the facility, and remain strongly opposed to an interest rate facility or compensation for situations that the staff paper describes as contingencies.

I listened with interest to Mrs. Ploix's proposal for providing concessionary compensatory financing to monoproducers. In my opinion, I agree that those producers do need assistance, but I am not sure that compensatory financing is the appropriate form. If governments are to provide exceptional assistance, which I think they would have to do in order to finance the Fund or the concessions that Mrs. Ploix has in mind, I consider that it could be much better done through other channels.

Finally, we judge it unproductive to ask the staff to discuss rules for early repurchases where projections have proven wrong. This would be time consuming, and in many cases could bear harshly on a member in the middle of a difficult adjustment program.

Mr. Mawakani made the following statement:

I welcome today's discussion, which I find very timely, particularly in the light of the Board discussion on Argentina's request for compensatory financing (EBM/87/28 and EBM/87/29, 2/18/87). At that meeting, it became apparent that some of the requirements for a drawing under the compensatory financing facility, such as the test of cooperation, which we usually take for granted, involve a lot of judgmental decisions by the staff and the need for unambiguous guidelines was clearly brought to light. I understand that the scope of our discussion today is limited to raising issues that will be addressed in a staff paper for the comprehensive review of the facility later this year. It should be stressed that in the preparation of such a paper, the staff should bear in mind that the facility was created for a specific purpose, and as such should be treated differently from the Fund's other facilities.

I would like to make general observations on some of the issues associated with the implementation of the compensatory financing facility, namely, conditionality, access, and phasing. Before doing so, I should mention that I strongly support the views expressed by Mrs. Ploix. Her proposal for lengthening the repurchase period and lowering the interest rate for drawings under the facility is of particular interest to the countries in my constituency. The latter proposal could well be implemented through a subsidy account similar to the one established for the supplementary financing facility.

This chair has consistently argued against tightening the conditionality attached to the compensatory financing facility on the grounds that such action would be contrary to the spirit of the facility and would discourage countries from using it. Therefore, it is no surprise to us to note that more countries have not been able to make use of the facility even though they have experienced export shortfalls due to circumstances largely beyond their control and could meet the other criteria for a drawing under the facility--the balance of payments need and the test of cooperation with the Fund. Indeed, the statistical work undertaken by the staff in mid-1986 shows that, based on data submitted for the world economic outlook exercise, 106 cases of export shortfalls were calculated for 1986, and only eight requests for compensatory financing were approved during that year. This is a disquieting finding, particularly at a time when many countries are confronted with large external imbalances and face serious difficulties in mobilizing external finances. Such a development can only be attributed to the tightening of the conditionality attached to the facility. Any further tightening could be construed as an attempt to dismantle the facility.

I find it difficult to endorse the staff's rather strict interpretation of the 1983 compensatory financing guidelines on the test of cooperation when it asserts that the guidelines create a "linkage" between conditionality under the compensatory financing facility and that under other facilities. I do not think that such a linkage is formally established under the guidelines. In fact, as previous speakers have noted, it is clearly stated in the text of the decision on the guidelines on cooperation that "the existence or the adoption of an arrangement is not a prerequisite." In my opinion, an arrangement that would satisfy the test of cooperation was meant to be adopted only to deal with situations of simultaneous requests for drawings under the facility and drawings under the credit tranches. As Mrs. Ploix notes, "the growing practice of associating requests for drawings under the compensatory financing facility to requests for stand-by arrangements should not be taken as a rule." We should resist establishing any kind of formal linkage between drawings under the facility and those under the credit tranches.

Access is also an issue on which this chair has frequently expressed its views. We have stated that the present access limits under the facility are inadequate and, therefore, should be "delinked" from quotas and instead linked to the size of the estimated export shortfall. The survey undertaken by the staff on past compensatory financing drawings is interesting, and the figures speak for themselves. Indeed, Table 3 on page 11 of the staff paper shows that during the period 1979-86, the weighted average rate of compensation has not exceeded 76 percent, and was even as low as 40.5 percent in 1984. Also, actual drawings under the facility represented only 64 percent of the total shortfalls. Obviously, the constraint of the existing access limits has played a major role in bringing about this situation.

