

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/37

3:00 p.m., March 3, 1987

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

Executive Directors

Alternate Executive Directors

G. Grosche

S. M. Hassan, Temporary  
Song G., Temporary  
M. Lundsager, Temporary  
L. K. Hubloue, Temporary  
E. Feldman  
T. Alhaimus

A. Kafka

Khong K. N., Temporary

T. P. Lankester

H. Fugmann

Y. A. Nimatallah

D. McCormack

G. Ortiz

D. Saha, Temporary

H. Ploix

I. A. Al-Assaf

G. A. Posthumus

L. Filardo

S. de Forges

G. Salehkhoh

I. Sliper, Temporary

K. Yamazaki

V. K. Malhotra, Temporary

S. Zecchini

L. Van Houtven, Secretary

A. Akanda, Assistant

1. Compensatory Financing Facility - Recent Experience and Issues for Consideration . . . . . Page 3
2. Working Party on Statistical Discrepancy in World Current Account Balances - Release of Report . . . . . Page 43

Also Present

Asian Department: A. K. McGuirk, H. L. Mendis. 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. M. Zervoudakis. External Relations Department: J. E. McEuen. Fiscal Affairs Department: A. Cheasty. IMF Institute: O. B. Makalou. Legal Department: F. Gianviti, Director; W. E. Holder, R. H. Munzberg, A. O. Liuksila, S. A. Silard. 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, J. S. Saladay. Treasurer's Department: D. Williams, Deputy Treasurer; M. A. Lumsden. Western Hemisphere Department: P. C. Leme. Bureau of Statistics: J. V. Carter. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Bertuch-Samuels, L. P. Ebrill, J. Hospedales, K. Murakami, I. Puro, N. Toé. Assistants to Executive Directors: A. R. Al-Abdullatif, H. Alaoui-Abdallaoui, O. S.-M. Bethel, F. Di Mauro, V. J. Fernandez, G. K. Hodges, A. Iljas, S. King, R. Msadek, A. H. Mustafa, C. A. Salinas, G. Seyler, H. van der Burg.

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

The Executive Directors continued from the previous meeting (EBM/87/36, 3/3/87) their consideration of the staff paper on recent experience with the compensatory financing facility and issues for consideration (EBS/87/13, 1/26/87).

Mr. Sliper made the following statement:

As the staff paper makes clear, the purpose of this discussion is to identify and clarify the major issues that should be addressed in the more comprehensive review of the compensatory financing facility to be held later this year. In our view, nearly all those issues are covered in the staff paper. However, we feel that it would have been helpful if the staff had provided a fuller discussion of the basic and theoretical role of the facility, including an analysis of whether there is still a need for a separate facility of this type.

A separate facility such as the compensatory financing facility has a number of benefits for members and the Fund. First, it gives the Fund more flexibility in tailoring financial assistance to a member's particular problems and needs. In this context, the facility has been used separately or in conjunction with other Fund assistance. Second, it allows more money to be provided up front than would be available under the regular credit tranches. Third, the facility generally carries lower conditionality. Nonetheless, the continuing need for a separate special facility can be questioned. In its purest form, the compensatory financing facility can provide assistance to countries with fundamentally healthy economies and sound policies in place, but which encounter temporary and unavoidable shortfalls in their export receipts because of external factors. In a less pure form, the facility can provide resources to countries with underlying policy inadequacies that encounter some further difficulties of a temporary nature that are largely beyond their control.

It could be argued that in the so-called "pure case"--a country with a fundamentally healthy economy experiencing a perceived temporary shortfall in tradables--should not have any difficulty in obtaining finance from the international capital markets. If, instead, the member wished to use Fund resources, it could do so under the regular credit tranches without any need for policy adjustment.

With regard to other cases in which policy inadequacies are exacerbated by a temporary shock not of a country's making, the need for a special facility can again be questioned. In such cases, it is crucial that the underlying policy inadequacies be addressed, which argues for having a Fund program. This is already

acknowledged in the number of drawings under the compensatory financing facility accompanied by a Fund-supported program. Moreover, it is not always evident that access to immediate disbursement of finance under the facility--sometimes the equivalent of the phased amount available under an arrangement with the Fund--strengthens a country's resolve to adhere to an adjustment program.

Notwithstanding these comments, we accept that for all practical purposes the facility should be retained largely in its current form.

As the staff notes, the introduction in 1983 of more specific guidelines on the test of cooperation was in recognition of the more difficult balance of payments circumstances of the 1980s. These guidelines created a linkage between upper tranche drawings under the compensatory financing facility and the existence of a stand-by or extended arrangement or, in their absence, the adoption by the member of policies that could be supported by the Board, to ensure that members facing underlying balance of payments problems did not receive compensatory financing without some commitment to address these problems. We support the continued thrust of the guidelines.

The guidelines on cooperation have operated as alternative conditions, one of which must be met by the member if it is to be seen as cooperating with the Fund. The use of alternative guidelines has instilled flexibility into the test of cooperation. However, it also makes the test only as strong as the weakest condition. The change in the test applicable to upper tranche drawings agreed to by the Board in its amendment to the decision on Argentina's request for compensatory financing on February 26 (EBM/87/33, 2/26/87), in which a new and fifth condition was introduced, must be viewed with concern, given the principle of equality of treatment between Fund members. The third sub-condition of the new condition only requires the member to be actively negotiating either on measures for a revised program or to reach agreement on a new program. The introduction of this new condition represents a significant weakening of existing upper tranche conditionality, which we believe will have to be reconsidered if the test of cooperation applicable to upper tranche drawings is to remain functional--namely, if it is to continue to protect the Fund's resources.

Indeed, the fact that the Board now has to consider the introduction of phasing and performance criteria on drawings under the facility in order to protect the Fund's resources more effectively suggests that conditionality is already not strict enough. In this context, it would be helpful to pay greater regard to medium-term debt commitments and the degree of uncertainty regarding export projections in considering eligibility for drawings under the facility not accompanied by a stand-by arrangement.

In our view, the most important consideration with respect to access is the total access available to a member under all facilities. This defines the total amount of assistance a member can obtain from the Fund and the total amount the member will have to service in the future, which is not to say that the limits under individual facilities are not important. In the case of compensatory financing in conjunction with a stand-by arrangement, the incentive to meet criteria set out under the arrangement could be undermined if most of the financial assistance is provided from outside the program.

Although we sympathize with the concerns that the absence of phasing under the compensatory financing facility might weaken a member's incentive to maintain its adjustment effort, the temporary nature of the problem that compensatory financing seeks to address must also be kept in mind. It is at the time of the shortfall that financial assistance is needed, not in the following years when the problem has passed. If some tightening of the use of resources under the facility is required, our preference would be to adjust initially access or conditionality rather than to phase drawings under the facility. Phasing would seem appropriate only if the shortfall was not considered temporary, in which case financing should more properly be provided under a normal Fund-supported program than through the facility.

We believe that the calculation of the export shortfall could be improved by considering the direction of the trend of exports. Of equal importance is the early identification of changes to the trend, which could require new policy responses or an early repurchase.

Judging what circumstances are largely beyond the control of the member has often proven to be difficult, and is probably best handled on a case-by-case approach. While Table 7 in Annex I to the staff paper provides a useful analysis of the primary causes of shortfalls and their relative importance, we could support a further examination of the requirement that a shortfall is attributable to circumstances largely beyond the member's control to determine, in particular, if its scope could be more narrowly defined.

We are not attracted to the idea of extending the compensatory financing facility to cover contingencies. Any future adverse events significant enough to warrant a drawing under the facility are best addressed if and when they are perceived as likely to occur or when they actually occur. It is only then that the most appropriate response can be determined, including, if relevant, a review of developments under an already existing stand-by arrangement.

We support the increased provision for early repurchases in circumstances in which it appears that a member has been overcompensated.

Mr. Zecchini made the following statement:

The compensatory financing facility was established in the 1960s to help countries cover short-term shortfalls of exports compared to a trend line. The basic rationale was that, given the nature of these shortfalls, which were temporary and beyond the control of the authorities, it was not considered necessary for the country to embark on major adjustment efforts because the shortfall could be reversed in a short time as a result of exogenous factors.

Thus far, the facility has fulfilled this function reasonably well, which is also a result of the several revisions and the close monitoring of its operations by the Board. Only in the period 1981-83 have some problems emerged because of several cases of overcompensation due to overestimations of the shortfalls. The real cause of this problem is the protracted decline of commodity export prices, which did not rebound as the Fund had expected. Therefore, a wedge emerged between the estimated trend line of exports and the actual one.

These problems have been corrected since 1984 by using a more cautious approach in the projection of export earnings, which has taken into account the new characteristics of trends in commodity markets. Moreover, the staff has tended to protect the financial position of the Fund by requiring, in most cases, that an adjustment program accompany the use of compensatory financing. As a consequence, the latter has recently become a complement to a stand-by or extended arrangement.

This development does not seem to us to be consistent with the nature and the function of the compensatory financing facility. If we assume that recent declines in commodity and energy prices are the last signs of a secular trend in the further decline of these prices, then we must draw the obvious conclusion that the recent or prospective shortfalls are not shortfalls, but to a minor extent, since they reflect secular negative trends. Obviously, even in the face of a negative trend we may experience a negative deviation, but its extent is much narrower than in the case of a flat or rising trend. Therefore, under this assumption, the scope for using the facility should be rather limited.

In contrast, several analyses, including the staff paper on primary commodity market developments and prospects (DM/86/63, 11/14/86) and the paper prepared for the April meeting of the Development Committee on market prospects of raw materials

(DC/87-6, 3/16/87), indicate that there is not enough evidence to indicate a continuously declining real price trend for primary products. Therefore, there is enough justification for the continuation of the facility and for using it in a manner that is consistent with its original principles and the letter of its regulations. We must adhere to these principles more strongly than in the recent past by preserving the particular function of the facility and its autonomy with respect to the standard adjustment programs supported by the Fund. In the light of this general consideration, we believe that no major overhaul of the facility is needed, but that a few adjustments at the margin may be appropriate. In our opinion, these adjustments should be limited to the interpretation of conditionality, the threshold level that separates the upper tranche from the lower tranche, the consideration of the trend, and the access criteria.

We are of the opinion that the test of cooperation in the majority of the cases does not require the approval of a stand-by or extended arrangement. This test has to rely on the policies that the requesting country has put in place or is committed to enact. The relatively large size of the accumulated debt by many developing countries and the present widespread difficulties in servicing this debt require more extensive cooperation, rather than mere assessment of a country's policies without a program. Specifically, it is necessary that the debtor and the Fund cooperate in devising and implementing policies that can reduce the future demand of the debtor for external resources without necessarily entering into a stand-by arrangement. To this end, we believe that a lowering of the threshold for the upper tranche is justified, and the staff could study various options in this respect.

