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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/156

3:00 p.m., November 17, 1987

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

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	Song G., Temporary
C. H. Dallara	
J. de Groote	J. Prader
	E. V. Feldman
M. Finaish	
	B. Goos
J. E. Ismael	J. Reddy
A. Kafka	J. Hospedales
T. P. Lankester	C. Enoch
M. Massé	
Mawakani Samba	C. V. Santos
Y. A. Nimatallah	I. A. Al-Assaf
	L. Filardo
J. Ovi	
H. Ploix	D. Marcel
G. A. Posthumus	
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	
	M. Sugita
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

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Also Present

Administration Department: H. Wiesner. African Department: A. D. Ouattara, Counsellor and Director; J. Artus, G. Devaux, J. Kakoza. Asian Department: R. J. Hides. European Department: R. P. Hicks. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; S. J. Anjaria, G. G. Johnson, H. B. Junz, C. Puckahtikom. External Relations Department: A. F. Mohammed, Director; P. C. Hole. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, General Counsel; T. M. C. Asser, A. O. Liuksila, J. K. Oh. Middle Eastern Department: B. R. H. S. Rajcoomar. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; R. G. Alter, D. A. DeRosa, E. Hernández-Catá, N. M. Kaibni, M. S. Kumar, E. Meldau-Womack, P. R. Menon, A. Muttardy, R. Pownall, H. H. Zee. Secretary's Department: M. Primorac. Treasurer's Department: F. G. Laske, Treasurer; D. Williams, Deputy Treasurer; S. I. Fawzi, D. Gupta. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director; A. S. Linde, J. Pujol. Bureau of Statistics: C. A. Patel. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, A. G. A. Faria, S. M. Hassan, G. D. Hodgson, A. R. Ismael, Khong K. N., K.-H. Kleine, A. Ouanes, P. D. Péroz, I. Sliper, D. C. Templeman, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: N. Adachi, A. R. Al-Abdullatif, R. Comotto, F. Di Mauro, W. N. Engert, V. J. Fernández, S. Guribye, C. L. Haynes, L. Hubloue, A. Iljas, J. M. Jones, S. King, V. K. Malhotra, C. Noriega, L. M. Piantini, S. Rebecchini, S. Rouai, G. Schurr, B. Tamami, E. L. Walker, Wang X., R. Wenzel.

1. TRAVEL AND REPORT BY MANAGING DIRECTOR

At Informal Session 87/5 (11/13/87), the Executive Board was informed of travel by the Managing Director to Europe.

The Executive Directors took note of the travel by the Managing Director.

Adopted November 17, 1987

The Chairman remarked that he had recently met in Europe with Finance Ministers from G-7 countries, the Governor of the Central Bank of Belgium, the Governor of the Central Bank of France, the Director-General of the Bank for International Settlements, and several other senior officials. In his conversations with those officials, he had encouraged them to react constructively and quickly to the efforts of the U.S. Government to improve the U.S. fiscal situation. Each of the countries concerned appeared to be making a positive contribution, as was reflected in the latest communiqué of the Council of Ministers of Finance of the European Communities, which stressed the Finance Ministers' continued commitment to the Louvre Accord. The strong commitment of the various individual countries to maintaining a cooperative strategy and their recognition of the need to stabilize the exchange markets in the context of sound economic policy developments were of course welcome.

The Executive Directors took note of the Chairman's statement.

2. COMPENSATORY FINANCING FACILITY - REVIEW

The Executive Directors considered a staff paper on the review of the compensatory financing facility and proposals for concessional compensatory financing and an external contingency facility (EBS/87/165, 7/28/87; and Sup. 1, 7/30/87).

The Director of the Research Department made the following statement:

> The review paper that is before the Executive Board contains a discussion of possible adaptations of the compensatory financing facility in order to deal with contingencies arising from unforeseen developments in export earnings. In view, however, of proposals made at the 1987 Annual Meetings, and in the recent report of the Group of Twenty-Four, for a broader treatment of external contingencies in Fund-supported adjustment programs, it may be helpful for today's discussion to outline some of the key issues raised by such proposals.

