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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/95

3:15 p.m., June 17, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
F. Cassell	
Dai Q.	
C. H. Dallara	
J. de Groote	
A. Donoso	
M. Finaish	
	B. Goos
	J. Reddy
A. Kafka	
	W. N. Engert, Temporary
	N. Toé, Temporary
Y. A. Nimatallah	T. A. Al-Assaf
G. Ortiz	L. Filardo
	M. Fogelholm
H. Ploix	D. Marcel
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	
K. Yamazaki	S. Yoshikuni
S. Zecchini	

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

Also Present

African Department: A. B. Taylor. Asian Department: R. J. Hides. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; H. B. Junz, Deputy Director; M. Allen, D. Burton, H. B. Junz, S. Kanesa-Thasan, G. Oliveros, J. P. Pujol, M. H. Rodlauer, B. C. Stuart. External Relations Department: D. M. Cheney. Fiscal Affairs Department: K.-Y. Chu. IMF Institute: O. B. Makalou. Legal Department: T. M. C. Asser, A. O. Liuksila. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. G. Alter, D. A. DeRosa, D. Folkerts-Landau, H. Hernández-Catá, N. M. Kaibni, P. R. Menon, R. Pownall, B. E. Rourke. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: D. Gupta, Y. Ozeki. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, S. M. Hassan, Khong K. N., K.-H. Kleine, D. C. Templeman, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: N. Adachi, D. Barr, H. S. Binay, R. Comotto, E. C. Demaestri, V. J. Fernández, B. Fuleihan, S. Guribye, M. Hepp, C. Y. Legg, S. Rouai, C. C. A. van den Berg, E. L. Walker.

1. COMPENSATORY AND CONTINGENCY FINANCING FACILITY - MODALITIES

The Executive Directors resumed from the previous meeting their consideration of a staff paper on modalities for the compensatory and contingency financing facility (EBS/88/100, 5/24/88; and Cor. 1, 5/25/88). They also had before them a paper updating the Fund's liquidity position (EBS/88/115, 6/10/88).

Mr. Sengupta made the following statement:

It has already been agreed that Fund assistance for export shortfalls and external contingencies should be combined into a single facility. We have agreed on the total access, the access available for each of the two elements, the access under the optional tranche, and the application of the guidelines on cooperation for the compensatory element. We emphasized that the essential features of the compensatory and contingency financing facility should be preserved, a point that was also endorsed by the Interim Committee in April. On the external contingency mechanism, we have touched upon different aspects in a preliminary way, but our discussions were largely confined to the establishment of the mechanism and the outlining of its broad features. We should not consider that we have reached a degree of finality on the basic features of this new mechanism and we should be willing to examine all possibilities of improvement.

The new mechanism should now be examined in depth from all possible angles, as it will hopefully become an important feature of the international monetary system. It is in this spirit that I will make an opening suggestion, which may go somewhat beyond the letter of the Interim Committee communiqué but would definitely be in line with the essential logic of this new mechanism. Since the idea is that the external contingency mechanism should help maintain balance of payments viability in the face of adverse external shocks, the mechanism should be treated symmetrically with the compensatory financing facility, which is the existing Fund instrument for assistance to meet export shortfalls due to exogenous factors. Accordingly, while in many or even most cases external contingency mechanisms may be related to pre-existing programs, that is not necessarily so. External contingency mechanisms could also be related to enhanced surveillance arrangements as Mr. Ortiz has mentioned, or even to some mutually agreed baseline scenario, drawn on the assumption of a set of policies being continued.

The external contingency mechanism is expected to provide insurance against prospective deterioration in members' balance of payments positions owing to certain specific external shocks. This implies that compensation for external contingencies will have to be based on deviations from prospective trends, which would require some judgment about the future course of events. Such a judgment is not difficult to make because national policy makers calculate prospective changes in key variables--such as export prices, market growth for exports, and workers' remittances. During the Article IV consultations, the country concerned may reach an agreement with the Fund on such trends and on the thresholds beyond which compensation may be called for, which could be related to the continuance of a set of policies that are considered desirable. The member country would then be assured that if, in the future, such deviations actually occur, it would be eligible for assistance under the external contingency mechanism.

When a country invokes its eligibility and requests the Fund for such assistance, it could be made subject to a test of cooperation of a type previously agreed to in the context of requests for compensatory financing support, in order to achieve perfect symmetry with compensatory financing conditionality. This would mean that members with a satisfactory record of cooperation would have outright access to the full external contingency element and may need to take prior actions before using the optional tranche. In cases in which there were substantial indications that the member's record of cooperation in recent periods had been unsatisfactory, or that the existing policies were seriously deficient in relation to the size of the existing or prospective payments imbalances, access for external contingency purposes would be subject to the three-tranche policy of the proposed arrangement.

Such a proposal would be fully protective of the spirit of the external contingency mechanism and of Fund resources. It could easily incorporate Mr. Ortiz's enhanced surveillance proposal, and I hope that it will be examined carefully.

On the operational modalities for external contingency mechanisms, we support the exclusion of contingency purchases from the access limits specified under the policy on enlarged access. We continue to hold the view that the access limits should be set in relation to members' quotas, rather than in relation to the basic access under the associated arrangement, since access should depend upon the country's need and the nature of the contingency, and not on the nature of the program. On a practical level, such links could also lead to a lowering of the "effective" access limits of the associated arrangements themselves.

In the case of a multiyear arrangement, it is very difficult to justify fixing the annual contingency access as a proportion of the corresponding annual access of the associated arrangement. If the external shocks are severe and external conditions remain uncertain, it would clearly be useful to allow for front-loading.

Minimum thresholds cannot be determined on a universal basis and would have to be set on a case-by-case basis, since the variations in countries' circumstances are too large. However, I am a bit uncomfortable with excessive case-by-case treatment, and I have sympathy with Mr. Kafka's point that he does not want too much discretion to be left to the staff. I am generally in favor of rule-based rather than discretionary decision making. I hope that the staff will not treat the thresholds in such a flexible way as to obviate the need for all contingency drawings; this point also applies to all other elements of the Byzantine structure of the operations suggested in the staff paper.