The parallelism between compensatory financing and a standard adjustment program, although it is not required in the majority of the cases, might be considered appropriate in two instances. First, the country might experience not only a temporary export shortfall, but also a more general and prolonged shortfall of exports on a net basis, namely, a deficit in the current account of the balance of payments that is largely imputable to its policies or to an imbalance in the capital account. Second, the shortfall might be due to a deviation around a trend that will continue to be negative in the following years.

In both cases, it is legitimate to doubt either whether the country will be able to fulfill its financial obligations at the maturity of the compensatory financing drawing or that a substantial part of the shortfall is not temporary and beyond the control of the authorities. Therefore, a more forceful approach to adjustment than the one normally required for use of the facility is necessary, which should take the form of a program supported by other resources of the Fund and which start in parallel with the use of the compensatory financing facility.

In this connection, the Fund's assessment of the exogeneity of factors leading to the shortfall has recently given rise to several doubts. We understand that it is not possible to specify the categories that should govern this assessment, and that the latter should be broadly judgmental. Nevertheless, judgments in this area are very seldom clear-cut or self-evident because they are often clouded by many doubts. It would be advisable to explore ways in which doubts about whether the exogeneity criterion has been satisfied could be reflected in the amount of financing and, if no simple rule can be devised in this respect, we might even consider a predetermined percentage reduction of the amount of the shortfall that can be compensated.

As to the estimation of the trend, a statistical extrapolative model does not necessarily appear superior to the present judgmental approach. However, a combination of the two approaches could prove to be better suited to avoiding overestimation or underestimation. The staff could study how to present the results of the two methods separately and then combining them in the final estimation of the shortfall. The trend does not necessarily have to be one based on historical projections, but can also be a "desired" one, such as in the case of the recent contingency clause introduced in Mexico's program. We believe it would be helpful to retain a degree of flexibility in the Fund's intervention by allowing for the possibility of compensating future shortfalls that are calculated with respect to a desired trend.

In our opinion, the direction of the trend is relevant mainly in cases of negative trends. In the case of positive trends, there should be no objection to the use of the facility, provided that the country has a balance of payments need and that the export projections are justifiable.

With regard to the criteria for access, the possibility of an early partial repurchase to correct for overcompensation should be further explored. If this possibility is accepted, it should be undertaken in a context of symmetry of treatment, which implies that further drawings have to be allowed also in cases of undercompensation.

There is no strong argument in favor of phasing except in the context of a linkage with a Fund-supported program. Without a program, phasing would imply a spurious form of conditionality because it is not linked to performance criteria. Moreover, if the facility has to offset a short-term shortfall that has already occurred, there is no rationale in delaying compensation, unless there is a stand-by arrangement.

In conclusion, these are the areas in which we think that some modifications may be studied and carried out. In our opinion, these changes have to remain marginal because there is now no strong justification for modifying the rationale and the basic features of the compensatory financing facility.

Mr. Fugmann made the following statement:

Over the years this chair has been skeptical of facilities that are directed toward individual items in the balance of payments position. On the other hand, we believe that, on the whole, the compensatory financing facility has functioned well under the present guidelines.

A basic problem with the facility lies in deciding whether the export shortfall is temporary or whether it originates from structural problems and/or circumstances largely beyond the control of the member.

Generally speaking, we agree with the staff that the problems in the raw materials sector are increasingly of a structural nature. However, situations will still arise in which temporary export shortfalls are largely attributable to circumstances beyond the control of the member. In such cases, the compensatory financing facility should continue to function as a facility clearly separated from the Fund's other facilities and it should have its own rules. In particular, drawings under the facility in these cases should not be subject to conditionality through formal linkages to stand-by or extended arrangements. We also support the present formulation of conditionality, which implies a stricter test of cooperation for drawings above a certain level.

Nevertheless, with the increased importance, or at least recognition, of structural problems in recent years of both a domestic and an external nature--for example, a declining long-term trend in export prices--we believe that some kind of conditionality that will increase the member's incentive to pursue adjustment measures is inevitable. It is important that compensatory financing not delay the necessary structural adjustment. When structural imbalances exist in conjunction with a temporary shortfall in export earnings, the borrowing member should be required to undertake adjustment that is acceptable to the Fund. Therefore, it is important to try to determine how much of the export shortfall originates from structural problems and how large a part is due to temporary imbalances; it is important that only the latter part is offset by compensatory financing. For export shortfalls stemming entirely from domestic structural imbalances, compensatory financing should, on the whole, be ruled out. In these cases, an outright stand-by or extended arrangement, or World Bank financing, is preferable. At the other extreme, in cases of purely temporary

export shortfalls in the traditional sense, the application of the present guidelines on cooperation should suffice.

We are of course well aware of the difficulties of allocating shortfalls between temporary and structural causes, and would therefore appreciate further staff work on the matter, which could build on the methods employed in obtaining the results given in Section C of Table 7 of the staff paper. Similar difficulties arise in determining the reasons for export shortfalls that are largely beyond the control of the member. However, we would also like this criterion--which is a fundamental one for access to the compensatory financing facility--to be more clearly defined and applied by the staff. For example, the effects of clearly inappropriate policies should be taken into account more explicitly than has been the case so far, and consideration should be given to excluding from compensation that part of a shortfall that can be determined to be related to the policies of the authorities. Also, the issue of the role of producer cartels should be analyzed, including to what extent members of a producer cartel should have access to compensatory financing when an increase in prices starts abating. I agree with Mr. Grosche that general guidelines probably cannot be established, and that this issue may have to be addressed from time to time.

Similarly, we might consider how to handle cases of compensatory financing in a situation in which the five-year average greatly exceeds the longer-term trend, and the rate of growth in export receipts during the shortfall year is not below the long-term trend, despite a fall in the growth rate. This seems to be only one variant of Mr. Dallara's more general point, and I support his request for further elaboration of these issues.

The actual difficulties of implementing these ideas must be tackled now, and one preliminary remedy would be to introduce phasing for drawings exceeding a certain level. In general, we are somewhat skeptical of phasing because it would, at least to a certain degree, go against the main idea of the facility. Nevertheless, for the reasons just mentioned, we consider that phasing could well be a possibility. The system could be formulated in such a way that drawings up to 50 percent of quota could be drawn immediately; remaining amounts--up to a maximum of 33 percent of quota--would be released only later, which might even make it possible to reduce the problem of over/undercompensation, because the second drawing could be used to adjust for any misjudgments.

Because we believe that, in general, the compensatory financing facility should be separated from the Fund's other facilities, we also believe that questions concerning access limits under the facility should be handled separately. If total access under all Fund facilities were to be reduced, which is probably the wish of some member countries, a joint access limit could lead to an

increase of the share of the facility in total Fund lending, which would not be desirable from the point of view of making the best use of the Fund's limited resources. Although the purpose of compensatory financing is not to cover the entire export shortfall, it is important that it compensates up to a certain level. We consider the coverage achieved so far--60-75 percent--to be reasonable.

As to the idea of differentiating between countries on their access to the facility according to the borrowing member's debt servicing capacity--in view of the increasing problem of arrears--the same principles and procedures that apply to lending from other facilities should be applied because we see this question as being related more to the revolving character of the Fund's resources than to the facility as such.

We consider the present method of forecasting deviations from the trend to be satisfactory, and prefer it to a more mechanical method.

Despite the changes that we have just suggested, it is also our view that the facility should function without unnecessary complications and time lags. To include the import component of exports or import costs in the calculations would be far too complicated and time consuming. At an earlier discussion, we were opposed to the creation of a separate interest rate facility, and our objections would be even stronger if that or other contingency mechanisms were to be included in the facility. Besides, such widening would go beyond the original purpose of the facility.

Finally, we cannot see any reason to handle the different types of overcompensation differently, and we would therefore support the extension of the early repurchase provision to all cases of overcompensation. The present system discriminates against the more swiftly disbursed credits under the early drawing provision as opposed to those that are disbursed only after a whole year. This is not desirable, given that this type of financial assistance should take place as soon as possible after the shortfall has occurred. As to how quickly early repurchases should be undertaken, the Fund should be flexible so that consideration can be given to the reasons for overcompensation and to the general financial situation of the country.

My authorities have not had a chance to evaluate Mrs. Ploix's proposals, but based on what I have stated today and on our general attitude to the Fund as an institution, I would not expect that my authorities would be able to support Mrs. Ploix's proposals.

Mr. Hassan made the following statement:

The compensatory financing facility was created as a special facility to provide timely assistance with low conditionality to primary commodity producing countries experiencing balance of payments difficulties as a result of fluctuations in their export proceeds. The creation of the facility was in recognition of the fact that difficulties stemming from export instability required a quick response. Reforms introduced in 1975 and 1979 were basically aimed at improving the facility to provide more timely and adequate support in view of the adverse developments in the international environment. In contrast, that move toward liberalization was reversed by the 1983 decision that strengthened conditionality, and again in 1984 when the access limit was reduced by 17 percent. The guidelines adopted in 1983 boosted the conditionality attached even to drawings in the lower tranche of the facility.

More disturbing is the way in which those guidelines were applied. Although the 1983 decision did not make the existence of a stand-by or extended arrangement a prerequisite for drawing under the facility--as might be concluded from the incomplete quotation from the decision on page 7 of the staff paper--the highly restrictive interpretation of the criteria by the staff established an effective linkage between the facility and stand-by arrangements to the extent that since 1983, almost all the upper credit tranche drawings have been coupled with a stand-by or extended arrangement. The unduly restrictive application of the guidelines has discouraged those members experiencing export shortfalls from requesting compensatory financing, and has deprived a number of them from the benefits that they were entitled to under the facility. For example, as already referred to by some Directors, the staff notes that in 106 cases of shortfalls in 1986, inquiries about the use of the facility were made in only 30 instances, out of which only 8 requests were approved.

It is our view that the restrictive application of the guidelines has made drawings under the compensatory financing facility subject to excessive conditionality, and that the practice by the staff of effectively making the existence of a stand-by or extended arrangement a necessary condition for drawings under the facility is unwarranted and should be reversed. In our opinion, it is counterproductive to overemphasize the revolving character of Fund resources--to the extent of hindering the Fund from fulfilling its major responsibility of providing assistance to its members in genuine need and depriving members of their right to receive Fund support. The staff proposal of setting and monitoring performance criteria for drawings under the facility is not acceptable because this would lead to a change in a basic principle of the facility. The staff does not provide convincing evidence that the use of compensatory financing has resulted in a weakening of adjustment efforts or has significantly contributed to the problem of overdue

payments to the Fund. In sum, this chair's position is that the conditionality attached to drawings under the facility in recent years has been excessive and needs to be reversed, and that no link should be made with other use of Fund resources unless the member concerned specifically requests it.