The motivation for considering a broader treatment of external contingencies reflects a set of interrelated concerns: (i) the external environment facing adjusting countries during the 1980s has been a difficult and unpredictable one; (ii) this unpredictability often extends beyond export earnings to other important components of the balance of payments; (iii) while the financing of most programs includes some margin to cover external contingencies (for example, via greater use of reserves), this margin is often insufficient to counter large deviations of actual developments from those assumed at the outset of programs; and (iv) failure to provide an effective and timely cushion against such unforeseen external developments can undermine the adjustment effort, with negative consequences for growth-oriented adjustment over the medium term.

If the compensatory financing facility were expanded--or if a new facility were established--to meet these concerns, criteria governing access would need to be established. A first question is whether eligibility might then be determined--in line with the present compensatory financing facility--in light of the member's balance of payments need, the degree of "temporariness" of external disturbances, the attribution of the disturbance to factors largely beyond the control of the member, and the member's cooperation with the Fund.

(a) If access to the broadened contingency facility were restricted to countries that have a Fund program, would it be appropriate to cast balance of payments need in terms of current need over and above that anticipated at the time the program was originally framed, that is, in terms of departures from the "baseline" scenario?

(b) Would a broadened facility involve the principle that the mix between additional financing and intensification of the adjustment effort should be weighted more toward financing for temporary disturbances--and more toward adjustment for permanent ones? If so, how should "temporary" be defined, and, in particular, for how long should the facility provide protection against unforeseen external disturbances? Also, would alterations in the adjustment/financing mix be determined on a case-by-case basis in midterm reviews, or instead by some more general, automatic formula?

(c) If the coverage of the facility were broadened to include elements of the balance of payments beyond export earnings, is it apt to be less or more difficult to establish beyond-the-control responsibility for external disturbances?

(d) Finally, in appraising cooperation with the Fund, should access to the facility be restricted to countries with either stand-by arrangements, extended arrangements, or arrangements under the structural adjustment facility? How would a member with a shadow program with the Fund, say, under the procedure of enhanced surveillance, be treated? Also, if purchases under the facility were to be phased, would cooperation require meeting all performance criteria?

Coverage - Should a broad contingency mechanism focus on the net increase in financing needs (attributable to unforeseen external developments) for the balance of payments as a whole? If so, would it be better to gauge increases in financing needs by reference to aggregate indicators, such as the current account, or perhaps the current account plus autonomous capital flows--or alternatively, to adopt a disaggregated approach and calculate the net change in financing needs associated with a limited number of elements of the balance of payments, such as export earnings, import prices, and interest payments? Which approach is likely to be more amenable to the different structures of foreign exchange flows across developing countries, to prompt compensation, and to beyond-the-control determinations?

Baseline scenario - If the contingency mechanism were to be triggered by deviations of actual values from anticipated ones, how should the "baseline scenario" be specified at the inception of the program? Also, how can one prevent the baseline scenario itself from becoming the subject of protracted negotiation?

Thresholds - If changes in net financing needs arising from unforeseen external developments were "small," would it be preferable to accommodate these deviations by alteration of the reserve target or by small adjustments in policies? If so, could that objective be met via the introduction of thresholds, such that only deviations in excess of a specified minimum would activate the contingency facility? Would there also need to be a specified maximum level for the threshold that, once exceeded, would call for a renegotiation of the program?

Symmetry - If a major purpose of a broadened contingency mechanism is to provide insurance against unforeseen external developments, is it desirable that the insurance be symmetrical with respect to favorable and unfavorable deviations from the baseline scenario? In this regard, the symmetrical feature of the Mexican program--whereby unexpectedly favorable oil prices would lead to increases in reserves or to prepayment of external debt to commercial banks, rather than to relaxation of adjustment efforts--was widely endorsed by the Executive Board.

Access and phasing - If the broadened contingency mechanism were to be established, would the cumulative access limit need to be larger than the existing 83 percent of quota under the compensatory financing facility? In this connection, what does historical experience suggest about the size of unforeseen exogenous developments in Fund programs? As regards access in individual cases, what consideration should be given to the availability of private and other sources of finance, to the country's debt-service profile and debt-servicing capacity, to current outstanding use of Fund resources, and to the likelihood that the member might be requesting a subsequent arrangement from the Fund? The issues of phasing of disbursements, and of the appropriate timing of such disbursements likewise do not permit simple answers. Phasing might be defended on the grounds of strengthening the adjustment effort, of providing better coordination with disbursements under related arrangements, and of holding sufficient resources in reserve against later possible unfavorable deviations. On the other hand, it could be opposed as being unnecessary for developments judged in any case to be beyond the members' control, and as unduly complicating the adjustment effort when early unfavorable deviations are large relative to early disbursements.