Incidentally, I also agree with Mr. Kafka regarding the lack of advance notice from the staff on transitional provisions; this should definitely have been avoided.

On coverage, we could go along with the staff proposals, but consideration should also be given to the issue of growth contingencies, which could easily be calculated. After all, in every future program, adjustment will incorporate economic growth, implying an assumption of the likely rate of economic growth in the program exercises. Deviations from the envisaged rate of growth would be a good basis for triggering contingency financing.

The discussion on contingency financing of interest rate costs gives rise to many concerns. First, there is the question of nominal versus real interest rate costs. While nominal rates might be constant, the real rates could be high because of a sharp decline in the deflator. Although there is a problem in selecting the variable to be used as a deflator, that is not altogether unsurmountable, and could be resolved by discussions with the member concerned. We have to find ways of compensating for the real interest rate costs that would be too high for a country with a large stock of debt. Attention may have to be paid to the extent to which real interest costs should be compensated, or to the inclusion of only that portion of outstanding debt that is subject to variable interest rates and that is of medium- to long-term maturity. I would urge the staff to further examine these issues.

There should of course be no subceiling on the compensation for changes in interest costs, nor should that compensation be constrained by a requirement for parallel contingent financing by the commercial banks. I agree with Mr. Ortiz that this would practically be tantamount to withdrawal of financing for interest rate contingencies.

The point has been made that the calculation of contingent deviations would take into account information about the lags with which changes in world prices and international interest rates have an effect on the member's current account. While this is analytically useful, it is often difficult to have data on such lagged effects for each country that is a potential user of external contingency mechanisms. Where such data are not available, information available for a country of similar economic structure should be used, in order not to complicate matters unnecessarily.

On the activation of the external contingency mechanism, we continue to favor some automaticity, though we could agree on the use of ad hoc reviews at times to help phase the contingent access in an appropriate manner.

It is generally claimed that the pattern of phasing takes into account balance of payments need and the envisaged path and speed of adjustment. In practice, however, purchase amounts in four out of the five purchase periods in a year are equal in most arrangements. Such evenly spread purchase amounts could be said to promote adjustment in a steady fashion. In the case of contingency purchases, the need for financing to overcome the external shocks quickly should be the determinant of the amount to be disbursed, rather than using a predetermined fixed proportion of the total amount available.

We favor the inclusion of external contingency mechanisms in arrangements under the enhanced and structural adjustment facilities, and could agree with the staff proposals relating to the repurchase period and the use of ordinary resources. Contingency access for multiyear, stand-by, and extended arrangements should be augmented, in cases in which external shocks make it difficult to apply contingency mechanisms.

We are opposed to the proposal that approval of contingency financing could be subject to the adequacy of financing and creditor involvement, and to the extent of parallel contingent support.

We now have an agreed interpretation of the guidelines on cooperation for the compensatory element. Our understanding of the tranching of the compensatory element for members whose record of cooperation had been unsatisfactory is that the first tranche will be somewhat larger than the second, about 25 percent. We would not like to treat requests for compensatory financing purchases differently when there is an arrangement approved in principle.

As for the cereal decision, we could agree to raising the joint limit on export shortfall/cereal excesses beyond 65 percent, while preserving the contingency element at 40 percent of quota. This would be Alternative A or B of the Annex.

We did not agree at the time of the review of the compensatory financing facility to place a limit on export projections for the two postshortfall years, since that would, in effect, reduce the amounts that would be available under the existing formula of calculating shortfalls, even if it is regarded as appropriate in covering the medium-term inflation rate. The present formula has stood the test of time well and could be preserved as it is.

As regards the relations between the compensatory financing facility and external contingency mechanisms, members should be given a free choice in the allocation of the optional tranche to either of the two elements, without any commitment to that choice.

We agree with the staff that the impact of financing the external contingency mechanism entirely with ordinary resources would not significantly affect the level of the Fund's usable ordinary resources.

Since the contingency mechanism is new, we should proceed with flexibility and in a spirit of international cooperation. I shall come back to these issues later. I now want to raise two points, specifically for discussion and clarification by the staff.

First, on the calculation of contingent deviations, I understand how the net sum of deviations from baseline values are calculated for individual variables. The variables could be export earnings, import prices, and interest rates, as well as tourism and workers' remittances. But then the staff talks about "the aggregate size of the contingent deviations." If the aggregation is done over all the variables, then their effects may very well cancel each other out. If our objective is to minimize the financing to be provided under the external contingency mechanism, then, indeed, the different trends would be averaged out, resulting in low financing, but my presumption is that this is not our objective.

For example, at a time when import prices are going up, most probably export prices will also go up. If the country is then asked to choose the variables to be covered by the external contingency mechanism beforehand, it would naturally choose only those variables to which its current account is most sensitive. However, the most important variables could not always be accurately predicted, which could result in less than optimal protection of a country's adjustment policies. One way out would be to apply a "binary weighting" of the values, attaching zero if the deviations are positive below a benchmark, and one if the deviations are negative above a benchmark. I would like the staff to return to this issue.

> The point raised by Mr. Salehkhou, if I understand him correctly, is that according to these proposals, as long as a country is under a Fund arrangement, export shortfalls would be treated as a deviation from the program scenario, and would consequently be eligible for contingency, but not compensatory financing. The reason is that double compensation is not permitted. That would mean the end of the compensatory financing facility, because most countries are under some kind of program. Otherwise, export shortfalls will have to be excluded from the list of variables covered by contingency financing under the external contingency mechanism. I would like to know how this can be avoided and how export shortfalls can be covered under both elements for countries under a Fund program.