Another issue relates to the current practice whereby outstanding drawings are taken into account when determining a country's access to the facility. This can lead to a situation in which a given country, after drawing under the facility up to the limit of 83 percent in year "t," could be denied access to the facility in the year "t+3," even though all the criteria were met and the shortfall was due entirely to temporary fluctuations in export earnings. A liberalization of access limits to enable the facility to compensate for the full amount of the calculated shortfall, regardless of the level of outstanding drawings under the facility, will avoid the occurrence of such cases. I am well aware that we should concern ourselves with the ability of member countries to repurchase, in due course, the resources that are made available to them. However, denying them access to Fund resources does not seem to be the best way to protect the revolving character of those resources. On the contrary, it could force them to reduce badly needed imports, thereby jeopardizing their future growth prospects. Full compensation for the shortfalls could enable them to sustain their imports and strengthen their capacity to service their debts.

I find the staff's suggestion for the proposed phasing of compensatory financing quite disturbing, given the philosophy behind the creation of the facility. This suggestion appears to be based on the unfortunate impression that the immediate availability of a relatively large amount of resources undermines the incentive for a member country to follow through on its adjustment program. But the statistical evidence provided in Table 4 on page 14 of the staff paper does not substantiate the assertion that a drawing under the facility could undermine the incentive to carry on adjustment programs. On the contrary, it indicates that during the period 1979-85, for under 52 percent of the 54 upper tranche stand-by arrangements accompanied by drawings under the compensatory financing facility, the available resources were fully drawn, compared with 48 percent for the cases in which the stand-by arrangements were not accompanied by compensatory financing drawings. In fact, the conclusion drawn by the staff is that "this evidence suggests that members using the facility have, on average, not allowed their adjustment efforts to weaken relative to the efforts of those members that did not have recourse to the CFF." There is, therefore, no solid ground on which one could make a recommendation for phasing compensatory financing drawings. Such phasings would equate the facility with other Fund conditional facilities. In this respect, I am pleased to note that the staff itself recognizes that "the phasing of drawings under the CFF could be considered to run counter to one of the central features of the facility as originally conceived, namely, that compensation should take place as closely in time to the shortfall to which it is related."

It follows from my preceding remarks that the current degree of conditionality and the formal linkage that is being established between conditionality under the facility and credit tranche conditionality are not appropriate. The brief historical background provided in the staff paper indicates that major reforms were made to allow the facility to meet its intended objectives. In particular, access was liberalized in line with the growing needs for financing stemming from export variability, and amendments were made to encourage more timely and adequate support in response to export shortfalls. Contrary to past experience, the recent tightening of conditionality is shaking the foundations of this important facility, because more and more countries with genuine export shortfall-related balance of payments needs are denied access to the facility. I would, therefore, suggest that the staff direct its attention primarily to finding ways to restore and strengthen the original spirit of the facility. This should encompass a reversal of the trend in conditionality and the introduction of a system of full compensation based on the calculated shortfalls. In addition, and in the light of the recent Board discussion on Argentina's request for compensatory financing (EBM/87/28 and EBM/87/29, 2/18/87), it would be desirable for the Board to review the guidelines on the test of cooperation in order to clarify them and to make their interpretation easy and straightforward. As to the issue of phasing, I do not think it is worthy of consideration for the reasons I have explained earlier.

I have no major difficulties with the current method of calculating shortfalls or with the way in which the trend is used. I do not believe that it is necessary to review in greater detail the requirement of determining circumstances "largely beyond the control of the member" since it has so far been interpreted with enough flexibility. The coverage of the facility should be broadened to cover increases in interest rates or, as recommended by the Group of Twenty-Four, the deterioration in the terms of trade.