Effects on the Fund's financial and liquidity position - If a broadened contingency mechanism were adopted, what would be the impact on the Fund's financial and liquidity position? Five issues arise in this context. First, would a widened scope of contingencies--including, for example, interest payments--result in a greater bunching of demands on the facility than has been the experience with the compensatory financing facility? Second, is it likely that the external variables to be covered by the facility would be subject to "prolonged" unfavorable deviations from anticipated levels? Third, might considerations of "moral hazard" result in some increase in risky behavior--on the part of both borrowers and private creditors--since unfavorable outcomes would be at least partly compensated by insurance provided by the facility? Fourth, would the facility envisage providing assistance on concessional terms to low-income members experiencing unforeseen external developments that were beyond their control? Finally, if there was an expectation that financial demands on the facility were likely to be greater than those under the existing compensatory financing facility, should attention be given to exploring avenues for catalyzing parallel contingency financing from other sources?

Compensation of external shortfalls outside a Fund program - How would the contingency mechanism deal with countries not needing a program with the Fund, but nevertheless experiencing temporary shortfalls in export earnings, or temporary increases in certain payments? Should compensation for this type of deviation continue to be a legitimate activity of the Fund? If so, what would be the relationship between this form of compensation and the contingency mechanism; for example, how would the amount of access under the two facilities be related, and what cooperation guidelines would be appropriate for members without a Fund program?

Mrs. Ploix made the following statement:

The Fund's financial resources are made available to members through a wide range of policies and facilities, which differ mainly in the type of balance of payments needs they seek to address and their degree of conditionality. Consequently, we think that considerations on possible changes in the compensatory financing facility must take into account its specificity.

While a stand-by arrangement is designed to provide financial assistance to members that commit themselves to an adjustment process and are experiencing balance of payments deficits due to overall economic difficulties, the special facilities follow a different line of reasoning. They do not address balance of payments needs as a whole but provide assistance with balance of payments difficulties identifiable by specific economic criteria and attributable to exogenous factors. The compensatory financing facility specifically assists members that have experienced shortfalls of a short-term character which are due to circumstances beyond the member's control. The goal of the facility to offset quickly the difficulties resulting from the deviation from a trend, not those difficulties resulting from a downward trend alone.

Indeed, export shortfalls can happen in combination with structural payments difficulties and then could require an additional adjustment program. But even in such a case, the compensatory financing facility must keep its specificity.

Finally, the compensatory financing facility is also different from a contingency mechanism which would be aimed at protecting a Fund-supported program against exogenous factors. Therefore, my authorities feel very strongly about (1) the uniqueness of the compensatory financing facility, (2) the need to increase its availability to the poorest countries, and (3) the fact that the possible implementation of contingency mechanisms can only be a supplement to the compensatory financing facility and not a substitute for it.

1. Preserving the unique characteristics of the compensatory financing facility

The compensatory financing facility is characterized by three special features: automaticity, low conditionality, and simplicity.

Automaticity and conditionality

It seems crucial to my authorities to preserve the automatic compensation for past shortfalls through the compensatory financing facility. Countries experiencing balance of payments deficits because of past export shortfalls must be able to receive financial assistance from the Fund quickly and in amounts sufficient to cope with their problems. This assurance was one of the most important goals of this facility when it was established in 1963; it must remain unchanged.

However, maintaining the compensatory financing facility alone is not sufficient: it must be made more available. In this respect, we are concerned with the decline in lower tranche purchases. I would like to remind the Board that the test of cooperation is met in the lower tranche if the member country agrees to discuss the appropriateness of its policies with the staff. For the upper tranche, a stricter test of cooperation is applied but even in this case, a Fund-supported program is not a prerequisite for a test of cooperation, as was clarified in 1983. However, this distinction tends to be blurred in practice; discussions for lower tranche credits have often been delayed until the conclusion of a stand-by arrangement. Since the beginning of 1986, half of these purchases have been concurrently discussed with stand-by arrangements. This situation has also been a cause of the decline in lower tranche purchases, because members have delayed requests until approval of stand-by arrangements, at which time they were assured maximum access. In some cases, this approach has driven members to forgo requesting compensatory financing. In this context, we believe that a reduction of the lower tranche would prove an inadequate solution to the main problem, that is, to make this facility more accessible.