Mr. Goos pointed out that Mr. Sengupta's concern, that it might be difficult for a country to decide which contingent criteria to activate, could be dealt with by considering all variables, so that the net result of the deviations would be covered. It would be difficult for his authorities to accept Mr. Sengupta's proposal that a country be allowed to draw on the contingency facility even in the absence of a need to protect a program. In that regard, he had made the proposal that, in activating contingency financing, the Fund should take into account all the offsetting factors that affected the current account in order to protect the program.

Export shortfalls could be covered through either the contingency or the compensatory element; either way, the need to protect the program would be met, Mr. Goos remarked. It should not be a requirement that export shortfalls be financed only through the compensatory financing facility.

Mr. Dallara said that he would certainly want shortfalls in export earnings to be covered by contingency financing. Mr. Sengupta's suggestions were interesting, but did not reflect the agreement reached by the Interim Committee; rather, they deviated quite noticeably from the path chosen.

Mr. Sengupta noted that he had simply suggested that the logic of covering arrangements for enhanced surveillance be extended to include coverage based on deviations from Article IV consultation baseline scenarios. Actual disbursement of financing would depend upon the test of cooperation, and when it was necessary to have a program, the country would be required to have one. It was true that the Interim Committee had not pursued that line, but it was in the spirit of the contingency mechanism.

The more variables that were covered by the contingency mechanism, the more likely that their deviations would cancel each other out with the ultimate level of financing being very small, Mr. Sengupta reiterated. However, the purpose of the external contingency mechanism was to help countries being faced by external contingencies. Accordingly, it might be preferable to have, instead of a simple aggregation of deviations, some method of weighting the different variables in order to come up with an index for compensation.

He was not suggesting that export shortfalls not be covered by the external contingency mechanism, Mr. Sengupta said, but was simply following up on Mr. Salehkhou's point that a country that already had a program would have export shortfalls covered by the external contingency mechanism, with the result that the country would not be eligible for compensatory financing. Accordingly, if the country were asked at the beginning of a program which variables it wanted to be covered under the external contingency mechanism, rationally, it would select any variable other than export earnings, since those shortfalls would be covered by the compensatory element. He was not making a judgment on the desirability of such results, but simply pointing out what might be the outcome of the current line of thinking.

Mr. Zecchini said that Mr. Sengupta's attempt to extend the scope of the external contingency mechanism raised problems about why the Fund had such an articulated system of financial instruments. The concerns expressed previously by Mr. Posthumus in that respect were fully justified, because if the philosophy behind Mr. Sengupta's proposal were accepted, there would be a real danger of crowding out the stand-by arrangement as the core instrument of Fund intervention in cases of imbalances that could be corrected over a short period of time. Much fuller consideration should be given to the question of extending the external contingency mechanism to all types of adjustment programs.

On the compensation of interest rate fluctuations, he had reservations about introducing the notion of real interest rates since there were outstanding problems with the definition and measurement of such values, Mr. Zecchini indicated. In dealing with the compensation of shortfalls that had an impact on the external account, the Fund should use a measurement of the interest cost that took into account changes in the terms of trade. Once the deviations in the terms of trade were introduced, the impact on both the import and export sides of the balance of payments would have to be determined. Then, there would be no reason to resort to an external contingency mechanism because the Fund already had other financial instruments that were more appropriate for covering balance of payments imbalances.

Mr. de Groote observed that Mr. Sengupta's proposals included the notion of a two-tier eligibility. One degree of eligibility would result from deviations from the baseline scenario, while a more immediate type of eligibility would result from the activation of a program and the accompanying conditionality. It might be useful, in the process of implementing the decision of the Interim Committee, to have different approaches to eligibility. That way, the situation of a country could be compared to its baseline scenario, thereby excluding a number of cases from eligibility at the first level. Then, given the fact that a country was, in principle, eligible, whether its authorities were taking appropriate measures, could be assessed.

Mr. Donoso made the following statement:

I will begin by commenting on the proposals related to the external contingency mechanism.

First, we can support the proposal to attach external contingency mechanisms to stand-by and extended arrangements and arrangements under the enhanced structural adjustment facility, but we are also willing to consider the eligibility of arrangements under the structural adjustment facility, as well as that of enhanced surveillance or monitoring under Article IV consultations. The proposal by Mr. Ortiz and Mr. Sengupta with respect to enhanced Article IV consultations is, in our view, a very important one.

Second, we agree with having the access limits for the new facility outside the limits specified under the policy on enlarged access, and on having contingency purchases and holdings resulting from such purchases excluded for the purpose of determining a member's reserve tranche position. Also, we support the proposal to finance external contingency mechanisms on the same basis as the compensatory financing facility, using ordinary resources with a repurchase period of three to five years.

The staff has proposed that a case-by-case approach be used to determine the threshold, actual access, and the mix of adjustment and financing. In our view, these are the main elements defining the facility, and without guidelines on these aspects, the Board will know little about the potential impact of the facility. If the need to have an external contingency mechanism is clear, it should also be possible to set guidelines on these basic aspects of the facility to orient the staff's work.

Regarding activation, if the staff proposal is accepted, member countries will not know the impact of the contingency financing until after a deviation occurs, even though they have already negotiated the use of the facility.

We agree with the staff's comment that the incorporation of contingency financing in Fund arrangements may help to give members the confidence to take necessary adjustment measures in an uncertain external environment, as long as the features of the external contingency mechanisms attached to individual Fund arrangements are specified in advance as clearly as possible. In the staff's proposal, however, it is not until the time of a review that Executive Directors would be asked to decide on whether an external contingency mechanism purchase was justified, the amount that was justified, the extent to which performance criteria might be modified, and understandings on adaptation of policies. We consider that that leaves too much to the review.

In the Board's discussions before the Interim Committee met in April, we insisted on having, at least on an exceptional basis, the possibility of predetermining in detail the components of the member's reaction to a contingent deviation. We are satisfied that in such an exceptional case, the Board would simply be informed. However, making the result of the review more predictable for the more common cases would also help.