On the question of access, the countries represented by this chair are very disturbed by the increasing tendency in the Fund to overlook the needs of low-income countries. It may not be intentional, but when access to use of resources is reduced progressively and conditionality increasingly tightened--based on various arguments, such as the prolonged use of Fund resources--the net effect is to put Fund resources effectively beyond the reach of those countries. The same tendency to discriminate against the low-income countries is again evidenced in the staff suggestion to reduce the access of those countries to drawings under the facility on the basis of debt servicing capacity and balance of payments uncertainties.

In that connection, I would like to comment on a point made by Mr. Dallara, and repeated by some other Directors, regarding indebtedness by some members to the Fund. It is true that the outstanding use of Fund resources by some countries--most of them low income--is high relative to their debt servicing capacity. It is important to note that this situation is not a reflection of excessive lending, but rather an indication that an important objective of Fund lending--to increase the debt servicing capacity of these countries--has not been achieved. This failure is in part due to the incompatibility of the conditionality attached to the use of Fund resources with the problems facing these economies. Therefore, a solution to this problem is not to be found in curtailing the Fund's financial assistance, but rather in reorienting Fund conditionality and the terms and maturity of Fund lending in such a way as to enable these countries to restore their debt servicing capacity and to resume economic growth.

In fact, these countries deserve particular attention and substantial financial support in view of the resource constraints they face, the limited capacity of their economies to adjust, and their lack of access to private markets. I believe that Fund facilities, including the compensatory financing facility, have a special role to play in the low-income countries to ensure financial support for domestic adjustment efforts that otherwise might hardly succeed. In this context, I welcome and fully support Mrs. Ploix's proposal, which clearly recognizes the special circumstances of this group. I urge the Board, and the industrial countries in particular, to support the initiative by France, which constitutes a step in the right direction. I also request that the staff explore, in the context of this proposal, the possible modalities of assisting low-income countries.

The rate of compensation under the facility has been far from adequate, having been limited at times to only 40 percent of the export shortfall. In this regard, the proposal for establishing combined access limits will only result in a further reduction of shortfall compensation. With respect to the use of contingent financing, I support the more general use of contingent clauses under stand-by and extended arrangements in order to protect programs from unforeseen developments.

The timeliness of drawings under the compensatory financing facility is related to the purpose of this special facility, which is intended to compensate for shortfalls that have already taken place. Thus, the phasing of drawings is not compatible with the central feature of the facility and will render it ineffective. Perhaps this incompatibility was an important reason for the abandonment of the annual limit on drawings under the facility in 1979. There is no evidence to support the claim that phasing would increase the incentive to pursue adjustment efforts, or that adjustment efforts under stand-by and extended arrangements accompanied by compensatory financing have been weaker than they otherwise might have been. On the contrary, the staff's own findings indicate that stand-by and extended arrangements accompanied by compensatory financing were more successfully completed: "(The) evidence suggests that members using the compensatory financing facility have, on the average, not allowed their adjustment to weaken relative to the effort of those members that did not have recourse to the compensatory financing facility." There is no evidence that drawings under the facility have contributed in any significant way to the problem of overdue obligations. For these reasons, we do not support the idea of phasing drawings under the facility.

Finally, at a time when an increasing number of developing countries, particularly low-income countries, face mounting external balance of payments difficulties, there is a clear need to reverse the recent trend to greater conditionality by liberalizing the facility along the lines mentioned on page 23 of the staff paper. There is a need to extend the facility to cover unexpected increases in payments caused by exogenous factors and declines in domestic investment and growth that result from adverse developments that are beyond the control of the countries concerned. I urge the staff to explore these possibilities in more detail in its forthcoming review of the facility.

Mr. Hubloue made the following statement:

I would like to comment briefly on the substantial changes that have affected the operation of the compensatory financing facility over the past 25 years showing that this instrument still has a very useful role to play independently of other Fund policies.

The facility was originally created to protect the balance of payments position of primary commodity producers from temporary shortfalls in their export earnings. Concern about the deflationary impact of deterioration in the balance of payments position of members and the desire to avoid resorting unduly to trade restrictions were the principal preoccupations leading to the creation of the facility, which was seen essentially as an instrument for providing short-term financial assistance.

In fact, the use of the facility as a purely financial instrument has always been rather limited, because most countries continued to enjoy satisfactory reserve positions or easy access to foreign borrowing throughout the 1960s and most of the 1970s. The use of the facility became widespread only with the emergence of overall balance of payments difficulties in the early 1980s.

The circumstances under which those difficulties emerged have affected the operations of the facility in two ways. First, the prolonged weakening of economic activity and import demand in the industrial world has raised doubts about the appropriateness of addressing the resulting export shortfalls in the developing countries with a facility designed to be of a rapidly revolving character, doubts reinforced by the fear that the weakening of demand for many primary commodities could be structural in nature. At the operational level, these doubts seemed confirmed by the relative increase in the number of cases of overcompensation of cyclical export shortfalls in 1981-82. However, the experience gained since that time shows that cautious implementation has largely eliminated this problem and suggests that the facility is a very useful instrument for smoothing the sharp fluctuations that might accompany a prolonged or even permanent weakening of export demand. In this connection, there seems to be no urgent need to change the present calculation methods or policies.

Second, because these widespread balance of payments difficulties have arisen during a long period of protracted financial flows to the developing world, the structural weakness of the balance of payments position of many countries has been brought to light, and the focus of corrective measures has inevitably shifted from financing to adjustment. Under the circumstances, the facility has become closely associated with the pursuit of adjustment policies aimed at restoring global balance of payments viability, a trend confirmed in 1983 by the adoption of guidelines on compensatory financing that established a formal link between drawings under the facility in the upper tranche and the existence of stand-by arrangements with the Fund. With the establishment of that link, access to resources under the facility has become in many cases an integral part of the financing made available from various external sources to make the pursuit of Fund-supported adjustment programs possible.

The osmosis, as it were, of compensatory financing and access to Fund resources under credit tranches should not be taken to mean that the original *raison d'être* of the compensatory financing facility has disappeared. Recent experience justifies the further development of the facility as an instrument of financial alleviation in the direction of protecting the pursuit of adjustment from external shocks of a temporary nature. In the context of access to Fund resources, the facility can provide an important element of financial flexibility not normally provided by stand-by arrangements. Issues related to conditionality, phasing, access, and coverage of the facility should be further examined from this standpoint.

The guidelines adopted in 1983 specify conditionality under the facility at two levels: first, by submitting upper tranche drawings to the general principles of Fund conditionality; and second, by establishing specific criteria for drawings under the facility. The decision to make upper tranche drawings under the facility conditional on the pursuit of adjustment policies that would make a member eligible for access to Fund resources under a stand-by arrangement reflects the basic notion that the balance of payments difficulties of most countries have become so all encompassing that only the adoption of comprehensive adjustment programs can promise a return to external viability. We fully share this belief and would refrain from taking steps that would weaken the principle of linkage between drawings under the compensatory financing facility and the adoption of sound adjustment policies.

To safeguard the identity and role of the facility, however, this principle should be implemented with an adequate degree of flexibility. The rules for activating and phasing drawings under the facility and establishing access to compensatory financing come into play here. Our recent experience with Argentina clearly shows that too rigid an interpretation of the rules governing use of the facility could deprive it of its requisite flexibility and confront the Fund with unwelcome situations in which only ad hoc solutions could serve the mutual goals of flexibility and promotion of sound adjustment that should guide all actions of the Fund. How to maintain and refine the proper balance required for flexible use of compensatory financing and ensuring support of adjustment programs should be the most important goal of our future work on the facility.

Several issues will have to be considered further in this context. First, and at a minimum, it should be accepted that a member will receive access to a drawing under the facility at the time of the approval in principle of a stand-by arrangement, because approval in principle reflects both the Fund's endorsement of the member's proposed policies and the expectation that external financing for the program will be forthcoming.

Second, the possibility should be explored of further increasing the flexibility by permitting drawings on the basis of early actions taken by the member to achieve a substantial correction of its external situation, and pending agreement on a full-fledged program consistent with those early actions.

Third, the staff paper does not contain any convincing arguments for giving much further consideration to the possible introduction of phasing or annual access limits. Since the principal function of compensatory financing is to stabilize a member's balance of payments capacity by offsetting export shortfalls that have already occurred, prompt compensation is fully warranted. Phasing is likely to disrupt this function of the facility and cause unnecessary substitution of Fund resources under the credit tranches, whose proper function is to finance prospective payments needs and to encourage adjustment policies throughout the program. Moreover, the empirical evidence collected by the staff shows that early access to resources under the facility has not been a disincentive to the continuation of adjustment efforts.

Fourth, since the role of the compensatory financing facility is to protect adjustment programs from external shocks of a reversible nature, its access limits should be determined independently of the access to resources granted under other Fund policies. The use of combined access limits would limit the flexibility of the facility and would weaken the initial effect on a member's balance of payments and reserve positions that it is intended to produce. For this reason, broader considerations related to a member's debt service capacity should continue to be dealt with in the context of the Fund's policies on access to credit tranche resources.

Fifth, the linkages established in recent years between the facility and the adoption of adjustment policies, and the proliferation of shocks due to various causes raise the question whether protection by the facility of a member's reserve and balance of payments positions should continue to be limited to cases where instabilities have emerged in the primary commodity markets. We might look forward to further study of proposals for extending the coverage of the facility to other external contingencies potentially damaging to the orderly implementation of adjustment programs. Alternatively, this goal might also be pursued through increased flexibility of access by members to Fund resources under stand-by arrangements.

I would like to make a comment on the limited use of drawings on the facility in the lower tranche. Since it is of paramount importance to the cooperative nature of the Fund that it continues to provide financial assistance to members at all stages of their adjustment processes, the flexibility of cooperation provided by lower tranche compensatory financing drawings should remain intact, and I would encourage the staff to explore ways of increasing the attractiveness of this facility to a wider range of Fund members.

In closing, we look forward to further study of Mrs. Ploix's proposal for assisting low-income countries with limited borrowing capacity and high export dependence on only one or two export commodities.

Mr. Alhaimus made the following statement:

The staff paper covers a wide range of issues, touching on both fundamental aspects of the compensatory financing facility as well as a number of operational matters. At the outset, let me express the concern of our constituency about what appears to be a persistent effort to weaken the facility and to reduce its integrity as an important Fund instrument for assisting member countries.