Clearly, however, because export shortfalls have become only one cause of external payments difficulties, it can be recommended that the compensatory financing facility be accompanied by policies providing adequate safeguards for the Fund's resources. In such a case, an agreement in principle on a Fund-supported program is sufficient since it is already a strong sign of commitment and prevents damaging delays in the recovery of the country.

In light of these considerations, we are of the view that phasing is likely to lead to a new tightening of conditionality and consequently, another reduction in the automaticity of the compensatory financing facility. Indeed, phasing runs counter to the quick-disbursing nature of this facility. In addition, it could reduce the confidence with which members count on receiving assistance. Moreover, it seems to us important that Fund members continue to receive compensatory financing facility funds in large allotments. Experience has proved that without a sufficient package, some countries would be unable to overcome difficulties resulting from temporary obstacles.

Finally, in referring to the shortfall conditions at each stage, phasing could also limit access to this facility and tighten conditionality. This does not seem to be in line with the characteristics of the compensatory financing facility. If one shortfall has been identified, it must be compensated within a reasonable period of time irrespective of the conditions prevailing at the time of the purchase. This means that requests for compensatory financing must be processed as quickly as possible, and that the member must certainly not be penalized for any delay between the shortfall and its compensation.

Simplicity

The staff has raised several technical issues which should be studied with a view to keeping this procedure fair and easy to implement.

Concerning the scope of the compensatory financing facility, I share the staff's conclusions on not limiting the facility to primary commodities, and not taking into account the import content of export shortfall calculations. Such a course of action would present major practical problems and would not necessarily be in accordance with the fundamental goals of the compensatory financing facility.

Concerning the formula currently used to calculate shortfalls, staff proposals are built on considerations which appear to be somewhat arbitrary. We fear that the application of a deductible factor, aimed at reducing or eliminating the compensation for small shortfalls, would penalize the poorest countries. We consider also that the use of a formula based only on past export earnings can be inadequate since it does not take into account the consequences of deflationary and inflationary cycles. However, we do agree with continuing to conduct shortfall calculations in nominal terms.

Concerning the issue of overcompensation, we are aware of the problems and we find some merit in the staff's suggestion to compromise. In the case of successive drawings under the compensatory financing facility, it should be possible to adjust the amount of future drawings to take into account any past accidental miscalculations.

In addition, I consider that it would be incompatible with the intent of the compensatory financing facility to eliminate compensation in cases where exports are caught in a steep downward trend; this facility is aimed at compensating deviations from a trend, regardless of that trend.

Lastly, as regards the cereal component of the compensatory financing facility when we last reviewed it in March, this chair was among those who favored reconsidering the three-year rule. The staff holds the view that the rule may not have directly affected access under the facility; however, there is also a clear indication that its actual use could be enhanced if the facility were to be activated on its own. We strongly support this idea and can thus favor the creation of a separate cereal facility. This would help address the specific problems of some of the poorest countries which still face severe food shortages despite the overall improvement in world food conditions. We also share the view that a combined access limit should be established under the two facilities. If at a later stage in our review we come to consider the broader issue of contingencies, it could be advisable, for the sake of simplicity, to regroup under one single facility various credit mechanisms which would be administered separately.

2. Increasing the availability of the compensatory financing facility to the poorest countries.

One of the most crucial problems with the compensatory financing facility is that of effective access. Indeed, the increase in compensatory financing facility drawings for 1987 has resulted from special cases and is therefore not very significant. In fact, many eligible low-income countries cannot afford the standard terms of the compensatory financing facility because they can no longer borrow at market conditions, even for temporary balance of payments purposes.