On coverage, we can support the specific suggestions by the staff except for the limitation of contingent financing of interest costs; we would favor formal guidelines in this case.

We share the views presented by the staff on symmetry except for the suggestion that full symmetry of reserve buildup may not be appropriate, particularly when reserves are at a low level. This proposal only makes sense if one assumes that the precontingent deviation situation is always one of disequilibrium--in which case the country should not wait for a deviation to correct the disequilibrium and increase reserves--or if one assumes that above a certain income level, the absolute preference of a country is for accumulating reserves--a curious preference. We would simply require full symmetry in all cases.

The participation of other creditors should be analyzed in depth. Our first impression is that given the Fund's relationship with the banks, we should simply not depend on the banks to activate this facility.

On the appropriate annual distribution of contingent Fund financing, we should avoid a system whereby countries with one-year arrangements end up having greater access to contingent financing than those with multiyear arrangements at a time when the Fund is promoting longer-term programs. Since we consider that one-year arrangements should have access close to the agreed limits, we favor the front-loading of contingent access in multiyear arrangements, with provision for the carry-over of unutilized contingency access.

We have no major difficulties with the staff proposals on the issues related to the compensatory financing facility. Regarding the guidelines on conditionality for the compensatory element, we agree that arrangements under the structural and enhanced structural adjustment facilities should be included when references are made in the guidelines to Fund arrangements. We have no problems with the suggestion to establish an ad hoc review in the course of an arrangement under the structural adjustment facility in order to allow the member to draw on the optional tranche. However, the staff is suggesting that a member with an unsatisfactory record will always have to go through a program review before drawing on the optional tranche. As we recall, the agreement was that there would be cases in which appropriate measures would be sufficient to allow a drawing. We would consider arrangements approved in principle as sufficient proof of cooperation.

On the question of the joint limit for compensation of export shortfalls and cereal excesses, we are in favor of an overall limit higher than 105 percent, which would allow the 40 percent for contingency financing, a joint limit for export shortfall and cereal excesses of 82 percent, and individual limits for the compensatory and contingency elements of 65 percent.

We do not see a need for countries to make a choice with respect to the use of the optional tranche. In our view, the optional tranche should be divisible and any part of it should be available at any time for compensatory or contingency use, since we would not involve commercial banks in the operation of external contingency mechanisms.

Finally, on transitional arrangements, I would like to express support for Mr. Dallara's proposal. On the setting of a date after which requests for compensatory financing should be understood as requests under the new modalities, the appropriate date would be when all decisions relevant to the new facility are adopted.

Mr. Zecchini made the following statement:

The position of this chair on the many technical issues raised in the staff paper remains in principle the same as that spelled out in the last Board meeting on this subject, with the addition of our decision to compromise on some issues where there is a very broad consensus in the Board. We are in favor of broadening the scope of the compensatory financing facility by adding an external contingency mechanism. As a result, a new financing facility will be created with two separate, albeit interlinked, mechanisms, namely, the compensatory financing facility and the external contingency mechanism. We consider it appropriate to maintain a large degree of flexibility in the operational details of the external contingency mechanism, in order to better fulfill the objective of protecting a member's adjustment program from unforeseen, unfavorable developments beyond the control of the country.

On the external contingency mechanism, in spite of the proposal to limit annual drawings to a proportion of the amount drawn under the associated arrangement, we should retain the possibility of front-loading access when required for the member to comply with the initial adjustment program. The threshold level for access, as well as the proportion of the deviation to be compensated, should be determined on a case-by-case basis, mainly in light of the likelihood that the country will achieve the original targets of adjustment. If it does not appear likely that those targets will be achieved, it would be advisable for the country to design a new program.

The external contingencies to be covered should also be determined according to the country's specific circumstances within a set of key variables that includes export earnings, import prices, nominal world interest rates, tourist receipts, and workers' remittances. The approach to calculation of the deviations as suggested by the staff seems acceptable since it tries to assess the net impact on the external current account of deviations from a projected path for individual relevant variables. In this light, interest rate compensation should be based on the expected increase in interest payments that is due to the variation in the interest rates; the portion of debt that carries a fixed interest rate during the program period should be excluded from the calculation.

On activation procedures, if the response to the contingent deviations is clearly specified in the original program, as in the 1986 Mexican program, a Board discussion would not be necessary; at that stage, the role of the Fund is merely to verify the actual data and the other requirements for access. In such a case, approval on a lapse of time basis would be the most appropriate procedure. Of course, if the deviations made the original adjustment strategy clearly inadequate, then it would be advisable to redesign the program rather than adapt it to the new events.

To link disbursement of Fund resources to parallel financing from other creditors would introduce a rigidity into the external contingency mechanism that would defeat the intended purpose of a prompt coverage of contingencies. Therefore, such a linkage should be avoided in principle, with the only possible exception being in the case of a rise in interest payments. Here, an additional contribution from the other creditors would seem warranted since they would be the ultimate beneficiaries of the Fund's contingency financing. At least, an increase in the financial support by creditors other than the Fund will be necessary in due course. The member country and the Fund should therefore cooperate to broaden the involvement of other creditors, particularly nonofficial creditors, in contingency financing.

The phasing of drawings should be guided primarily by an assessment of the net cash impact of the external events on the current balance of payments. As to the application of symmetry in response to favorable developments, a two-stage system could be devised. Initially, the country could be required to accumulate reserves. Subsequently, when there is less uncertainty about the permanence of the favorable developments, the country should make early repurchases or, if possible, accept a smaller drawing under the basic arrangement.

The external contingency mechanism, because of its purpose and structure, is a complement to stand-by and extended arrangements and arrangements under the enhanced structural adjustment facility. Arrangements under the structural adjustment facility could also be complemented by an external contingency mechanism, if their monitoring is appropriately modified to match the requirements of the external contingency mechanism. Mr. Ortiz's proposal of applying the external contingency mechanism to enhanced surveillance procedures merits serious consideration in the next round of Board discussions on this matter. Of course, such an extension would require that the adjustment programs under enhanced surveillance show a much higher degree of effort on the part of the member than that shown in recent cases.