There is no question that the trend recently has been to make access to the facility more limited and more difficult. If the present review is to be seen as an occasion to formalize and accentuate this trend, that would in our view be quite unfortunate, given the implications for the Fund's ability to respond effectively to the needs of members facing large fluctuations in export proceeds, especially at a time when those needs are increasing.

The first issue regarding the implementation of the facility that has been raised in the staff paper is whether the extent of conditionality spelt out under the present guidelines is appropriate. The staff paper states that although the application of these guidelines involves a considerable degree of judgment, in practice this judgment has been exercised rather cautiously in recent years. Some of the figures that the staff cites on the recent use of the facility, however, indicate a large restrictiveness. As the staff paper shows, of the 27 upper tranche drawings approved since 1983, only one was not accompanied by a stand-by or extended arrangement, indicating a virtual merging of the facility with regular arrangements, and leaving only a few independent drawings in the lower tranche. Furthermore, the paper also states that although 106 members experienced shortfalls in 1986, only eight drawings were approved. Of course, one would expect that legitimate considerations would disqualify some of the members experiencing shortfalls, but the figures nevertheless show a sharp contrast between the few drawings actually made and the numerous and widespread shortfalls experienced by members.

In the light of such experience, the question arises as to what the likely picture would be in the event that conditionality was tightened further. How many cases of compensatory financing would remain unlinked to arrangements, and how much more would the Fund's responsiveness to shortfalls be reduced?

As to the question of whether present access limits should be maintained, experience again shows that actual drawings remained

considerably below the export shortfalls throughout the period 1979-86, as shown in Table 3 of the staff paper. Any further lowering of access limits would certainly exert downward pressure on an already low level of compensation. Moreover, it is not appropriate to merge the access limits of the various Fund facilities because each was designed to address different circumstances. In considering individual cases, it is of course appropriate and necessary to take into account any serious doubts about the debt-servicing capacity of a member, something which is already being done. We do not think, however, that differentiating access is a useful mechanism, because in practice it may prove quite contentious.

The suggestion to phase drawings under the facility would constitute a major change and, if carried through, could lead to a formal linkage of purchases under the facility to regular purchases, thereby reducing the usefulness of the facility. The main rationale for the current system, as pointed out in the staff paper, lies in the different functions of the compensatory financing facility and stand-by arrangements. The present system of immediate compensatory financing is vital for the members that require meaningful support for their reserves, especially when alternative resources are not readily available, thereby increasing their ability to adjust without undue recourse to restrictions. It may be, as is now being argued, that it is not always easy to distinguish between difficulties rooted in structural problems and those stemming from export variability. However, even when structural difficulties are an underlying cause for weakness in the external balance, there is a case for timely financing when this weakness is compounded by an export shortfall, especially if it is large and abrupt. Such compensatory financing is being provided by the Fund on the conditionality specified in the guidelines, and, in practice, is approved to an increasing extent only in association with stand-by or extended arrangements.

It is not clear how much phasing can add to the present array of measures designed to reduce the likelihood of future overdue obligations, including the increasing attention to the ability of members to make repurchases. The fear that the immediate availability of resources would undermine a member's incentive to adjust and thus increase the possibility of arrears emerging in the future is not substantiated by the actual experience cited in the staff paper. In fact, the evidence seems to show that on the contrary, members using the facility have on average "not allowed their adjustment efforts to weaken relative to those members that did not have recourse to the compensatory financing facility."

Phasing would also mean that a program for compensatory financing would have to be designed, encompassing perhaps some new breed of performance criteria if no other Fund program is in place.

Such a system may in effect impose some form of program, even on countries where the reversibility of the shortfall does not require a corrective policy program.

The compensatory financing facility can in certain instances be useful in keeping some Fund programs on track if it can be adapted along lines broadly similar to the oil price contingency mechanism included in the stand-by arrangement with Mexico. Although the contingency provision does not in itself add to the entitlement of the member, who would still be required to meet the conditions of the facility, it can nevertheless be helpful in building compensatory financing into the program from the outset in case financing such a contingency materialized. Further consideration by the staff of this issue would be useful.

The Mexican oil contingency mechanism, however, remains almost the only significant response by the Fund--in form at least--to the most significant commodity price decline in recent history, namely, the collapse in the price of oil, which led to a massive transfer of income from developing to developed countries. Experience has shown on several occasions--for example, during the Board's discussion on the request for compensatory financing by Ecuador (EBM/86/136, 8/15/86)--that some members of the Board consider that requests by oil producers should not be treated on a case-by-case basis as generally agreed during our formal discussion on the subject in mid-1983. Frankly, we are concerned that the attitudes of some major members on this issue could induce the management and the staff to discourage potential requests for compensatory drawings involving an oil shortfall.

It appears that little, if any, change is warranted in current practices on entitlements to draw. The accuracy of projections cannot be expected to be perfect, given the state of the art and the extreme uncertainties surrounding commodity developments. What appears from the staff survey of 165 cases is that there was in fact a net underestimation of shortfalls and that, in any event, the quota limits on drawings greatly limit the scope for overcompensation or undercompensation.

Not much improvement, either conceptual or practical, can be expected by changing the formula for calculating shortfalls to incorporate the direction of the trend. The historical evidence cited in the staff paper shows that there have been only a few cases of compensation of shortfalls associated with lower average exports in the postshortfall year than in the shortfall year. The staff paper also convincingly states that even when exports of a commodity fall sharply and remain low at the new level, there is a need for compensatory financing because adjustment to the new long-term level of exports will take time.

The methods used by the staff in coming to a judgment on the responsibility for the shortfall seem to be working reasonably well, despite the difficulties associated with disaggregating factors that are purely beyond the control of the member. Historical evidence shows that about 80 percent of the drawings made since 1976 were clearly due to factors beyond the control of recipients, and the rest were largely beyond members' control. With this broadly satisfactory record, it does not seem necessary to pursue an approach that limits compensation to the actual shortfall that is entirely beyond the control, an exercise that is not easy to undertake in any event.

One aspect of the responsibility for the shortfall that has been raised in previous Board discussions relates to the impact of exchange rate policy on the export profile. However, a recent staff paper on the effects of collective devaluation on commodity prices of exports (DM/87/1) indicates the real possibility that, for example, in African cocoa producing countries, a simultaneous increase in production through exchange rate depreciation might entail reduced export earnings; similar results can be expected in the case of other commodities, such as copper. Situations such as these suggest that the staff should be careful not to fall into the fallacy of aggregation by examining each case in isolation and ignoring the whole.

Regarding the coverage of compensable shortfalls, it seems that the current treatment of exports, which is the main issue here, is a reasonable one, and that there are problems with alternative approaches. The import component of exports does not seem to have had a distorting impact on the calculation of the shortfall; the staff paper shows that since 1976, in only 5 percent of cases has high import content contributed to either an increase or decrease of the shortfall. As the staff paper states, the alternative of netting out this impact also presents practical difficulties owing to the unavailability of accurate data on import content and the entry of imports at times other than the shortfall period. The more ambitious method of netting variations in import costs, irrespective of the import content of exports, will entail, if symmetrically applied, an increase in compensation in cases of higher import costs. This implies a basic deviation from the central purpose of the compensatory facility, which is to finance export shortfalls.

The final issue raised in this review relates to overcompensation owing to inaccurate export projections in the postshortfall period. While there may be logic in requiring early repurchases in those cases, there are obvious drawbacks in requiring a member to reverse a purchase made over two and a half years previously. Furthermore, it seems that the cases of significant overcompensation due to erroneous calculations of the shortfall have been relatively few.

Finally, in our view, Mrs. Ploix's proposal for concessionary compensatory financing for low-income countries merits careful consideration. Therefore, we support her request that the staff undertake a study focusing on that issue.

Mr. Feldman made the following statement:

Like previous speakers, we welcome today's discussion on compensatory financing facility. We are satisfied with the coverage of the staff paper and the set of issues proposed for the Board's consideration. As a preliminary examination, the staff paper offers a fair and detailed description of the evolution of the current facility and the factors behind its main developments.

However, we note with concern that some relevant aspects in the evaluation of the facility have not been treated appropriately, or have been simply disregarded. We cannot but regret the incomplete quotation of previous Board decisions; the deletion of a complete section provides a totally different understanding of the decision itself and of the member's eligibility to use the Fund's resources.

Like other speakers, especially Mr. Kafka, we feel that the last paragraph on page 7 of the staff paper--expressing the sense and scope that a test of cooperation by a member country with the Fund should have in order to allow the former to make a drawing in the upper tranche of the facility--represents a particularly unfortunate slippage by the staff.

Similarly, statements like that in the first paragraph on page 8, which leave the impression that the normal criterion for access to the upper tranche of the compensatory financing facility is to have a stand-by arrangement at the same time, either approved or in place, go against the original spirit of the facility. There are no such prerequisites in the decisions on the facility; on the contrary, the 1983 decision stresses exactly the opposite, namely that the Fund will be satisfied whenever the current and prospective policies of the member meet the criteria for the use of resources in the credit tranches, irrespective of the existence of such an arrangement.

The fact that 26 out of 27 drawings in the upper tranche of the compensatory financing facility have been accompanied by stand-by or extended arrangements does not mean that there has been any change in the nature of the decision, but simply reflects an increasing tendency to reduce a member's access to the resources of the Fund and to tighten the requirements for such access. In other words, it reflects a particular interpretation that runs against the spirit of the decision on compensatory financing and is biased toward the reduction of the level of access of member countries, which we strongly oppose.

The world economic situation continues to be characterized by a major decline in a number of commodity prices, while the economic conditions in several indebted countries are similar if not worse than a few years ago. Under such conditions one would have expected the continuation of a relatively high level of access under this facility--for instance, 100 percent of the member's quota--as well as a more flexible or liberal approach to eligibility for access to Fund resources by this means. None of these outcomes have materialized, and access to the facility has been reduced both in terms of the resources made available and in terms of the prerequisites that need to be met. We believe that such a tendency must be halted and reversed, and we feel that this review represents the most appropriate opportunity to reaffirm the real scope and nature of the decision on compensatory financing.

As to the specific issues suggested for consideration, let me refer to the problem of the conditionality that should be associated with the use of resources under the facility, which in turn relates to the question of responsibility for any shortfall. In this connection, we can identify three basic scenarios that in our view deserve different policy responses.

First, we have the traditional case of an export shortfall taking place within the scope of either a relatively flat trend, or an upward trend. In both circumstances, and assuming that the shortfall remains beyond the member's control, the compensation to which the member is entitled should not be subject to any form of conditionality; the member should receive prompt disbursement of such compensation. No doubt these cases fully reflect the spirit of the decision, with compensation taking place after the shortfall has actually occurred, and with an almost complete assurance of the temporary nature of the shortfall; thus, one can hardly foresee any risk of the Fund not being repaid fully and on time.

