FOR AGENDA

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EBS/90/179
Supplement 3

CONFIDENTIAL

November 9, 1990

To: Members of the Executive Board

From: The Secretary

Subject: The Response of the Fund to Recent Developments in the Middle East - Introduction of an Oil Import Element into the Compensatory and Contingency Financing Facility (CCFF)

Attached for consideration by the Executive Directors is a paper on the possible introduction of an oil import element into the compensatory and contingency financing facility (CCFF). A summary and concluding remarks appear on pages 7 and 8.

It is suggested that Executive Directors have an informal technical meeting on this subject at 3:00 p.m. on Monday, November 12, with a view to facilitating the formulation of a consensus at the Executive Board meeting scheduled for Thursday, November 15, 1990.

Mr. Wickham (ext. 4792) or Ms. Eken (ext. 6734) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

The Response of the Fund to Recent Developments in the Middle East--Introduction of an Oil Import Element into the CCFF

Prepared by the Research and Exchange and Trade Relations Departments

(In consultation with other Departments)

Approved by Jacob A. Frenkel and Jack Boorman

November 8, 1990

I. Introduction

At its meeting on November 2, 1990, the Executive Board discussed the Fund's response to recent developments in the Middle East on the basis of background information and staff proposals contained in "The Response of the Fund in the Wake of Recent Developments in the Middle East." 1/ At the conclusion of the discussions, Directors requested the staff to prepare a short paper on the modalities of a possible oil import element under the compensatory financing component of the compensatory and contingency financing facility (CCFF). 2/

This paper outlines for the consideration of the Executive Board options for a possible oil import element, including various provisions for the treatment of oil import excesses, access and conditionality, as well as its duration. It is assumed that, except as might be necessary to accommodate an oil import element, other aspects of the CCFF would remain unchanged. Regardless of the modalities of an oil import element, care would need to be taken to avoid double compensation if a member availed itself of both an oil element drawing and augmentation under an existing (or access under a new) arrangement that was determined in part with reference to increased oil import costs. As regards assistance in dealing with higher oil import prices, these mechanisms are clearly alternatives.

A decision to introduce an oil import element into the CCFF would require an 85 percent majority of the total voting power.

1/ EBS/90/179, 10/16/90 and "The Response of the Fund in the Wake of Recent Developments in the Middle East - Modification of Access Under ESAF Arrangements," (EBS/90/179, Supplement 1, 10/29/90).

2/ See the Managing Director's Concluding Remarks at Executive Board Meeting 90/156, (Buff statement forthcoming).

II. Treatment of Oil Import Excesses

An oil import element could be introduced to cover imports of crude petroleum and petroleum products. 1/ For purposes of such an element, it would not be appropriate to distinguish between these two categories because the distribution of oil imports between crude and refined oil products depends inter alia on relative prices of these products and the domestic refining capacity of the specific member. Of course, it would be possible also to cover imports of other energy items, such as coal, natural gas and electric power, but imports of these items by developing countries are generally small relative to imports of petroleum and petroleum products, and their inclusion may not be warranted given the problems of data collection and assessment.

Procedures to calculate a compensable excess similar to those employed under the cereal element of the CCFF could also be applied to an oil import element. When a member is in a position to request a compensatory drawing that encompasses an export shortfall, a cereal excess, or an oil import excess, the option to request a drawing under an oil import element would be at the discretion of the member. An arithmetic average of five annual observations centered on the excess year would be calculated, and the excess derived would be netted out against a calculated export excess (or added to an export shortfall) to obtain the net compensable amount. The purpose of such netting would be to take directly into account export performance when compensating for excesses in oil imports. It was the staff's understanding from the discussion on November 2, 1990 that the Board would prefer such an approach if an oil import element were to be introduced into the CCFF. As noted in EBS/90/179, the present rule that limits the growth in post-shortfall exports to no more than 20 percent over pre-shortfall exports in the calculation of export shortfalls may reduce an export shortfall (or enlarge an export excess) and therefore lower the compensable oil import excess.

As with the cereal element and with services in the export element, up to 12 months of estimated data could be used in the calculation of an oil import excess. Such a step would permit the calculation to be forward-looking and would accelerate the availability of resources to requesting members. 2/ Use of estimated data would involve a risk of overcompensation, but would be consistent with other provisions and

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1/ These goods are covered under the Standard International Trade Classification (SITC) 33.