As to the introduction of contingencies such as those included in the Mexican program, I am of the view that such contingencies should be introduced into Fund-supported adjustment programs as a way of ensuring the necessary flexibility to deal with specific problems facing countries on a case-by-case basis.

Regarding the issue of overcompensation, when it appears that a member has been overcompensated in relation to the actual shortfall incurred, a provision for early repurchase would be in order.

In conclusion, I should emphasize that since the creation of the compensatory financing facility, the presumption has always been that the use of the facility is independent of use of Fund's resources under the credit tranches. The Board should reaffirm this and resist any attempt to establish a formal link between the two categories of Fund assistance.

Mr. Yamazaki made the following statement:

There is no doubt that the compensatory financing facility has played an important role in alleviating the balance of payments difficulties of members caused by export variability. However, certain issues have been raised among ourselves recently as to the operation of the facility in view of our experience since the early 1980s. The principal issue is to ensure that the use of the facility is accompanied, where necessary, by policy adjustments needed to restore a sustainable external position of purchasing members, as correctly stated in the staff paper.

In practice, we have already adapted the operation of the facility to changing circumstances quite effectively. For example, since the adoption of the guidelines on the test of cooperation requirement, all but one of the upper tranche drawings have been accompanied by a stand-by or extended arrangement. While fully recognizing that compensatory financing alone can be provided in appropriate cases, the practice that we have been following is well justified, given the serious underlying balance of payments difficulties faced by many countries.

Another example of the practical and welcome adaptation of the facility is the exercise of judgment by the staff and potential users of the facility as to whether the drawings are appropriate and timely in view of the size of medium-term debt service obligations of the member, the uncertainty of future export earnings, and the desirability of retaining access to the facility in the future, as explained in the staff paper.

We do not see any need for modification of the access limits under the facility at this time. However, since the access limits are based on quotas, the review of these limits should take place on the occasion of the next quota increase. In the meantime, the access limits for special facilities could continue to be briefly reviewed on the occasion of the yearly review of the enlarged access policy.

One can see some merit in the introduction of phasing in the sense that it could more effectively help members pursue adjustment under certain circumstances. At the same time, however, I accept that the introduction of phasing involves important issues that should be carefully addressed. I hope that the staff paper for the forthcoming detailed review of the facility will deal with these issues, and that it will also include the suggestions made by Mr. Dallara that I believe are worth further exploration.

Let me touch briefly on the oil price contingency mechanism in the case of Mexico and its implications for the compensatory financing facility. On contingency mechanisms in general, this chair has stated its position on several occasions and I will not repeat it at this time. As to the technical features of the oil price contingency mechanism in the case of Mexico, I accept, where justified, the formulation of anticipating--at the time of the adoption of an accompanying stand-by arrangement--a future drawing under the facility in certain circumstances, to be followed by formal Board approval when the actual drawing will be made. Such a formulation is perhaps as far as we can depart from the principles of the facility; therefore, the contingency concept in general should not be introduced into the compensatory financing facility itself.

At EBM/87/33 (2/26/87) it had been agreed by the Board that the approval of Argentina's request for compensatory financing would become effective on the date that the stand-by arrangement--approved in principle at EBM/87/29 (2/18/87)--became effective, but no later than July 15, 1987, provided that Argentina continued to cooperate with the Fund. I accepted that decision on the condition that it should not be used as a precedent for approving future requests for compensatory financing. Such an approach should not be generalized.

With respect to the issues related to the determination of members' shortfalls, I am interested in the views expressed by Mr. Dallara on the case of the calculation of shortfalls when the trend of export earnings is consistently upward during the relevant period, including the shortfall year. I expect that this point will be dealt with by the staff paper for the comprehensive review of the facility.

I continue to believe that we should maintain the existing case-by-case approach in connection with the question of assessing the "beyond the control" requirement.

Finally, in my view it is not desirable to extend the compensatory financing facility to cover increases in interest payments, because this would go beyond the fundamental principles of the facility.