A second case that may be distinguished is that of a shortfall taking place in the context of a downward trend, and in which it is clear that, due to technological innovation or the emergence of additional and competitive supply sources, international prices are deteriorating, thereby leading to a permanent loss of export revenues for the member. In such a case, it is clear that the member should be expected to adopt the structural measures needed to reduce its reliance on the export proceeds of the commodity whose price is falling. Therefore, the drawing in the upper tranche of the facility would be subject, as at present, to the adoption of policies that meet the criteria for the use of the Fund's resources in the credit tranches. Thus, it would be desirable for the member to undertake a comprehensive structural adjustment program over the medium term aimed at diversifying the export base of the economy and at improving the overall competitiveness of the external sector.

To some extent, we view the compensatory financing facility as providing bridge loans to compensate for a shortfall that would be reversed once the structural measures began to yield the expected outcome of export diversification and increased competitiveness. The medium- to long-run perspective embodied in the second scenario makes it desirable, although not compulsory, for the member to have a program supported by the Fund or the World Bank. In this case, the facility can be seen as a means of providing transitional financial support leading to a structural adjustment loan.

The third case is similar to the second in the sense of there being a downward trend in international prices and export revenues, but with the nature of the trend being different. In contrast to the second case, in which we recognize technical innovation or the addition of new competitive sources of supply as the exogenous sources for price decline, the third case allows us to identify exogenous factors underlying the price deterioration. These factors include all forms of protectionism, particularly subsidies, that allow a number of inefficient or noncompetitive industries, as well as a number of agricultural producers, to stay in the market and to gain shares in that market, thereby creating artificial excess supply and, subsequently, a deterioration of international prices. A good example is subsidies on wheat production in major industrial countries, which have caused a permanent deterioration in the export earnings of less developed countries.

In the third situation, we cannot ask the members facing the shortfall to embark on a structural reform aimed at changing their export base. In these cases, the Fund should recognize the source of the disequilibria and should urge the member countries following such protectionist measures to dismantle them promptly, or to compensate the affected member if such compensation is measurable.

By no means should a country that has comparative advantages in the production of a certain commodity be prevented from fully exploiting its advantages, and be induced to specialize in other products simply because protectionism and ineffective subsidization practices exist elsewhere.

We would again like to stress the importance my authorities attach to keeping access limits to the facility at least at the present levels; beyond that, we reiterate that actual access to the facility in the future should better reflect the total magnitude of the shortfall, as well as the maximum entitlement of the member to the drawings.

Speeding up the calculation of the shortfall would also contribute to the effective and timely alleviation of the member's imbalances. We do not see any convincing argument in favor of phasing the disbursement of the calculated and approved compensation. Even when the test of cooperation requires the adoption of

adjustment policies and measures, there would be no reason to delay the full disbursement of the agreed compensation, given the ex post nature of such action in relation to the occurrence of the shortfall.

This preliminary review has been very appropriate in reaffirming the real scope and nature of the compensatory financing decision. We join previous speakers in urging the Board and management to expedite the forthcoming comprehensive review of the facility in order to allow members to benefit fully from the facility by means of a more effective adherence, on the part of the Fund, to the principles and guidelines embodied in the current decision on compensatory financing.

Mr. Posthumus made the following statement:

The compensatory financing facility is a balance between different considerations, as the staff paper makes very clear. On the one hand, there is the wish to have a facility in the Fund that makes it possible to compensate temporary shortfalls in export proceeds. Once it is established that there is a shortfall that is temporary, compensatory financing should be provided automatically. On the other hand, a country experiencing such a shortfall may also experience other problems. There may be a fundamental disequilibrium in the balance of payments position, insufficient adjustment policies, or a large debt service burden, or all of these at the same time. The case for automaticity may still be there, but in such a situation there is justifiable concern about maintaining the revolving character of the Fund's resources.

The underlying financial and economic situation of individual countries and the state of global trade developments, monetary conditions, and external debt change the required balance between these two considerations. In the 1970s, the change was in the direction of increasing access to the facility. At the moment, there is growing concern about the revolving character of the Fund's resources. By the end of October 1986, countries that were in arrears to the Fund by more than one month and countries that borrowed continuously from the Fund from 1979 onward, together had a compensatory financing debt representing 25 percent of their total debt to the Fund, which is 50 percent more than the share of compensatory financing obligations in total obligations to the Fund for all countries--17 percent.

However, I would hesitate to say that there is a trend in arrears. The world economic situation, as well as the situation of the countries concerned, may change drastically in a few years. In fact, my belief at this stage of the discussion is that the character of the facility should not be changed, and that in its implementation considerations relating to the revolving character of the Fund should be maintained as far as possible on a case-by-case basis.

One of the countries that elected me has suggested for consideration by the Executive Board a proposal that, in my opinion, would probably not change the present balance of considerations, but would strengthen it to some extent. The lower tranche access limit, now 50 percent, would become 33 percent, to be released automatically and unconditionally once the shortfall was established. The upper tranche access limit of 50 percent would only be released in conjunction with an existing or new stand-by arrangement. Thus, the risk for the Fund would be diminished to the extent of the conditionality that could be imposed. This proposal encompasses another simplification with respect to calculating shortfalls outside the postshortfall years.

On the issue of determining shortfalls, I have two questions. The first, relating to the staff's question of whether its judgmental projections were superior to more mechanical or extrapolative methods, is to ask what the calculated shortfalls would be in the absence of projections. In other words, what would the result be if the shortfall year was the previous year, and the shortfall to be compensated was the difference between the average export proceeds calculated over three or more years in the past, including the shortfall year, and the export proceeds in the shortfall year? The second question is what the consequences for outstanding compensatory financing credit would be if there was no compensation for a total export proceeds shortfall, but only for a shortfall of the proceeds of the export of primary commodities, which was the original rationale for the facility. I do not expect the answers to these questions to show a substantially different outcome for the facility, but they might show that the facility can be run more efficiently.

Mrs. Ploix's proposal for concessionary lending contains a possible answer to a concern that I have had for some time. Some countries, particularly countries with structural adjustment arrangements that have a substantial debt burden, do not in fact qualify for short-term loans at market-related interest rates. In theory, the revolving character of the Fund's resources might be maintained if their use was provided for more than three to five years, so long as the drawings were repurchased; this practice has been an accepted feature of extended arrangements. Also, if interest subsidies were provided, interest rates below market rates would not jeopardize the resources of the Fund. Mrs. Ploix's proposal in this respect is limited of course to the compensatory financing facility, and to a special group of countries. However, in contrast to the extended arrangement, less conditionality attaches to compensatory financing than to stand-by arrangements. Like Mr. Lankester, I wonder whether Mrs. Ploix's proposal is superior to another solution, namely, certain limitations on the use of Fund resources in such cases, and an increase of funds from other sources, bilateral and multilateral, using the same interest rate subsidies. In the present situation, however, all ideas and proposals should be discussed first, rather than dismissed first.

This also holds true for Mr. Dallara's suggestion to consider the reintroduction of phasing, but only in situations where total outstanding use of Fund resources exceeds a certain limit. The idea conflicts with the consideration of a full release of compensatory financing, once certain conditions have been established. But it brings into focus the issue of guaranteeing the revolving character of the Fund. Thus, we should also discuss Mr. Dallara's proposal at our next discussion of the facility.

Mr. Salehkhoh made the following statement:

I welcome this timely opportunity to discuss the issues raised in the staff paper concerning Fund policies and recent experience with the compensatory financing facility.

It should be noted that, other than structural balance of payments difficulties, the conditionality associated with the use of the compensatory financing facility has intensified in conjunction with the increase in access to this facility--from the "test of cooperation" to "a stricter test of cooperation"--in an effort to find solutions for balance of payments difficulties. According to Table 2 of the staff paper, since 1979, 87 percent of drawings under the upper tranche of the facility were accompanied by stand-by or extended arrangements. Furthermore, since the issuance of specific guidelines on cooperation in 1983, all but one of the upper tranche drawings have been subject to existing or concurrently discussed stand-by or extended arrangements. In those circumstances, the question arises as to whether export shortfalls have become an integral part of the structural problem, or whether the linkage has simply been a matter of coincidence. In any event, the situation does not call for Board reconsideration of the facility by means perhaps of the elimination of upper tranche drawings and their inclusion in normal stand-by or extended arrangements. In this regard, I share fully the views of Mr. Kafka, Mr. Sengupta, and other speakers on the misrepresentation in the staff paper of the possibilities offered by the September 1983 decision of the Board regarding drawings in the upper tranche of the facility without a concurrent arrangement with the Fund.

Although the reason for the creation of the compensatory financing facility was to alleviate the balance of payments difficulties of members and to enable them to stabilize their capacity to import, and while in the 1960s and 1970s the main concern was to liberalize access to the facility, in recent years the Fund's policy has moved rapidly away from the original intention. Furthermore, notwithstanding clear evidence of export shortfalls and the increased linkage of conditionality to the use of compensatory financing in the upper tranche, concern about the inconsistency of a member's total access to Fund resources, together with judgment on the member's capacity to service its outstanding debt to the

Fund, has further deprived a large number of countries of access to the facility. In recent years, many cases have shown that it would not be wise to make a sizable drawing under the facility at the same time as an agreement on a stand-by arrangement.

Taking into account the requirements under which a country qualifies for the use of compensatory financing--inter alia, that the shortfalls in export earnings be temporary and largely attributable to circumstances beyond the member's control--drawings under the facility should be treated separately from purchases under stand-by or extended arrangements, which are designed solely to help the country effectively address deep-rooted balance of payments difficulties. Based on the information provided by the staff in Annex I, it is worth mentioning that over 80 percent of the total volume of export shortfalls during the past ten years was attributed to causes beyond the control of the authorities, resulting mainly from the weak external demand that affected the volume of exports, adverse weather conditions, and declining commodity prices that effected changes in the unit value of the export commodities. The cyclical pattern of economic activity in the major industrial countries has also been reflected in the considerable use of the facility since the 1970s.

These developments clearly suggest that primary product exporting countries should not be penalized for the temporary balance of payments difficulties stemming from circumstances beyond their control. Instead, Fund policies should be directed toward addressing the root cause of the problem. For instance, given the interdependence of the economies of industrial and developing countries, if export shortfalls result from weakened demand or increased protectionism in industrial countries, emphasis should be given to encouraging those countries to implement appropriate measures to stimulate their economies, thereby helping to accelerate world output and trade.