Turning to the compensatory financing facility, I have already explained my reservations about tranching and, in principle, I would be inclined to support Mrs. Ploix's proposal to raise the first tranche to 25 percent. However, in view of the difficult compromise reached by the Interim Committee on this subject, it would not be useful to reopen the debate unless there is significant support for this proposal in the Board.

On the issue of whether or not approval in principle of a program is a sufficient condition for drawing on the compensatory financing facility, this has to be decided on a case-by-case basis. If the degree of adjustment that has been carried out by the time of the approval in principle is consistent with the requirement of prior actions for the drawing of the first compensatory tranche, or if the country has a good record of cooperation with the Fund, the disbursement of the compensatory financing in amounts permitted for those two cases should be allowed before final approval of the program. In all other cases, it would be advisable to wait for the achievement of the "critical mass" of external financing.

We can accept the 20 percent limit on the export increase in the post-shortfall year proposed by the staff, with provision for periodic revision to meet exceptional developments in external markets.

As to the cereal facility element of the compensatory financing facility, we favor Alternative B of the Annex, which retains the parity of tranches between the compensatory and the cereal elements, and appears to most appropriately meet the facility's objective of assisting a member in the face of such a hardship.

In view of the need for flexibility, we support the staff proposal for an optional tranche that is completely divisible, with the member's decision on the division normally, but not necessarily, being taken at the beginning of a program.

I can go along with the staff proposal on procedures aimed at avoiding double compensation.

Finally, regarding transitional arrangements, I wish to support Mr. Dallara's proposal of ensuring a 40 percent of quota initial access to the external contingency mechanism for all members, irrespective of their current use of the compensatory financing facility. This would be consistent with the spirit of making the financial intervention of the Fund more effective in the current period, and it would not pose any significant strain on the Fund's liquidity position in the near future.

Mr. Kafka noted that the staff had proposed that in the case of an interest rate contingency, other creditors should be asked to contribute. Mr. Zecchini had attempted to argue that such an expectation was justified since it was other creditors who benefited if the Fund indemnified a country because of rising interest rates. Would the same logic not suggest that, when import prices rose, other governments should be asked to levy a tax on their own exports?

Mr. Zecchini remarked that such a tax on exports was only one of the many ways in which surplus countries could help debtor countries, but it had not been applied because it was a disruption of the free trade system that the Fund was supposed to defend. However, creditor and surplus countries had supported the debtor countries by enlarging their financial support, not only bilaterally through export credits and other forms of financing, but also multilaterally, for example, by supporting the World Bank's general capital increase.

Mr. de Groote said that he had difficulty in understanding why the threshold should be deducted; it made more sense to simply change the limits on access. Accordingly, if it were agreed that the threshold should be 10 percent of quota, then access to contingency financing could instead be increased from 70 percent of the access of the associated arrangement to 80 percent. As he understood it, the threshold was simply an administrative rule to prevent applications for financing of minor external shocks.

On the arrangements eligible for contingency financing, attention should be paid to the proposal by Mr. Ortiz to cover enhanced surveillance, Mr. de Groote commented. Other possibilities should also be examined, since the purpose of the contingency facility was to help members implement their policies. He did not see why arrangements under the enhanced structural adjustment facility should be excluded from such support, although members in such arrangements would probably have to review the conditions under which they were operating, since access to contingency financing might imply additional restrictions.

Mr. Goos remarked that deductibility of the threshold was a reflection of the margins in a country's program that should cover certain minimal contingencies. If the threshold were not deducted, the perception would be created that the same contingencies were being double compensated. It was not clear that deducting the threshold and increasing the access limit would be equivalent to not financing the threshold; that depended on the adjustment/financing mix.

Mr. Nimatallah said that the best argument for deducting the threshold was equity; it did not seem fair to fully finance the contingencies that were slightly higher than the threshold level, while providing no financing at all for those countries whose deviations were just below that level.

The Chairman observed that the element of equity depended on the level of the threshold. A lower threshold could more easily be deductible, since it would not disqualify significant deviations from being financed.

Mr. Zecchini said that there was a definite link between financing of the threshold and the rule that only a proportion of the shortfall would be compensated. The contingency financing was aimed at ensuring the success of a program, but the Board had not yet established the appropriate mix of adjustment and financing. Contingency financing had to place a country in a position to achieve its original adjustment targets.

Mrs. Ploix added that a deductible threshold would introduce problems to the concept of symmetry; if a threshold were deducted at the beginning of a program, it would be difficult to calculate a country's appropriate response in times of favorable developments.

Mr. Goos noted that the level at which the threshold was set reflected a judgment of the amount of shock that the program could comfortably absorb. A country that experienced slightly more than that level of deviations should not be compensated for the whole amount, since its program was strong enough to absorb the initial threshold amount. Additional financing should be provided only for those deviations that could not be covered by the program.

Mr. Ortiz remarked that the idea of a threshold was to avoid compensation for very small deviations and to avoid continuous activation of the mechanism. If it were decided that disbursements could be made only once each quarter and there was a gradation between adjustment and financing, there would be no reason for a threshold.

Mr. Zecchini said that the example of Mr. Goos could be handled by financing a proportion of the deviation, which would be more in line with the principle of assuring the achievement of the adjustment targets--a goal that should have high priority.

He would have found an ex post simulation by the staff to be more useful than the ex ante simulation in the paper, Mr. Zecchini went on. Analysis of a precise historical period in which large external shocks had occurred and simulation of the implications of the shocks on the programs would have been useful in pointing out potential problems with the mechanism, and would perhaps have provided insight into the issue of the threshold.

On another topic, baseline scenarios were not necessarily point estimates, Mr. Zecchini pointed out, and could be range estimates in economic terms. There was more reliability attached to such ranges, and they would provide a built-in threshold at the same time.