Mr. McCormack made the following statement:

At the outset, I would like to emphasize that this chair feels that the original objective of the compensatory financing facility remains valid. There are obvious cases where countries have suffered temporary export shortfalls due to factors beyond their control that were expected to be reversed without strong policy measures. The facility has met, and should continue to meet, those needs effectively. On the whole, we do not perceive the need for major reforms in the facility, although some modifications might be made in order to better safeguard the use of Fund credit.

In the more difficult economic environment of the 1980s, there has been an increasing tendency for export shortfalls to be associated with fundamental balance of payments disequilibria, thereby requiring the implementation of corrective policies. Furthermore, there has been an element of permanence in changes in the terms of trade for many countries. Since the creation of the facility, it has been recognized that there is a particularly difficult problem in distinguishing ex ante between temporary shortfalls related to short-term price fluctuations, and shortfalls of a more structural nature resulting from more permanent changes in the terms of trade.

The decision in 1983 to strengthen the degree of conditionality by redefining the test for cooperation for compensatory financing was intended to avoid the postponement of adjustment in cases in which countries faced structural problems as well as temporary declines in export revenues. In that regard, I note that since the 1983 decision, only one upper tranche drawing out of 27 has not been associated with a stand-by arrangement. Although it is not entirely clear whether the granting of resources under the compensatory financing facility has seriously undermined incentives to undertake adjustment measures, it is our initial reading that purchases under the facility have not created such a disincentive. The staff notes that during the calendar year 1986, 106 cases of export shortfalls occurred and 30 requests for compensatory financing were made, but only 8 purchases were approved, of which 5 were in the upper tranche. This evidence suggests that the Fund has exercised considerable discretion in approving drawings and ensuring appropriate conditionality. It does not suggest that excessive use of the facility has been made, or that through purchases under the facility, countries have delayed adjustment efforts. We hope that the next staff paper might provide more evidence on this issue, but at this time we are not inclined to approve changing the nature and degree of conditionality attached to the facility.

We see no reason to question the continuation of existing access levels, nor do we see a need to combine access of ordinary and special facilities.

The staff has raised the question of whether access should be differentiated on the basis of other criteria, most notably a member's debt-servicing capacity. In the present circumstances, we feel it is important that in order to safeguard the use of Fund resources, a member's debt-servicing capacity and overall use of Fund resources should be factored into any request for compensatory financing. As noted on page 8 of the staff paper, the staff has indeed highlighted concerns about a member's debt-servicing capacity when discussing the potential use of the facility with that member, which is appropriate and correct. However, I wonder whether some broad guidelines should not be established, similar to those for stand-by and extended arrangements, that set out more explicitly the criteria for assessing a country's debt servicing capacity, rather than leaving that matter entirely to the discretion of the staff. Factors such as a member's existing debt service burden, projected capacity to make repayments, uncertainty about projected export levels, and the trend direction of exports could be assessed. We would like the staff to conduct further work on such a set of explicit and consistent criteria related to debt servicing so that the Board can judge whether or not a member is capable of servicing the additional debt that might be related to a drawing under the compensatory financing facility.

On the issue of contingency financing, my authorities feel that there are a number of appealing features in the contingency financing mechanism agreed with Mexico. The symmetrical nature of the oil facility could play an important supporting role in that it might ensure that a member's financial position and debt-servicing capacity is strengthened when commodity prices rise above the assumed base level. The phasing and conditionality of such a facility within the context of a Fund program are also appealing features. In examining the feasibility of generalizing such a facility, consideration would have to be given to the length of time that it should operate, as well as to the appropriate degree of automaticity of the arrangement. However, we also can see a number of potential problems that need to be resolved, including data availability, the need to ensure that any adverse developments being covered are indeed beyond the control of the authorities, and issues with respect to the financing of such a facility. The case of Mexico was exceptional, and the willingness of commercial banks to participate might also be exceptional. We feel that further staff work on this issue is warranted. We would tend to think of contingency financing as an essentially ex ante concept that fits, if at all, into stand-by arrangements and other Fund programs. In our view, the compensatory financing facility is intended to deal with ex post shortfalls. For a given country, the two concepts may prove to be complementary in practice.