It should be emphasized that without the effective cooperation of the industrial countries in providing developing countries with access to their markets, no amount of adjustment can bring about necessary export growth. Furthermore, if export shortfalls are combined with structural balance of payments problems, unconditional and timely use of compensatory financing as a temporary relief can help the affected countries pursue appropriate adjustment program under stand-by or extended arrangements in an orderly fashion. In this connection, I welcome Mrs. Ploix's proposal regarding supplementary contributions by industrial countries to assist low-income monoproducer members to cope with excessively market-oriented Fund rates of charges. I wish to emphasize, however, that eligibility for such concessional rates should not in any way be linked to the use of resources under the structural adjustment facility.

I regret to note that contrary to its cooperative nature, the Fund has given more emphasis to the revolving character of its resources than to the member's right to access under the compensatory financing and other facilities. In this regard, a reconsideration of existing guidelines on cooperation in the context of reducing the degree of conditionality, particularly in the upper tranche of the facility, appears appropriate and timely.

Given the different nature of members' external balance of payments difficulties and relevant Fund policies, it appears appropriate that access limits under the facility be determined separately from those under other Fund facilities. While the determination of access limits under stand-by or extended arrangements is a highly judgmental matter, depending on the magnitude of the adjustment and the member's financing need, this has not been the case for the compensatory financing facility. Moreover, Fund policy should be more flexible and responsive at the time that export shortfalls are determined. In this regard, the prospective capacity of an economy to service its debts to the Fund should not be overemphasized to the extent of limiting the member's actual access to its financial resources.

Given the different functions originally associated with the use of compensatory financing compared with purchases under stand-by or extended arrangements and the reasons expressed on the issue of phasing in 1979--which remain valid to this date and which led to the decision to abandon phasing for use of the facility--there is no need to change the existing provisions of the facility. Fund resources are to be made available and drawings should take place as soon as the request for compensatory financing is approved. The increasing amounts of overdue financial obligations to the Fund in recent years have reopened the question of a return to the distribution of access to the facility over a certain period. Since the overall amount of overdue obligations has been heavily concentrated in a small number of countries already declared ineligible to use the Fund's resources, the problem of arrears should not be considered as appropriate justification for resuming discussion on the issue of distribution or phasing of access. The possible weakening of adjustment efforts under stand-by or extended arrangements by members that have immediate and relatively large access to compensatory financing is not an area of concern. On the contrary, it is interesting to note that the staff report states, "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 welcome the contingency mechanism recently provided by the Fund in response to developments in commodity prices, to be applied either by automatic adjustment, as under the oil price compensation mechanism in the case of Mexico, or by adjustment during the review

of the program, such as compensation for the decline of agricultural prices in the case of Argentina. The broadening of prospective shortfalls to encompass export receipts is strongly recommended.

I have four specific points on the entitlement of members to draw under the facility. First, it is encouraging to note that the large discrepancies between projected and actual shortfalls during 1981-82, which resulted mainly from the miscalculation of the duration of the recession, have decreased in recent years. However, the issue of the overestimation of shortfalls should not be considered as cause for serious concern, particularly at a time when compensation based on overestimation has been largely reduced by the impact of quota limits on the entitlement to draw under the facility. In general, taking into account the existing provisions of the facility and the limited access of members to the facility, it appears undesirable to consider the issue raised by the staff regarding early repurchases for instances of overcompensation, the amount of which requires about two and a half years to verify.

Second, I strongly share the staff's view that it is very difficult to assess precisely the extent to which the shortfall for a given commodity, or indeed for total export earnings, is due to factors outside the control of the member. The rationale for the idea that shortfalls should be largely attributable to circumstances beyond the control of the member is even stronger in present circumstances than in 1963 when the facility was established. Despite the logic behind it, limiting the amount of compensation to the part of the export shortfall that is attributable to factors clearly outside the control of the member requires making an accurate distinction between the two factors, hence making the calculation of shortfalls more complicated and difficult. Therefore, the existing practice of providing compensation for the entire shortfall should be maintained.

Third, while I agree in principle that it would be reasonable to have a necessary adjustment for the import component of exports, the application of individual adjustments does not appear to be feasible. There are practical problems behind the issue, including a member's inability to provide accurate data concerning the import component of final value and the time lag between imports and exports. I support the idea of a more far-reaching adjustment of export shortfalls against import costs, regardless of whether or not the imports were a component of exports, should the practical difficulties pointed out by the staff be resolved.

Fourth, this chair, while confirming its strong support for the inclusion of compensation for the excess cost of cereal imports, also favors the extension of the facility to cover other exogenous contingencies, such as interest rate fluctuations, to help countries maintain their capacity to import. I strongly suggest that the issue be brought up again at the Board for further consideration.

The Director of the Research Department said that the conflict of views between those Executive Directors who wished to increase conditionality and those who supported liberalization was more apparent than real. If the issue was seen in terms of targets and the instruments needed to achieve those targets, then the difference of opinion simply represented different emphases. In other words, in a world that was fundamentally multiobjective, different emphases could be given to different targets. The difference of emphasis was evident also in the need to maintain the integrity of the compensatory financing facility on the one hand, and to protect Fund resources on the other.

The logic of those Directors who wished to increase conditionality was that, as far as Fund resources were concerned, the marginal product of a dollar was the same across all users, and therefore the allocation of resources would follow that principle, the Director observed. Thus, there would be a need to have consistent criteria applied to the various uses of the resources, which would necessitate reviewing such factors as joint access limits, the balance of payments position, and the external debt situation. However, there were Directors who believed that, from the perspective of the country and from a systemic viewpoint, the value of resources was not the same for all recipients, and that the effects of those resources might vary depending on the nature and depth of the existing economic situation. Although the Executive Directors had all agreed that circumstances had changed, a number of them believed that, for some countries, it was necessary to tighten conditionality because of the uncertain future. However, other Directors considered that it was more important to improve program design than to tighten conditionality. In the opinion of the staff, those viewpoints were not mutually exclusive because the key difference was in the time perspective; thus, the conflict was not fundamental, but reflected different emphases.

There were two aspects to Mrs. Ploix's proposal, the Director continued. The first was the identification of a problem, in which there was the recognition that those developing countries that were monoproducers and had no access to capital markets should be assisted while they embarked on a long process of adjustment and diversification. The second aspect was whether the solutions to their problems should be found in the compensatory financing facility through such means as increasing maturity or interest rate subsidies. Those issues would be examined in the forthcoming comprehensive review of the facility.

The studies that had been suggested by the Executive Directors would be undertaken in the forthcoming review of the compensatory financing facility, the Director noted. Those studies included the role of the direction of trend in the calculation of shortfalls; the possibility of introducing a threshold; alternative ways to calculate the export trend; an examination of the advantages and disadvantages of contingency mechanisms, and possibly compensation for interest rate variations; more detailed examination of the requirement that shortfalls be beyond the control of the authorities; the role of exchange rate policies; the role of other commodity market arrangements; the importance of debt-servicing capacity

in the context of the compensatory financing facility; the accuracy of projections; the effect of phasing on the facility; identification of structural changes and permanent long-term change in terms of trade that might require the use of facilities other than the compensatory financing facility; access limits in relation to growth in international trade and reserves; the incentives or disincentives that facilities such as the compensatory financing facility might introduce into an economy; the feasibility and usefulness of distinguishing between official and commercial borrowers; a quantitative analysis of the linkages between compensatory financing and the emergence of arrears to the Fund; the possibilities of lowering the threshold between the higher and lower tranches of drawings under the facility; the possibilities of making a downward adjustment in the entitlement of members to draw under the facility in certain circumstances; the examination of various repurchase schemes, with special attention to the principles of symmetry and the possibility that the usefulness of the facility would be reduced because of increased uncertainty faced by recipient countries; and the interpretation of statistics related to those members who had not made full use of their entitlement.

The suggestions of the Executive Directors constituted a very demanding agenda for the forthcoming comprehensive study, the presentation of which to the Board he hoped could be postponed somewhat in order to take into account the report of the Group of Twenty-Four that would soon become available, the Director concluded.

The Director of the Legal Department observed that the current interpretation of the so-called test of cooperation with the Fund under existing guidelines was consistent with the practice of the Fund. Some Executive Directors had taken issue with that practice and formulated two propositions, both of which were contrary to the current interpretation. The first proposition was that for purchases under the compensatory financing facility, the approval in principle of a stand-by arrangement would be equivalent to an approval, without qualification, of a stand-by arrangement. That proposition related to the interpretation of the guidelines on cooperation under the compensatory financing facility (Decision No. 7528-(83/140), adopted September 14, 1983), and specifically, to the phrase that referred to the adoption of an arrangement. The issue was whether adoption of an arrangement meant outright approval, or included approval in principle. In the practice of the Fund, that phrase meant outright approval, although some Executive Directors had interpreted it to include approval in principle.

There were some basic differences between outright approval and approval in principle, the Director continued. Approval of an arrangement created a right for the member to use the resources of the Fund. That was consistent with the definition of a stand-by arrangement in Article XXX(b) of the Articles of Agreement. A stand-by arrangement meant a decision of the Fund by which a member was assured that it would be able to make purchases from the General Resources Account in accordance with the terms of the decision during a specified period

and up to a specified amount. In contrast, an approval in principle represented only a contingent decision under which, in order for the stand-by arrangement to become effective, certain conditions would have to be met, particularly the Fund's finding that satisfactory arrangements had been made by the member for financing its balance of payments deficit. Therefore, in the case of an approval in principle, there was no assurance and no right for the member to make purchases until that finding had been made and until the stand-by arrangement had become effective. A consequence of the difference between the two forms of approval was that a press release was issued when the Executive Board approved a stand-by arrangement, whereas no press release was made for an approval in principle because no right had been established for the member until the stand-by arrangement became effective.

Moreover, the Director observed, if an approval in principle was regarded as sufficient to meet the test of cooperation, there would be a conflict between that interpretation and another part of the guidelines, specifically, the last sentence, containing the so-called fourth case of cooperation, which was applied when a member did not have a stand-by arrangement with the Fund. The last sentence of the decision on guidelines on cooperation stated that, "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." If adoption of an arrangement was taken to include approval in principle, then the last sentence of the decision would not apply, because the member would have an arrangement "adopted" by the Fund. However, an approval in principle, in contradistinction to an outright approval, meant that the Fund was not satisfied that the member's policies were satisfactory enough to meet its balance of payments problems, and that the Fund's findings would be deferred until the member had undertaken the necessary arrangements to resolve the problem. An approval in principle was a recognition that the conditions of the fourth case of cooperation were not met, otherwise an outright approval would have been granted. Therefore, it was not possible to reconcile an interpretation of "adoption" as including approval in principle with the conditions prescribed in the last sentence of the guidelines.