2/ Limiting estimated data to 6 months in the excess year, say, beginning in August 1990, and given a data lag of about 3 months, a member would not be able to request a drawing until April 1991. Allowing up to 12 months of estimated data would permit a request to be made immediately.

suggestions relating to the use of estimated data in compensatory financing. 1/ As under existing provisions, a determination of overcompensation in the light of actual data for the excess year would give rise to an expectation that the member would make a prompt repurchase in the amount of the overcompensation.

In cases where the oil import excess in the shortfall year is based almost entirely on estimated data, some phasing of drawings might well be justified given the acute uncertainty at present regarding the future path of oil prices. A phasing of purchases would reduce the risk of overcompensation and the consequent need for early repurchase in a large number of cases.

The calculation of an oil import excess would necessarily involve the projection of oil prices for part of the excess year (if an early drawing is requested) and for the two post-excess years. For oil, as in the case of a number of other commodities, the projection procedures used by the staff in connection with the World Economic Outlook exercise and with the establishment of baselines for the contingency element of the CCFF are largely based on observable indicators, such as price quotations in the spot and futures markets.

III. Access

One straightforward approach would be to provide access under an oil import element of up to 40 percent of quota, or 65 percent of quota including the optional tranche, parallel to access under the compensatory and contingency elements of the CCFF. 2/ Such access could either be within the present total limit of 122 percent of quota, an option which appears consonant with the views expressed by a number of Directors, or be incremental to the present limit, thereby raising the total access to 162 percent of quota.

If the current limit were maintained, drawings made under an oil import element would reduce the potential access remaining under the CCFF and the question would arise as to how such a reduction could be distributed. Two options could be considered: access under the oil element could be offset either against access under the export element alone, or against cumulative

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1/ It was proposed in EBS/90/179 that the period covered by estimated data for exports in the shortfall year could be increased from up to 6 months to up to 12 months, consistent with present practice with respect to eligible service receipts and cereal imports.

2/ The provision under the compensatory and cereal elements of the CCFF decision that access of 83 percent of quota would be available to members whose balance of payments difficulties consist only of the export shortfall or cereal excess could be extended to apply to the oil import element as well.

access under the export and cereal compensatory elements. 1/ The first option would imply maximum access of 65 percent of quota (including the optional tranche) on account of the addition of oil import excesses to export shortfalls, whereas the second option would imply maximum access of 82 percent of quota.

The attached Table illustrates the effect of the various options on member countries' additional access to compensatory financing resulting from the introduction of an oil import element. If an oil element drawing is charged against only the access under the export element plus the optional tranche, 66 members would potentially benefit at an average of 26 percent of quota. Potential additional use of Fund resources would amount to SDR 2.7 billion in the simulation. If an oil element drawing were charged against access under the export and cereal elements, 10 more members would potentially benefit; although the same average in relation to quota would be calculated, the amount of potential financing would rise to SDR 3.5 billion. If an oil element were allocated separate additional access of up to 40 percent of quota plus the optional tranche, the number of eligible members would remain at 76, but the potential average financing in percent of quota would rise slightly and the total potential additional financing would rise to SDR 4.2 billion.

It should be noted that the above simulations probably substantially overstate likely use because some members may be unable to meet the tests of balance of payments need, "beyond the control," and cooperation with the Fund; in addition, many members may choose to deal with increased financing needs in the context of Fund arrangements, including concessional ESAF resources, 2/ while others have arrears to the Fund. Moreover, the attached table is provided for illustrative purposes only since the data used for the calculations make no allowance for a response in oil import volumes as a result of adjustment policies. To the extent that a member country has received assistance from other sources specifically to cover

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1/ To illustrate how the first and second options would work, suppose that a member incurs an oil import excess of 45 percent of quota and an export shortfall of 25 percent of quota for a total net compensable amount of 70 percent of quota. Under the first option, that part of the net compensable amount attributable to the oil import excess would be charged against access under the export element alone. The net compensable amount would exhaust access of 65 percent of quota (including the optional tranche) and would leave 5 percent of the net compensable amount uncompensated. The second option would be to charge the net compensable amount against the existing combined access under the export and cereal elements. Under this option, the net compensable amount of 70 percent of quota would be fully compensated, because access would be charged against the existing combined access limit of 82 percent of quota for exports and cereal imports.

2/ Of the potential beneficiaries under an oil import element, about half either currently have Fund arrangements in place or are holding discussions on arrangements with the Fund.

increases in oil costs, this factor would also have to be taken into account.