Our general feeling is that there is no need to introduce phasing of compensatory financing at this time. Although phased drawings might have the advantage of reinforcing adjustment efforts, they would introduce the disadvantage of increasing the length of time between the actual shortfall and the payment of compensation. We must recall that the facility is intended to compensate shortfalls after the fact, and that further delays in financing through phasing would only increase the burden on the member concerned. We would prefer not to tamper with this unique feature of the facility. If, however, subsequent staff research were to show that purchases under the facility have indeed acted as a disincentive to adjustment, we would be prepared to consider the reintroduction of annual access limits that might act as a modest incentive to adjustment. Lowering the threshold separating the upper from the lower tranches might also serve to improve incentives to implement adjustment measures, if further staff research suggests that a problem exists.

Among other more operational questions, there is a crucial and obvious need for accuracy in projections. On the whole, existing procedures do not appear to be unduly prone to systematic error, and therefore we see no need to proceed to mechanical or extrapolative methods.

There have been cases where export trends, both upward and downward, have raised general questions about the appropriateness of compensatory financing. Regarding an upward trend, we would be interested in the staff's reaction to some threshold export growth rates above which a purchase under the facility would not be permitted. A downward trend is likely to occur in cases where structural changes are occurring in a particular country's exports, an issue that I will address later in my statement.

As to the issues of treatment of past excess compensation and the handling of variations in import costs, changes in these areas have been proposed in the past and have generally been rejected owing to practical difficulties, including the availability and timeliness of data and the need to ensure equality of treatment among members. At this time, the benefits to be gained from changes in these areas do not appear to outweigh the complications that procedural changes might introduce. My authorities, however, have on occasion been concerned about the extent to which a member's policies may have contributed to export shortfalls that have resulted in a subsequent request for compensatory financing. Therefore, I encourage the staff to further review the application and definition of the "beyond the control" requirement.

The extension of the facility to cover compensation for interest rate movements, or the provision of coverage for contingencies outside the external payments sector, would in our view seriously undermine the original rationale of smoothing fluctuations in foreign exchange receipts. The Fund cannot attempt to provide protection against every conceivable eventuality, particularly for something such as interest rates, which would affect nearly all members. We see no need for further exploration in these areas.

Finally, I have a few thoughts on the question of possible compensation in cases of a structural decline in export receipts. In the staff paper, there is an implicit message that the facility is not an appropriate mechanism for structurally related problems. I am sympathetic to this line of argument, since there is a risk that compensatory financing for structural problems could worsen the financial position of both the Fund and the member. Further I would not want to see the facility become more conditional, thereby excluding members who face legitimate, temporary export shortfalls.

At the same time, there is a real need to find the means to help countries that are undergoing long-term structural declines in their export capacity, or have experienced a sudden shift to a lower level of real income. The issue is one of identifying a more permanent terms of trade problem and finding the most effective combination of financing and policy action that permits a member to resolve its balance of payments difficulties, diversify its economy, and restore reasonable growth. The structural nature of these problems suggests that, ideally, they should be resolved by the World Bank. However, there appears to be a role for the Fund in cases in which a country clearly needs to address those areas that traditionally have been associated with the mandate of the Fund. I am certainly not suggesting the creation of a new facility, but I would appreciate the views of other Directors and the staff on how we might identify more permanent terms of trade changes and what more we can do in the case of a country that needs to carry out wide-ranging structural measures in response to a discrete structural decline in its export capacity. Perhaps we should examine, for example, the more general applicability of a policy framework paper in developing countries that are not on the list of countries eligible for IDA assistance, but which face severe structural export shortfalls.