The second proposition that had been raised by some Executive Directors was that there should be no difference for compensatory financing as between a member whose policies were sufficient to solve all its balance of payments problems and a member whose policies could solve only part of its balance of payments problems and that would need additional financing to close the gap, the Director noted. There were two different situations associated with this argument: first, the case of a member that had only an export shortfall as strictly defined under the decision; second, the case of a member that had not only an export shortfall but also a broader balance of payments problem. The issue was whether both the members qualified for compensatory financing on the sole basis of the export shortfall, or whether a distinction had to be made under which the

second member would be required to adopt policies in order to resolve the additional balance of payments problem. That issue had already been addressed in the basic decision on compensatory financing. The guidelines were only an explanation of the basic decision.

According to the decision on the compensatory financing facility, a member was required to meet two conditions for the use of the Fund's resources, the Director stated. First, there had to be an export shortfall of short-term character and largely attributable to circumstances beyond the control of the member; and second, the member would have to cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties. A further condition was that when a member wanted to make a upper tranche purchase under the facility, the member, in addition to providing evidence of future cooperation, should demonstrate that it had already been cooperating with the Fund in an appropriate manner. Thus, the issue was defining "balance of payments difficulties" and determining whether they were strictly export shortfall-related balance of payments problems or whether they involved other difficulties. If the difficulties were those that related to the export shortfall, it would be strange to make it a condition, on the one hand, that those difficulties be beyond the control of the member, and on the other hand, that the member find appropriate solutions for them. That interpretation would raise the issue of whether the export shortfall was within or beyond the control of the member if the two conditions dealt with the same balance of payments problem. Moreover, the second condition was that the member find solutions "where required" for its balance of payments difficulties. The words "where required" meant that there could be cases in which there were no such balance of payments difficulties. Obviously, those words could not refer to the export shortfall, which by definition, was always present in cases of compensatory financing. Therefore, the words "where required" could only refer to other balance of payments difficulties. Thus, the second condition meant that, in addition to the existing shortfall, the member should cooperate with the Fund in order to solve other balance of payments difficulties. The solution of such difficulties required the adoption of appropriate policies, thereby raising the issue whether appropriate policies could be determined, regardless of the size of the member's financing gap, or whether they had to be adjusted according to the size of the gap. In the practice of the Fund, a distinction had always been made between a member that was required to resolve all its balance of payments difficulties because it could not find additional financing and a member that had access to additional financing. Was the distinction relevant? In other words, should the Fund take into account the existence of the global financing gap, or only those policies that might be found satisfactory, regardless of the existence of a gap?

There were some explanations in the guidelines that offered a solution to those questions, the Director went on. For instance, in the decision on the guidelines, the first case in which the member met the test of cooperation with the Fund was based on the existence of a satisfactory balance of payments position, apart from the effect of the export

shortfall, which was expected to be self-reversible. Thus, if the member did not have any additional balance of payments problem, the test of cooperation would be met ipso facto, which meant that, in other cases, the existence of a broader balance of payments problem, in addition to the shortfall, was relevant for the purposes of the test of cooperation. Similarly, when the Fund approved a stand-by arrangement in principle, the same distinction was made between a member that could close its financing gap through financing arrangements and one that could not close its financing gap; in the latter case, the policies had to be adjusted. Moreover, when compared with the upper tranche test of cooperation, the lower tranche test of cooperation showed that the member was required to give the Fund reasonable assurance of adopting policies that would correct its balance of payments problems. Therefore, it was obvious that adequate policies for the resolution of balance of payments problems was a requirement. Since conditionality in the lower tranche was less than in the upper tranche, whatever was stated about lower tranche conditionality applied a fortiori to the upper tranche. To ensure that the financing gap was closed, corrective policies had to be in place. That interpretation had prevailed under existing guidelines, based generally on the provisions of Article V, Section 3(a), which required the Fund to adopt policies establishing adequate safeguards for the temporary use of Fund resources. It should be noted that the compensatory financing facility was part of the General Resources Account. In that context, the requirement of adequate safeguards was as applicable to the compensatory financing facility as to any other facility in the General Resources Account. The difference was in the existence of a self-reversing shortfall, but that difference did not bear on the problem of additional balance of payments problems that the member had to resolve.

If the interpretation that had been presented--and which the staff had followed until the present time--was challenged and found incorrect by the Executive Board, the Director of the Legal Department stated, it would be better, in the interests of clarification and future implementation of the decision and guidelines of the compensatory financing facility, to amend those guidelines in order to reflect the Board's opinion.

The Director of the Exchange and Trade Relations Department assured the Board that the staff would consider the issues that had been raised during the discussion, particularly in the light of the clarification made by the Director of the Legal Department. In his understanding, the Board did not wish to consider in detail certain issues such as the oil contingency mechanism for Mexico, but had requested a more detailed examination of improvements that could be made in exercising conditionality through other facilities.

Mr. Kafka noted that the Director of the Legal Department had pointed out that an approval in principle of a stand-by arrangement did not imply that the country had policies, current and prospective, that were adequate to entitle it to access under the Fund's resources in the credit tranches. That point had been emphasized by the Director because countries might have policies that could only be implemented if additional financing was

made available; approval in principle was granted when additional financing had not been made available. However, there had not been a single case in which a stand-by arrangement had not become effective after approval in principle and then only after a relatively short time, with the exception of Mexico, which had taken a little longer. The fact remained that approval in principle was not a statement that the country's policies were not adequate, but one that was intended to prompt the cofinanciers of Fund programs to faster action in providing funds. On the basis of historical experience, there was no question that Fund resources would become available to a country whose financial arrangement had been approved in principle. Therefore, the policies that were being contemplated by a country and that had been accepted by the Fund were obviously being put into effect from the very beginning; otherwise the proposed stand-by arrangement would collapse. Consequently, there was no reason why approval in principle should not be as acceptable as approval.

Mr. Ortiz noted that the criterion of gathering a critical mass of financing in connection with approval in principle was not itself a guarantee that the financing would be in place at the start of a program. Thus far, in every instance in which the critical mass had been put together--except for Mexico, which remained pending--there had eventually been participation by most of the banks that had originally agreed to participate. He supported Mr. Kafka's argument that approval in principle was one way to put pressure on other creditors in providing funds to complete a financial package. But, if the issue was that of providing adequate safeguards for Fund financing, the fact that a critical mass of financing was potentially available to the country was not an absolute guarantee that the financial package would actually be provided.

Mr. Zecchini said that he was not clear about the legal status of the signing of the letter of intent in the context of the test of cooperation. He recalled that the 1983 decision on compensatory financing clearly referred to the adoption of policies that were appropriate, without specifying whether the adoption referred to the authorities or to the Fund. He wondered whether the letter of intent, which presented the commitment of the authorities to carry out a certain set of policies, did not represent the adoption by the authorities of a certain policy stance that would meet the test of cooperation.

A second issue related to the interpretation presented by the Director of the Legal Department, Mr. Zecchini continued. He asked the Director to consider an alternative interpretation that followed the argument which, under Roman Law, was called a *contrario*: if a country had signed a letter of intent and had received approval in principle, and was carrying out the intended policies but faced delays in finalizing a financial package, was it not true that the country was cooperating with the Fund in the context of the compensatory financing facility?

In the extensive program that the staff said it would undertake for the forthcoming review of the facility, there were repeated references to the balance of payments position and, as emphasized by the Director of the

Legal Department, the same reference was to be found in the Articles of Agreement, Mr. Zecchini observed. If that line of argument was pursued to the extreme, the distinctiveness of the compensatory financing facility compared with general balance of payments financing would be lost. A fine line had to be drawn between the attention that the facility paid to the export side of the balance of payments position and policies that generally referred not only to the export side but also to the import side and the capital account. That distinction should be kept in mind when analyzing any further development of the facility and in evaluating future proposals.

Mr. Dallara commented that the present discussion was not an occasion for an in-depth discussion of the relationship of approval in principle and financing prospects. However, although he did not dispute the fact that there had not been an instance of an approval in principle in which financing had not eventually materialized, he believed that achieving the critical mass did not provide much assurance of complete financing. The use of the critical mass criterion over the past few years had served as an indication that the financing package was ready, but could not be taken as a guarantee. For example, in the case of Mexico, the commercial financing that had been expected and that was an essential part of the adjustment program had not yet materialized. Mexico's previous adjustment efforts and the stabilization of oil prices had allowed it to avoid a substantial balance of payments problem, but it was conceivable that the country's efforts might have been undermined by the lack of external finance. Thus, it was important to ensure that the financing not only materialized, but did so within a reasonable period in order to support policy implementation. It was doubtful that the experience of approvals in principle prior to mid-1986 could provide much assurance at the present time that financing was likely to materialize within a reasonable time frame. Indeed, if the use of the critical mass was no longer a certain sign that financing was available immediately, then perhaps there was also a need for further review of that concept.

Mr. Grosche doubted that the Board's previous experience with the procedure of approval in principle justified the conclusion that financing for a program would indeed become available to the extent stipulated under the program. He supported Mr. Ortiz's observation that the achievement of a critical mass did not guarantee that financing would actually become available. Thus, he was in favor of raising the current threshold of 90 percent, because it was not clear that it would provide reasonable assurance that financing would actually become available within the short time that was inherent in a program that had been approved in principle.

Mr. Nimatallah said that the test of cooperation appeared to address two points: the declaration of the intention of the member to implement an adjustment program; and the actual implementation of the program. The intention to carry out an adjustment program could be demonstrated by signing a letter of intent, by obtaining approval in principle, or by having a declaration of the availability of financing by all parties concerned. As to implementation, despite the declaration of intention,

it was not certain that the program would be in place. For example, the program could fall apart immediately after the member received the funds, as in the case of South Africa. The issue here was whether to give the member the benefit of the doubt and accept the intention as declared in the letter of intent and by approval in principle; the declaration of the availability of the financing package added very little because the most important part was the implementation of the program, which would take some time. An alternative approach that could ensure the safety of Fund resources would be to insist that the program be implemented and to disburse the funds in stages corresponding to the reviews of the program, that might be better than accepting indications of the member's good intentions without insisting on the finalization of a financing package.

Mr. Lankester observed that it was necessary both to protect Fund resources and to assist borrowing countries. It was more likely that Fund resources would be protected if financing for a program were in place. Obviously, it was not certain that programs would be implemented. On the one hand, it would not be appropriate to withhold compensatory financing until a program had been implemented and, on the other hand, it was not enough to say that compensatory financing would be made available at a time when bank financing had not been finalized. He considered the interpretation of the Director of the Legal Department to be a commonsense approach that met the overall objectives of the Fund.