Mr. Sengupta commented that the purpose of the external contingency mechanism was to ensure that a country's policies would continue to be followed. Not all countries needed a program to follow good policies, and quite often a country might be following appropriate policies but not have the balance of payments need to have a program. In order for external contingencies to be covered without an attached program, there had to be a yardstick against which the amount to be compensated could be calculated, and it had to be assessed whether there was sufficient assurance that the country could make its repayments. For the former, a medium-term scenario could be established during the Article IV consultation, based on a set of policies that the country agreed to follow. If those policies were on track and external deviations occurred, the country would be eligible for contingency support. With the compensatory financing facility, there was an understanding that deviations from the trend would be compensated; contingency financing should offer the same assurance. Of course, if it was felt that a program was necessary to ensure that the country was following appropriate policies, then that would be a condition attached to contingency financing.

On interest rates, he had proposed coverage of the real interest rate because that would make it clear that only the member country, and not the banks, was being compensated, Mr. Sengupta said. The country would be compensated for changes in interest rates owing to variations in nominal interest rates, in the deflator, or in the actual total amount of debt. Using real interest rate costs would do away with any problems of moral hazard. The basic problem in such a calculation would be that of the deflator, and prior agreement would have to be reached on the particular level of that variable.

Mr. Templeman remarked that the Interim Committee had specifically referred to the modalities of the new combined "compensatory and contingency financing facility." He did not consider it necessary to discuss the issue of the facility's title any further; it seemed that there was clearly a consensus in favor of a combined facility.

Mr. Dallara had said earlier that, based on other Directors' comments, he might be willing to consider the eligibility of enhanced surveillance for contingency financing, Mr. Templeman recalled. That was still the case, although his chair did have concerns about the Fund's past experience with weak performance under enhanced surveillance. If that arrangement were to be considered as a basis for contingency financing, he would certainly want to have quantified programs with clear policy commitments that the Fund had found to be adequate and that were the result of an interplay of advice and discussion between the Fund staff and the borrowing country. He was not attracted to the idea of linking contingency financing to Article IV consultations. However, if enhanced surveillance were strengthened, his chair would be willing to consider Mr. Ortiz's suggestion concerning that option.

On the variables to be covered, Mr. Dallara had suggested in his statement, for reasons of uniformity and simplicity, agreement to use the core three or four variables in every case, Mr. Templeman went on. That did not seem to be far from the staff's proposal, but he had not heard much reaction from Directors to Mr. Dallara's suggestion.

It appeared that there was a majority in favor of a common threshold, Mr. Templeman noted. His chair had suggested 10 percent of quota as a threshold figure, and he hoped that the Board could reach an agreement on that question fairly soon. His chair would be willing, if necessary, to consider a low and narrow range, if that would help to reach a consensus.

On the tranching of the compensatory element for the second category countries--those with a poor record of cooperation--he had had the clear impression that the consensus had been for a tranching of 20/20, which it now appeared that a majority of Directors supported, Mr. Templeman concluded.

The Director of the Exchange and Trade Relations Department said that the staff had proposed deductibility of the threshold based on the assumption that all programs had some built-in flexibility. There was clearly a link between the deductibility of the threshold and the financing of a proportion of the deviation; the staff's approach had been based on the desire to smooth the mixing of financing and adjustment. For example, one could have a case in which an external contingency mechanism had a threshold of 20 percent and a financing proportion of 50 percent, with deductibility. If a country experienced a contingency deviation of 19 percent, it would receive no contingency financing, and if its deviations moved to 21 percent, the country would be eligible to receive contingency financing of 0.5 percent. However, if there were no deductibility, the same country would receive no financing in the first case, and 10.5 percent financing in the second. The staff's desire to eliminate such abrupt discontinuity had led it to propose deductibility of the threshold.

On the question of symmetry, deductibility of the threshold would also work in the other direction, the Director continued. Therefore, if a country experienced a favorable deviation whose net value was less than the threshold value, the symmetry provisions would not be invoked; if the deviation went beyond the threshold, the country would be expected to respond only for the amount of the deviation beyond the threshold.

On the figure or figures to be chosen as the threshold, the staff had begun by equating simplicity with simple rules, but it had been forced to move away from that position, the Director indicated. The staff's simulation for its statement on the design of contingency mechanisms had led to the conclusion that it would be extremely difficult to set a common threshold for all cases. A guideline could possibly be set, but there would be a significant number of deviations from that figure. It would probably be preferable to set a range of, perhaps, 10-25 percent of quota.

The staff's statement had suggested that the threshold be expressed in terms of quota, for the reasons set out in that document, the Director remarked. It had considered using GDP as suggested by some Executive Directors, and the sample examined suggested that there would be some clustering around particular figures expressed in terms of GDP. However, there could be debate as to the accuracy of GDP statistics, since not only were they often produced with considerable delay, but also there could be questions about the appropriate exchange rates to use for converting local currency estimates to estimates in foreign currency. Another alternative would be to link the threshold to the access under the basic arrangement, but there one ran into the problem that the access would depend, at least in part, on the extent to which other creditors were involved in the financing, as well as on a wide range of other considerations that might have little to do with the size of the possible shocks that were facing the country. It was for those reasons that the staff had set the threshold in terms of quota.

The staff had not found convincing economic arguments for setting a different proportion of coverage for interest rates than for other external contingencies, the Director indicated. While the requirement of parallel financing would complicate matters, as illustrated by the Mexican case, it was easier to make a link at the outset than to do so later. If the possible Fund contingency financing was low relative to the size of the shock being faced for interest rate contingencies, it would be prudent to do all that was possible to secure the participation of other creditors.

The staff had taken the Interim Committee's communiqué as a starting point for consideration of Mr. Ortiz's suggestion that enhanced surveillance be covered by contingency financing, the Director said. The proposal was interesting and could be examined in the context of the review of enhanced surveillance, scheduled for the period following the 1988 Annual Meetings.