Finally, I will report Mrs. Ploix's proposals to my authorities who, I am sure, will examine them with an open mind.

Mr. Nimatallah observed that some of the Directors had mentioned that they were not aware of cases of abuse in which adjustment efforts had been relaxed after the disbursement of compensatory financing. Noting that most of the members of the current Board were not present when South Africa had requested compensatory financing approximately five years previously, he recalled that that request, in his opinion, was one of real abuse of the compensatory financing facility that had led to a relaxation in the country's adjustment efforts. He was not sure whether South Africa had ever intended to implement adjustment measures, but after receiving the entire amount of compensatory financing, the country had made no efforts at adjustment, even to the present time.

Mr. Song made the following statement:

> At the outset, we welcome Mrs. Ploix's initiative, which deserves further thorough study.
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> Apart from the description of the creation and evolution of the compensatory financing facility and the major policy issues associated with its implementation, the following significant operating features of the facility mentioned in the staff paper warrant special attention.
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> First, drawings under the facility relative to total drawings during the period 1976-86--the period subsequent to the further liberalization of the facility in the mid-1970s--account for 25-38 percent, with outstanding compensatory financing drawings in relation to total Fund credit outstanding totaling about 20-25 percent during this same period.
>
> Second, about 87 member countries have made use of the facility since 1976. Not only the developing countries, but the industrial countries also--many of which do not have debt-servicing difficulties--have used the facility.
>
> Third, purchases and outstanding obligations under the facility since the mid-1970s have undergone two fluctuations that reflect the cyclical pattern of economic activity in the major industrial countries. This means that the facility has fulfilled its objective in alleviating the temporary effects of export shortfalls on the balance of payments resulting from such cyclical economic fluctuations.
>
> Fourth, as mentioned in Annex I of the staff paper, a recent analysis shows that over 80 percent of the total value of shortfalls was attributable to reasons that were clearly outside the control of the country concerned. Among those reasons were prices received for exports, weak external demand, weather conditions, and other unpredictable factors affecting the volume of exports.
>
> Fifth, as mentioned on page 13 of the staff paper, there is evidence that members using the facility have generally not allowed their adjustment efforts to weaken relative to those members who did not have recourse to the facility.

Thus, we can conclude fairly confidently that the introduction of the facility has benefited a broad range of member countries, and that compensatory financing has helped to alleviate the balance of payments difficulties faced by them as a result of export variability. In addition, most of the member countries concerned have cooperated well with the Fund, and at the same time have not weakened their adjustment efforts.

Obviously, as a special facility, the compensatory financing facility has some characteristics that distinguish it from other Fund credits. Since the intention of the facility was--and still is--to alleviate the temporary effects of export shortfalls on the balance of payments, thereby stabilizing the capacity of countries to import--especially primary product exporting countries--it is certainly reasonable to expect that drawings under the facility are not to be subject to the type of safeguards provided by phased access and performance criteria; it is also reasonable to expect that compensation takes place as closely as possible in time to the shortfall to which it relates. I believe that these two points constitute the essence of the facility and that any substantial change in this regard would represent a change in the nature of the facility, thereby causing the facility to become anything but one of compensatory financing.

The instability of export receipts in most developing countries, and in some industrial countries, is a long-standing phenomenon that cannot be expected to abate by itself because most of the reasons for the instability are unavoidable and beyond a country's control. This reality has warranted not only the creation and liberalization of the facility, but also its continuation in a similar vein in the future. Therefore, at the moment, we need to focus on preserving the essence of the facility, while simultaneously improving its functions and procedures. Only in this way can we encourage a speedy response to difficulties stemming from export instability.

Unfortunately, for the past several years there has been a tendency to tighten conditionality and to reduce access to the facility. For example, since 1984, access has been reduced from 100 percent to 83 percent of quota. Furthermore, the issuance of specific guidelines on cooperation in 1983, and especially their application since that time, have resulted in a stricter test of cooperation being applied under the facility, particularly for the upper tranche. We believe the debt service problems of a number of developing countries and the need for the Fund to ensure the revolving character of its resources are not sufficient reasons for further tightening conditionality or changing other features of the facility.