IV. Conditionality

In determining the conditionality to be associated with drawings under an oil import element, three alternatives could be considered. First, conditionality under an oil import element would follow the provisions of paragraph 12 of the CCFF decision 1/, but require the member specifically to pursue appropriate domestic energy policies in addition to the present more general requirement of appropriate policies to deal with its balance of payments difficulties. 2/ Under the framework of paragraph 12 of the CCFF decision, members falling under paragraph 12(a) (i.e., those having satisfactory records of cooperation) generally are not required to adopt prior actions before making a request. Members falling under paragraph 12(b), in contrast, are required to do so. Under an oil import element, all requesting members would be required to take satisfactory prior energy policy actions. Such an approach would be justified by the quantitative importance of oil imports for many members and the relatively large fiscal consequences of delaying adjustment. Furthermore, an argument for adjustment could be made on the grounds that oil prices are expected to remain significantly above the 1989 level and that the increase therefore has a permanent component.

A second approach, as suggested by some Directors at the Executive Board meeting on November 2, 1990, would be to require that compensatory drawings on account of oil excesses be subjected to stricter conditionality than that envisaged under the provisions of paragraph 12 of the CCFF decision and as modified in the first approach. One possibility would be to require that a member requesting a purchase at any level of access under an oil import element have a Fund arrangement in support of a program, or equivalent policies, that meet the criteria for the use of the Fund's general resources in the upper credit tranches. Such an approach could entail the risk of delaying purchases under an oil import element as negotiations on a program that meets upper credit tranche conditionality, including the specification of performance criteria and benchmarks for the

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1/ "Modification of Compensatory and Contingency Financing Facility Decision," SM/90/115, Supplement 1, 7/20/90.

2/ The question of what would constitute appropriate domestic energy policies is a complex one. Members have different oil purchasing arrangements as well as different initial pricing conditions, ranging from state subsidization of prices to uncontrolled private markets. Given these conditions, the term "appropriate domestic energy policies" would be understood in general to mean a substantial movement of domestic energy prices toward international levels. This approach would permit a case-by-case examination of the policies that might be appropriate to a requesting member's circumstances.

program period, may take some time. Furthermore, apart from possible questions of phasing, this approach would seem closely comparable, as regards conditionality, to an approach that focused on augmentation of existing arrangements (or access under new arrangements) as proposed in EBS/90/179.

A third approach would be to follow the conditionality provisions under paragraph 12 (as modified under the first approach) but, when a request under an oil element is not already associated with an upper credit tranche arrangement, the member would present a written statement, to be developed together with the Fund staff. The statement would lay out in detail the member's macroeconomic objectives and policies to be followed, including domestic energy policies, and would permit evaluation of the member's energy policies in the light of the appropriateness of its macroeconomic policies as a whole. The staff considers that the letter of intent that accompanies a member's request for use of Fund resources in the first credit tranche could serve as a useful model in this regard, would ensure the consistency of the proposed purchase with the Fund's policy on financing assurances, and would facilitate assessments of the member's capacity to repay the Fund. As in all cases of use of Fund resources, drawings under an oil import element could be limited by considerations relating to the member's capacity to repay. Under this approach, a member might also be required to adopt prior actions beyond the area of domestic energy policy.

As suggested earlier, an important issue in estimating excess oil imports relates to the length of the period for which estimated data may be used. The adoption of a provision which allows the use of up to 12 months of estimated data may run the risk of overcompensating members, given the volatile nature of the oil market at present. On the other hand, limiting the use of estimated data to 6 months would reduce the Fund's ability to react promptly in providing resources to members. One option would be to provide Fund resources in two equal tranches in those cases in which substantially more than 6 months of estimated data, say, 9 months, are used. The first disbursement would be provided at the time of the request and the second when the actual data covering 6 months of the excess year become available. Under this approach, the disbursement of the second tranche would be subject, at the time of the purchase, to balance of payments need and to the fulfillment of the test of cooperation--that is, in this context, a continuation of the policies and policy understandings underlying the initial purchase. Such phasing would apply only to purchases on account of the oil import excess, and purchases on account of export shortfalls and cereal import excesses would not be phased.

V. Duration of an Oil Import Element

Many Executive Directors have considered that an oil import element, if accepted, should be introduced on a temporary basis and lapse after a given period unless renewed by the Board (by a further decision requiring an

85 percent majority of the total voting power). It could be stipulated that the oil import element would remain in effect through end-1991. This expiration date would encompass the period during which the oil price increase is expected to have the most severe impact. In any event, it is expected that by this date the new quotas would be in effect, and access policies for the use of Fund resources in general would have been reviewed.