This situation is paradoxical, since the poorest countries are mainly primary product exporters, often monoproducers; they are therefore the most vulnerable to market fluctuations. Last spring, we proposed increased access to the compensatory financing facility in favor of these countries by allowing them to make drawings under this facility on concessional terms. Such concessionality could take two different cumulative forms: increased maturity and lower interest rates for countries eligible for the structural adjustment facility. The drawings could be granted to the countries which have an agreed policy framework paper that clearly addresses the issue of diversification of the country's exports and includes adequate policies. Certain countries which do not have a policy framework paper could also be entitled to a certain amount under this concessional facility.

It seems to us that the total cost of such a concessional arrangement would not be excessive. The staff has evaluated the arrangement at SDR 80-100 million a year at a rate of charge of 3 percent. If the rate of charge were equivalent to that of the structural adjustment facility, the total cost would nearly double.

In our mind, it is clear that this concessionality proposal must be examined along with the enhancement of the structural adjustment facility; we would like once again to express our desire to see it completed expeditiously.

3. Investigating contingency mechanisms: a possible supplement to the compensatory financing facility

Clearly, the contingency clauses and the compensatory financing facility are substantially different: the compensatory financing facility provides financial assistance to compensate for past shortfalls experienced by Fund members that have not necessarily undertaken a Fund-supported adjustment program; contingency mechanisms provide additional resources in the course of a Fund program if export earnings fall below the level projected in the program. The compensatory financing facility compensates for the adverse consequences of an existing situation, while contingencies can be considered as insurance for the future.

Given the uncertainties inherent in the international economy, it could be desirable to create such contingency mechanisms. Indeed, it is clear that certain exogenous factors can severely destabilize Fund programs and thus discourage countries from adhering to adjustment measures. However, contingency mechanisms are likely to reassure governments which are undertaking far-reaching adjustment programs and ease the acceptance of such programs in public opinion. Moreover, clearly isolating exogenous factors from other developments can allow for a better analysis of the reasons for the failure of a program; this would help to clarify the relationship between the Fund and the country concerned.

Furthermore, contingency mechanisms could reinforce the credibility of adjustment programs by avoiding numerous reappraisals of the situation.

We are ready to examine this question with an open mind. On a more technical level, as was expressed in the staff statement, several questions must be addressed. From a more general point of view, if we try to address too many contingencies, the need for adjustment could be lessened. In addition, it is clear that major deviations, even those owing to exogenous factors, call for modifications in policies. We would like some guidance on such questions as the contingencies we should choose, their scope, the establishment of adequate terms of reference, and the financial needs arising from certain external contingencies and their impact on the Fund's financial situation.

Before this Board proceeds on this issue, I think it would be important to have further analyses from the staff on the issues they raised in their buff statement.

Mr. Dallara made the following statement:

I welcome this opportunity to continue our review of the compensatory financing facility, and to have a preliminary exchange of views on related proposals, including Secretary Baker's proposal for an external contingency facility.

At the Board discussion of the compensatory financing facility on March 3 and in previous Board meetings, I expressed my authorities' concerns about a number of serious problems regarding the operation of the facility. These reflect some important changes in the world economic environment in recent years, such as the rather widespread emergence of deep-seated balance of payments and debt problems, persistent weakness in commodity prices, and the significant growth of arrears to the Fund. These developments suggest the need for a substantial modification of the compensatory financing facility which would take into account the need to: (1) help ensure that compensatory financing is associated with effective economic measures to strengthen the country's balance of payments position; (2) avoid supporting dependency on the export of commodities which are in secular decline; (3) provide compensatory financing in a manner which is fully consistent with safeguarding the use of Fund resources; and (4) preserve flexibility in the use of the compensatory financing facility.

My authorities recognize that there may be more than one way to achieve these objectives. One is to modify the compensatory financing facility, while maintaining the central elements of the existing facility. The staff paper contains useful proposals which go in this direction, although we believe that in some areas even more substantial changes would be required, if the Board opted to preserve the basic elements of the facility as it exists today.

An alternative approach would be to transform the compensatory financing facility into a facility designed to help address, more broadly and in an effective and timely manner, some of the unexpected financing needs of members which can throw their economic programs off course. It was this consideration and the desire to help ensure the success of members' growth-oriented adjustment programs which motivated Secretary Baker to set forth his ideas for an external contingency facility at the 1987 Annual Meetings. My authorities believe that such a facility would not only deal with the problems which have merged in the operation of the compensatory financing facility, but also redirect, and expand modestly, resources to address a problem which has become increasingly evident in recent years. In our review of Fund-supported programs, we have seen a variety of factors limiting their success in certain cases. Some of the problems relate to implementation and design. But other difficulties derive from adverse developments that often stem from factors beyond the control of the member, and range much beyond just export shortfalls. Such adverse developments, which are not infrequent in today's world economic environment, can not only undermine well designed and fully implemented programs, but also undermine the morale of policymakers and the political support for sound policies, both of which are crucial to achieving payments viability and growth.