The advantage was that contingency financing could give substance to a facility that had not lived up to initial expectations. However, there was a risk that covering enhanced surveillance would require long-term contingency financing arrangements. Also, under the current decisions on enhanced surveillance, the Fund was not able to abrogate the agreements, so that the Fund would not have any control over an arrangement on enhanced surveillance if it was not working satisfactorily. Such difficulties would have to be carefully considered.

The staff paper had assumed that arrangements under the enhanced structural adjustment facility would be covered by contingency financing, the Director indicated. As he understood it, most Executive Directors wanted contingency financing to be extended to arrangements under the structural adjustment facility, and the staff would work on the modifications necessary to make that possible.

Mr. Abdallah had asked whether the proposed modalities were fair to countries that were likely to be faced with large contingencies, the Director recalled. The staff considered that the threshold should be at a level below which a country's normal policies would handle external shocks. A country expecting large shocks would build up reserves and make other arrangements to cover such shocks; the fact that that country's threshold might be set somewhat higher would not reduce its use of the external contingency mechanism, but rather, would equate its use with that of more stable countries.

Since 1983, approvals in principle had been given to arrangements for 17 countries, 7 of which had included a simultaneous compensatory financing request, the Director indicated. The delays before the decisions became effective were generally quite short--about 11 cases were in the one-month range, 4 in the one- to three-month range, and 2 in the four- to five-month range. In two cases, the approval in principle had lapsed, but in each of those two cases, the matter had been brought back to the Board within a very short period of time.

The staff considered that the proposal to allow combined compensatory and contingency access of more than 105 percent when the member had an outstanding purchase of more than 65 percent--Mr. Dallara's proposal--did not raise questions on the uniformity of treatment, the Director said.

On phasing, the staff had assumed that disbursements should be related to the cash effects on the current account, and that contingency coverage should be relatively higher in the early period--immediately after the shock had occurred--and should decline subsequently, the Director commented. For those reasons, a phasing approach appeared appropriate and, indeed, matched the Fund's conventional approach under all its facilities.

On proportionality, the staff had considered it agreed that application of the external contingency mechanism would involve a mixture of adjustment and financing particular to the circumstances of each case, the Director remarked. Accordingly, the staff found it very difficult to set a specific figure for the proportion that would apply in all cases.

The repurchase period would be three to five years, according to the staff proposal, whether or not it was associated with a stand-by or extended arrangement, the Director said.

In response to Mr. Rye's questions on activation, the first paragraph on page 11 of the staff paper stated that when all details were prespecified, the Board could be informed and the disbursements could be made, the Director of the Exchange and Trade Relations Department recalled. An analogy could be made to performance clauses under a stand-by arrangement, whereby if they were met, the Board was informed and disbursements were made. In the second paragraph to which Mr. Rye had referred, the phrase "in this approach" did not refer to the preceding paragraph, but rather to the broad approach. In other words, when a substantial amount of prespecification had been made, but not to the degree of, say, the Mexican case, the review could be done on a lapse of time basis.

The Economic Counsellor and Director of the Research Department said that the staff did not have plans to modify substantially the computation of the world economic outlook baseline. The staff's practice in calculating the medium-term scenarios was to hold oil prices and interest rates constant, but it did allow for changes in those rates when it came to short-term projections.

On the coverage of natural disasters, the staff considered that Executive Directors had agreed not to include such shocks in contingency financing, the Economic Counsellor indicated. However, the policy on emergency assistance would continue to cover such shocks.

On the question of capital flows, a global calamity limiting access to capital markets would most likely manifest itself in high interest rates, the Economic Counsellor remarked, so that one of the rationales for covering interest rates was to take into account such shocks.

Mr. Kafka remarked that the coverage of interest rates would not necessarily protect countries that were caught in a credit crunch since the reaction of the international economy to such an event might not be a rise in interest rates, but rather, credit rationing.

The Economic Counsellor recalled that Mr. Finaish had raised the question of countries that could not be considered either first category countries--with a good record of cooperation--nor second category countries--with a poor record of cooperation. Certainly the question would arise of which category some countries belonged to. However, establishing another category would merely create another border line at which a judgment would have to be made.

In deciding in which terms the threshold should be expressed, the staff had identified the key issues involved, the Economic Counsellor indicated. Percentage of quota--the usual reference of the Fund--was a measure of a country's economic size, taking into account the openness of the economy and other variables. It was a synthetic measure which reflected a country's economic strength. On the other hand, one could argue that GNP was more current, and perhaps also better measured the sacrifice that would have to be undertaken by the country in the context of adjustment. To express the threshold in terms of the access under the associated arrangement made sense in that it was the arrangement that was being protected by the contingency financing; however, the size of the arrangement did not reflect the country's capacity to deal with external shocks. In addition, countries undertook many arrangements outside the Fund.

In selecting a threshold figure, the general principle would be to avoid triggering the external contingency mechanism for inconsequential deviations, the Economic Counsellor continued. Accordingly, a single number might cause difficulties, with a range being preferable.

On the issue of the transitional period, while the staff had made a proposal, the staff could, of course, be guided by any approach that the Board considered appropriate, the Economic Counsellor said.

In responding to a number of questions on the guidelines on cooperation, the Economic Counsellor indicated that a Fund arrangement was not necessarily a prerequisite for access to the optional tranche for first category countries. Policies equivalent to a Fund arrangement would also be adequate. For second category countries, similar considerations applied. In general, if a country had a Fund arrangement, access to the optional tranche would call for a review, but that access could also be made available upon approval of an arrangement.

The decision to base contingency financing on the net impact of several variables could mean that those variables would offset each other; there would then, appropriately enough, be little financing, because there would be little balance of payments difficulty, the Economic Counsellor said. If the shocks happened to be positively correlated, contingency financing would then be greater.

Contingency and compensatory financing could be used simultaneously during the program period, with the coverage, the period, and the method of calculation being different for the two types of coverage, the Economic Counsellor explained.