Our position on this is based on two reasons; first, not all countries using compensatory financing face debt-servicing problems; and second, only a few of those facing debt-servicing problems have incurred payments arrears to the Fund under the facility, which means that drawings under the facility have not impaired the revolving character of the Fund's resources, as the staff has assumed.

My authorities believe that it is best to maintain the current main features of the compensatory financing facility, namely, its existing conditionality, access, and phasing, and at the same time to liberalize the interpretation of the requirements relating to requests for use of the facility, inter alia, the interpretation of the test of cooperation in the upper tranche.

My authorities consider that there has been a great deal of judgment applied both in calculating the shortfall from a trend and in determining the reasons for the shortfall. Certainly, it seems logical that if the provisions are made more complicated, the results might be even more inaccurate, and in this regard the best way might simply be to decide each case on its own merits and on a case-by-case basis.

As to the question of whether the direction of a trend should be taken into account in determining shortfalls and whether other contingencies--such as those included under the Mexican program--should be incorporated into the facility, we are of the opinion that, strictly speaking, those issues are different in nature to the issues relating to the facility, and therefore should be dealt with separately.

Finally, I would like to reiterate what we said during the previous Board discussion on program design and performance criteria (EBM/86/190 and EBM/86/191, 12/3/86). In our view, the Fund as an international financial cooperative institution should always highlight its cooperative nature in providing financial support to member countries. Too much emphasis on the need to ensure the revolving character of its resources cannot but jeopardize the purposes and tasks of this institution. This is particularly true in the current circumstances in which many of our members are confronted with debt-servicing difficulties. Thus, the size and profile of debt service obligations should not be an additional condition for assessing a request for compensatory financing if the conditionality associated with the facility has been met.

In this connection, I believe two points deserve special attention. First, to place so much emphasis on the link between the facility and other Fund arrangements is improper because, according to the guidelines on cooperation adopted in 1983, the existence or adoption of an arrangement is by no means a prerequisite for the use of the upper tranche of the facility; it merely serves as evidence that a member country has met the test of cooperation. Even if no arrangement exists or has been adopted, the test of cooperation can still be met in ways that are already provided for in the guidelines.

Second, it is unfair and unsatisfactory to assert that, in accordance with Fund practices, the adoption of an arrangement in principle cannot be accepted as evidence verifying that the test of cooperation has been met and that only when the arrangement becomes effective can it be regarded as such evidence. In my opinion, this practice is contrary to the words and spirit of the guidelines on cooperation, in which the words "becomes effective" do not appear at all. I would appreciate further comments on the subject from the staff.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/35 (3/2/87) and EBM/87/36 (3/3/87).

2. STRUCTURAL ADJUSTMENT FACILITY - ELIGIBILITY OF KIRIBATI AND TONGA

Kiribati and Tonga are eligible to receive balance of payments assistance under the Structural Adjustment Facility within the Special Disbursement Account. The list annexed to Decision No. 8240-(86/56) SAF, adopted March 26, 1986, shall be amended accordingly. (EBS/87/44, 2/25/87)

Decision No. 8542-(87/36), adopted
March 2, 1987

3. MADAGASCAR - 1986 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1986 Article IV consultation with Madagascar to not later than March 9, 1987. (EBD/87/66, 2/27/87)

Decision No. 8543-(87/36), adopted
March 2, 1987

4. STAFF MEMBERS - LEAVE WITHOUT PAY

The Executive Board approves the proposal set forth in EBAP/87/35 (2/25/87) concerning extensions of leave without pay for two staff members.

Adopted March 2, 1987

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/87/37 (2/26/87).

Adopted March 2, 1987

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/87/40 (2/27/87) is approved.

APPROVED: August 13, 1987

LEO VAN HOUTVEN
Secretary