VI. Summary and Concluding Remarks

In presenting possible options and characteristics, the staff has been mindful of the view of the Executive Board that a new facility is not intended and that an oil element, if accepted, should be integrated into the existing CCFF. This consideration and the importance of coming to early conclusions on the Fund's response to the Middle East crisis suggest that options for consideration be limited.

As stressed in earlier discussions, many of the countries adversely affected face problems that are broader and most appropriately addressed in the context of comprehensive adjustment programs that could be supported by Fund arrangements. A considerable number of the potential beneficiaries of an oil element already have or are actively considering such arrangements, and requirements specifically related to increased oil import costs could be addressed either directly in those arrangements or through an oil import element of the CFFF. For others that might potentially benefit from an oil import element, the broader nature of their difficulties and the need to safeguard the Fund's resources would suggest that access to such an element should be maintained within the bounds of the existing CCFF and be associated with both satisfactory prior actions and at least a statement, developed with the Fund staff, describing the member's macroeconomic objectives and the policies to be followed.

The following summary presents characteristics and options for an oil import element for the consideration of Executive Directors.

1. Treatment of oil import excesses

An oil import excess would be calculated on the basis of an arithmetic average. The compensable amount would be equal to the excess net of any export shortfall (or excess). The excess year could include up to 12 months of estimated data under the early drawing procedure.

2. Access

a. Access could be up to 65 percent of quota including the optional tranche with the total access limit under the CCFF to be:

(i) maintained at 122 percent of quota; or

(ii) increased to 162 percent of quota with an incremental access of 40 percent of quota on account of an oil import excess.

b. If the total access limit were maintained at 122 percent of quota, drawings under an oil import element could be chargeable to:

(i) the access limit for the export element alone; <u>or</u>

(ii) the cumulative access limits for the export and cereal elements.

3. <u>Conditionality</u>

a. The member's request for a compensatory purchase under an oil import element:

(i) Would be subject to paragraph 12 of the CCFF decision with a special provision requiring appropriate domestic energy policies, including prior actions in the energy field for all members making requests for compensation under the oil import element; <u>or</u>

(ii) Would be subject to stricter conditionality than that envisaged under paragraph 12 as modified under subsection i. above, that is, for any level of access would be accompanied by a request for, or the existence of, a Fund arrangement in support of a program (or by equivalent policies) that meets the criteria for the use of the Fund's general resources in the upper credit tranches in addition to the pursuit of appropriate domestic energy policies; <u>or</u>

(iii) Would be subject to provisions of paragraph 12 as modified under subsection i. above, but would also require a written statement to be developed jointly by the member and the Fund staff laying out in detail macroeconomic objectives and policies to be followed, and might involve prior actions, including those outside the energy area.

b. The member's request for a compensatory purchase under an oil import element:

(i) Would not be phased; <u>or</u>

(ii) Would be phased in two equal tranches in those cases in which 9 months or more of estimated data are used for the excess year.

4. <u>Duration</u>

The oil import element could be allowed to lapse at the end of 1991.

Table. CCFF: Potential Additional Financing for Selected Members Under an Oil Import Element: Alternative Assumptions on Access Where Oil Excesses Are Netted Against Export Shortfalls 1/

	Existing Total Access Limit of 122% of Quota		Total Access Limit Raised to 162% of Quota
	Oil element drawings chargeable to:		
	One element: Exports only + Optional tranche (40%+25%)	Two elements: Exports+Cereal + Optional tranche (40%+17%+25%)	Oil element Has own Access + Optional tranche (40%+25%)
Countries potentially eligible for additional financing	66	76	76
Not SAF/ESAF eligible	31	38	38
AFR	5	7	7
ASD	4	5	5
EUR	6	8	8
MED	1	2	2
WHD	15	16	16
SAF/ESAF eligible	35	38	38
AFR	22	23	23
ASD	6	6	6
MED	1	2	2
WHD	6	7	7
		(In percent of quota)	
Average potential additional financing	26	26	29
Not SAF/ESAF eligible	30	30	34
SAF/ESAF eligible	22	22	23
		(In billions of SDRs)	
Total potential additional financing	2.7	3.5	4.2
Not SAF/ESAF eligible	2.0	2.7	3.4
SAF/ESAF eligible	0.7	0.8	0.8

1/ IMF staff calculations.