The staff simulation had indeed been ex ante, the Economic Counsellor agreed. An ex post examination would not have been very helpful, in that it would have been against the background of policies that the countries had carried out without the assurance of contingency financing.

Mr. Cassell remarked that, while the current world economic outlook baseline did include interest rate forecasts, the new contingency facility would give those forecasts a greater profile than they had had in the past. Accordingly, their accuracy would then be of more concern.

It would be helpful if the staff could inform the Board of any work on the effects of nominal versus real interest rate changes on countries' balance of payments, Mr. Cassell indicated. He considered that most of the information necessary for contingency financing could be gained from the nominal rate.

While the staff paper had assumed that arrangements under the enhanced structural adjustment facility were covered, Mr. Cassell said that his authorities considered that some concessionality should be built into contingency financing for those countries receiving credit under the enhanced structural adjustment facility. It was the lack of concessionality that had concerned his authorities, and not the fact that they did not want to provide such countries with contingency financing.

Mrs. Ploix observed that her authorities had long supported a concessional compensatory financing facility.

Mr. Sengupta said that his concern with respect to the question of aggregating the deviation of variables was that the staff proposal appeared to support preselection of only a few variables. Accordingly, the net deviation of those variables might not accurately reflect the effect of the external shocks on the country's balance of payments position.

Mr. Yamazaki remarked that the Board should recall the comment by the Economic Counsellor that quotas should reflect a country's economic realities when the time came to discuss the Ninth General Review of Quotas.

Mr. Posthumus suggested that a further Board meeting, at which proposals raised at the current meeting could be discussed thoroughly, be scheduled.

The Chairman observed that the current meeting had offered an opportunity for Directors to put forward their latest positions, and a subsequent meeting could be scheduled to concentrate on the key remaining issues.

He was encouraged by the progress made in the current meeting, the Chairman went on. The outline of an agreement that could be reached in the near future was emerging. There was clearly a common desire by Directors to move forward on the issue. The basic compromise agreed to by the Interim Committee had been respected, with Directors clearly willing to build on that consensus. In the process of developing important new policies, there had been general agreement to work in an experimental fashion. The Board should strive for the establishment of rules that were as simple as possible, and yet as clear as circumstances permitted in order to avoid arbitrariness in the administration of the facility. It was of course agreed that the implementation of contingency mechanisms would be an opportunity not for any lessening of adjustment but, on the contrary, for reinforcing orderly adjustment and promoting economic growth.

As the development of the facility proceeded and specific problems of implementation arose, those issues should be brought to the Board, which had to be fully involved in the development of those policies, the Chairman continued. Directors had agreed on the need for an early review of the facility; they would recognize that a decision on the precise timing of that review should be based on the need to amass enough experience so that the review would be of significance. The staff would be alert to guidance provided through the Board's consideration of each case.

He would not attempt to present a summing up of specific views; that would be premature given the complexity of the issues at hand, the Chairman said. Rather, management and staff would carefully study the statements of Executive Directors in the following few days in order that they might do justice to Directors' positions with an extensive and detailed synopsis and a clear assessment of the consensus as it currently stood. At the next meeting on the compensatory and contingency financing facility, he would suggest that Directors concentrate on the principal areas of diversity on the basis of a statement that the staff would circulate for clarification of the debate.

As he saw it, the Chairman said, differences still needed to be narrowed on the question of the threshold; the proportion of deviation financed; limitations on contingency financing of interest rates; parallel financing by the commercial banks; symmetry of the use of Fund resources; compensatory financing tranching; the question of implications of approval in principle for the guidelines on cooperation; and how to accommodate the cereal decision in the new facility.

Those questions would constitute the main focus of the next meeting, the Chairman indicated. The listing might not be exhaustive--there was, for example, the question raised by Mr. Ortiz on enhanced surveillance. Management and staff would carefully study Directors' comments on all issues discussed at the current meeting to the extent that they were not too far from the compromise and guidance the Board had received from the Interim Committee. He was hopeful that after the Board's next substantive meeting--the Board might be in a position to summarize clearly the degree of consensus on the range of issues as a whole, and a specific narrowing of any points of difference that might remain. He hoped that Directors shared his reasonable confidence that, on the basis of the current meeting, the Board would be in a position, in the spirit of compromise that prevailed, to come to full understanding and agreement before the middle of July.

The Chairman suggested that the next Board meeting on the compensatory and contingency financing facility be held on June 27. Directors could meet over lunch on the following day, June 28, to discuss the possible remaining difficulties prior to the Board's final discussion on the topic.

The Director of the Exchange and Trade Relations Department indicated that the staff would prepare a statement by June 23 summarizing the views expressed by Directors at the current meeting, together with a statement providing a background on the remaining outstanding issues.

Mr. Sengupta suggested that sufficient time be allowed between the following meeting and the meeting at which decisions would be taken on the compensatory and contingency financing facility in order that Directors might obtain clearance from their authorities. He also asked the staff to prepare a document in which his proposal for expanded contingency financing could be analyzed, to which he could respond, with the involvement of individual Directors, but without taking up the time of the Board.

The Chairman suggested that Mr. Sengupta's response to the staff paper be circulated for the information of all Directors.

The Executive Directors then adjourned their discussion of modalities for the compensatory and contingency financing facility.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/94 (6/17/88) and EBM/88/95 (6/17/88).

2. BURUNDI - TECHNICAL ASSISTANCE

In response to a request from the authorities of Burundi for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/88/163 (6/14/88).

Adopted June 17, 1988

3. ISSUES IN THE DESIGN OF GROWTH EXERCISES - ISSUANCE AS WORKING PAPER

The Executive Board approves the proposal to issue, in the Working Paper series, the staff paper entitled "Issues in the Design of Growth Exercises" as set forth in EBD/88/159 (6/10/88).

Adopted June 17, 1988

APPROVED: January 25, 1989

JOSEPH W. LANG, JR.
Acting Secretary