Mr. Hodges supported the remarks of Mr. Lankester, Mr. Grosche, and Mr. Dallara. His authorities tended to believe that the Fund was currently not exerting pressure on the banks so much by approving the financing packages in principle. Whether the pressure had been turned the other way was not yet clear.

The Director of the Legal Department noted that the discussion was addressing issues that went far beyond the problem of the compensatory financing facility. If the conclusion was that approval in principle was always followed by adequate financing, then it might not be necessary to have a distinction between approval in principle and approval in making stand-by arrangements effective. Whenever the Fund determined that the member had proposed an adequate program and was negotiating with the banks, a stand-by arrangement would be approved and would become effective immediately. Thus, the issue was no longer related to the compensatory financing facility, but rather to the Board's policy with respect to the distinction between approval in principle and outright approval. During the discussion, doubt had been expressed as to whether the attainment of a critical mass was an absolute guarantee of the availability of a total financing package. The issue then was whether the Fund should continue its practice of approvals in principle and stand-by arrangements becoming effective upon attainment of the critical mass.

Turning to the nature of the letter of intent, the Director noted that the letter was a statement of intention that did not create any obligation on the part of the member to carry out the policies stated in that letter. The letter of intent was the basis on which the Fund could,

depending on the substance, approve a stand-by arrangement for the member. Whether those policies were adequate for the purposes of compensatory financing required an interpretation of the guidelines. According to the guidelines, the Fund was required to determine that the current and prospective policies of the member as set out in the letter of intent would, in the Fund's view, meet the criteria for the use of resources in the credit tranches. In the practice of the Fund, the adequacy of policies was assessed in different ways depending on the existence of an additional financing gap that had to be met. Policies could not be adequate in the abstract, regardless of the financing problems of the member. If the Board believed that a more flexible approach should be adopted, then clearly a departure from existing policies should be contemplated, provided that the new policy was consistent with the general rule in Article V, Section 3(a), that policies may be adopted by the Fund to safeguard the temporary use of its general resources.

Mr. Ortiz said that the real issue was to determine what provision constituted an adequate safeguard for the resources of the Fund. Although he understood the interpretation of the Director of the Legal Department that there was a much lower risk of there not being a financing package when a critical mass had been reached than when there was no critical mass, many programs had been approved and implemented in which substantial financing gaps remained even after the conclusion of a program. The Fund's exposure would remain substantial because a country would have to repay the Fund over several years after the conclusion of a program. If the argument about safeguarding the Fund's resources were carried to the extreme, then there should be assurance that the agreed policies, including the financing, would exist not only for the duration of the program but for the entire repayment period. In that sense, the evaluation and ordering of risks could be extended in many different respects. The interpretation that had been provided pointed out to the Board an ordering of risk evaluation that was by no means unique.

The Director of the Exchange and Trade Relations Department reiterated that the staff would examine the issue of approval in principle in the forthcoming review of the compensatory financing facility.

The Chairman then made the following summing up:

Executive Directors noted that the discussion was preliminary in nature. The Board will return to the issues on the occasion of the next phase of the comprehensive review of the compensatory financing facility in the summer of 1987.

In these closing remarks, I will not attempt to draw firm conclusions. Instead, I will try to draw together the range of views that has been expressed by Directors. In that context, I note first of all that all Directors continue to consider that compensating members for export shortfalls should remain an essential activity of the Fund. In my remarks, I will begin with broad policy issues related to conditionality, access, and phasing, and

then go on to consider some specific questions related to the calculation of shortfalls and entitlements to draw. Finally, I will say a few words on where we go from here.

#### Conditionality, access, and phasing

It was noted that the conditionality associated with the compensatory financing facility was embodied in the test of cooperation, and that the interpretation of cooperation had been clarified in 1983. I have observed a difference of emphasis--more than of opinion, I would say--between those Directors who stressed the need to ensure that the facility provided timely compensation for temporary shortfalls caused by factors beyond a member's control, and those who emphasized the need to protect the revolving character of the Fund's resources. Several Directors felt that recent practice had given too much emphasis to the latter consideration. They noted that in a number of cases, members with stand-by arrangements had been discouraged from drawing under the compensatory financing facility, despite the existence of export shortfalls. In addition, the use of compensatory financing in cases where there was no stand-by arrangement had almost ceased, despite the fact that such use was clearly possible under the guidelines of the facility. Those Directors considered that such a tightening of conditionality undermined the purpose of the facility, because it reduced the confidence with which members could count on receiving Fund assistance to deal with balance of payments problems resulting from export shortfalls.

In contrast, other Directors viewed the development of conditionality under the compensatory financing facility as a natural and necessary consequence of changes in the global economic environment. They believed that safeguarding the temporary nature of the use of Fund resources should be viewed as a paramount responsibility. Against this background, they considered that it was not in the interest of the Fund or the member to permit the Fund's resources to be used in circumstances in which repayment according to the prescribed schedule was in doubt. They also pointed out that members drawing their full entitlement under the facility could sometimes strain their future debt servicing capacity.

Those Directors also generally viewed questions of access and phasing as part and parcel of the issue of conditionality. They believed that with up to 83 percent of quota being immediately available under the compensatory financing facility, adjustment discipline might be weakened, which could increase the risk that developments after the inception of a program would jeopardize the viability of adjustment efforts. For those reasons, they expressed a preference for moving to a system of phased access under certain circumstances, such as when drawings in the higher compensatory

financing tranche were requested, or when the amount of the request was large in relation to that of the stand-by arrangement, or when the outstanding use of Fund credit by the member was high.

Other Directors, however, were firmly opposed to any scaling back of access limits or to any phasing of drawing entitlements. They pointed out that fluctuations in export earnings had become greater in recent years, and that the present access limits covered only a small part of the export shortfalls. Moreover, phasing would reduce the effectiveness of the compensatory financing facility in providing prompt balance of payments relief for shortfalls in earnings.

If there appeared to be a dichotomy of views, I believe that those views can be reconciled, and in that context I note that there were no calls for a major overhaul of the compensatory financing facility. There was a strong desire to preserve the characteristics of the facility so that it could be used in a timely and appropriate way by all members facing reversible balance of payments problems. Such use would aid in the process of adjustment to unforeseen external developments, and could help avoid unnecessarily disruptive responses. At the same time, there was also the belief that the use of the facility should not serve to weaken the incentive to adjust or contribute to future debt servicing difficulties. There is no logical incompatibility between those objectives, even though certain features of the present operation of the facility may be seen as making those objectives conflicting. More precisely, I might add that most Directors stressed that the test of cooperation does not require the existence of a financial arrangement with the Fund and that there was no call to reduce access under the facility. In preparing the next staff paper, we will need to be imaginative in searching for new mechanisms that will promote a better reconciliation of the key objectives of the facility.

#### Determination of shortfalls and drawings

Directors commented on a number of aspects of the method of calculation of entitlements to draw. On the use of projections, they considered that the present method of making projections, while clearly far from perfect, was nevertheless broadly satisfactory. As to the issue of how the trend of export earnings should be taken into account, most Directors said that present procedures were appropriate and that access to the facility should be determined on the basis of deviations from trend, irrespective of the direction of the trend itself. Some Directors, however, saw this as potentially incompatible with the constraints that ought to be associated with the use of Fund resources. If exports were on a declining trend, compensatory financing would enable a member to postpone a needed adjustment to adverse external circumstances, which made it more necessary that the Fund be satisfied

that policies were in place to correct the underlying disequilibrium, and that such cases should be dealt with in the framework of a stand-by arrangement rather than through the use of the compensatory financing facility. The appropriateness of compensatory financing when exports in the shortfall year were still on a rising trend was also questioned. The staff will study the suggestions that were made concerning ways in which the formula governing entitlements to draw might be modified.

Concerning the "beyond the control" requirement, most Directors believed that it was not feasible to make fine distinctions between the parts of a shortfall attributable to one cause rather than another, and that current policies and procedures were adequate. However, some Directors felt that the staff could make a greater effort to examine the issues, particularly the impact of the member's exchange rate policy on the export shortfall.

On the question of the coverage of the compensatory financing facility, several speakers favored extending the coverage to include such factors as changes in interest costs. Most Directors, however, felt that the present basic coverage should be retained. As to the issue of whether compensation should be provided for contingencies outside the foreign trade sector--for example, the growth contingency in the Mexican program--there was little support for such provisions.

On the subject of early repurchase for overcompensation, several Directors stressed the inherent logic of an expectation of early repurchases to take place as soon as it was clear that overcompensation had occurred. Other Directors, however, pointed out that a generalized early repurchase provision would present some difficulties. Since the overcompensation would be caused because export receipts turned out to be lower than expected, a requirement to repurchase early would compound the difficulties a member was facing. We will examine the question of early repurchase in our further work.

#### Further work

I have taken note of Mrs. Ploix's proposal, which was supported by a number of Directors, to provide small, low-income countries with access to compensatory financing on concessional terms, that is, through longer maturity and lower interest rates. The proposal is intended to help some of the most vulnerable Fund members to sustain the diversification effort. The scope for such arrangements will be studied in the context of the forthcoming comprehensive review.

We will soon have a discussion in the Board on issues on conditionality, and we will be reviewing the cereal decision before the end of May. The next phase of our review of the compensatory financing facility, which will be undertaken in the summer of 1987, will take into account the views expressed at those meetings, as well as those we have heard today. We will also have the benefit of the forthcoming G-24 report.

The staff paper on the review of the compensatory financing facility will be relatively broad ranging in its examination of suggestions for possible modifications to the features of the facility. Today's discussion has confirmed that we all remain agreed on the central goal of the facility, namely, the desirability of helping members adapt in an optimal way to externally caused fluctuations in export earnings. However, we need to consider ways of avoiding some of the difficulties that surround the operation of the facility at present.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/36 (3/3/87) and EBM/87/37 (3/3/87).

2. WORKING PARTY ON STATISTICAL DISCREPANCY IN WORLD CURRENT ACCOUNT BALANCES - RELEASE OF REPORT

The Executive Board approves the proposal set forth in EBD/87/63 (2/25/87) to transmit the staff memorandum entitled "Final Report of the Working Party on the Statistical Discrepancy in World Current Account Balances" (SM/87/13, 1/12/87) to the participants in the expert group meeting of the Intersecretariat Working Group on National Accounts, to be held in Washington March 23-April 2, 1987.

Adopted March 3, 1987

APPROVED: August 13, 1987

LEO VAN HOUTVEN  
Secretary