Some of the advantages that we see in the external contingency facility proposal, compared to the compensatory financing facility, are that it would: (1) directly promote adjustment and reform programs; (2) offer a response to a broader array of potential threats to a member's balance of payments position; (3) provide somewhat larger access than the compensatory financing facility; (4) make the financing available at an earlier date; and (5) be easier to administer than the compensatory financing facility.

I will elaborate further on these advantages and other aspects of a possible external contingency facility. However, I would first like to offer some specific comments on the proposed modifications of elements of the current facility which are suggested in the staff paper.

The compensatory financing facility

The staff paper accurately summarizes many of the concerns raised by Executive Directors regarding the operation of the compensatory financing facility. We generally concur in the direction of change being suggested to improve the compensatory financing facility, although some proposals do not go far enough, in our view, to bring about desired changes in the facility, and some may not effectively address existing problems.

Phasing of drawings

We would support the basic idea suggested by the staff to reduce the size of the first tranche of the compensatory financing facility and to phase drawings above that threshold in two additional tranches. Specifically, we could support a first tranche limited to 25 percent of quota, in light of uncertainties that might prevail at that stage of the program. For drawings above that amount, we would favor an additional 33 percent of quota at the initiation of a Fund-supported program, which would still be large enough in most cases to provide substantial initial financing in support of the more comprehensive adjustment efforts contemplated for this level of access. Finally, we support a "reserve" tranche of an additional 25 percent which might be made available during the course of a Fund program. This would provide continuing financial support as progress is made in achieving the objectives of the program.

Conditionality

Our general approach to the policies associated with the use of the compensatory financing facility is guided by our desire to balance flexibility and responsiveness in the use of the facility against the need to ensure that, no matter how modest the drawing, it is faithful to the Articles. Specifically, it should be provided in the context of sound economic policies--along with sufficient financial support for those policies--in order that we can have confidence that our resources "will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund" [Article V, Section 3(a)]. As we consider conditionality issues, it is important to keep in mind that all drawings under the compensatory financing facility are subject to these requirements.

Concerning a 25 percent first tranche, we would be willing, on a case-by-case basis, to consider drawings where the Board has approved of an economic program "in principle," and to support drawings where a country is "demonstrating a willingness to cooperate with the Fund." We have serious reservations about permitting first tranche drawings to take place "in the early stages of discussion of a program."

For the first upper tranche drawing of 33 percent, we might also be willing to consider application of the present guidelines on cooperation, but would explicitly add to that the possibility of access for countries with structural adjustment arrangements. In addition, we might also be willing to consider in very exceptional circumstances a first upper tranche drawing in the case of programs which have been approved "in principle." However, we do not believe that an upper tranche drawing would be consistent with conditionality requirements in the case of a first credit tranche arrangement.

For the third tranche of 25 percent, we support the idea in the staff paper that the disbursement would be contingent on compliance with the stand-by arrangement or extended arrangement, as confirmed by a review of performance under the arrangement. While we could also support making this tranche available in the case of structural adjustment arrangements, this would, as the staff suggests, require some form of review. We would not support release of a third tranche in the case of a first credit tranche arrangement.

Formulas for calculating shortfalls

Our primary concern regarding application of the compensatory financing facility formula in recent years has been that it has facilitated the extension of compensatory financing in inappropriate circumstances. In fact, the existing formula has had the effect of allowing drawings to be made without adequately taking into account whether shortfalls were genuinely temporary, and without regard to the export trends which underlie the shortfall. We believe that compensatory financing should not be provided in three types of cases: (1) when there is a continuing decline in exports; (2) when exports in the shortfall year actually rise by a noticeable amount (e.g., by more than 5 percent); and (3) when there is a "pronounced" recovery of exports in the two post-shortfall years in cases in which there is a pattern of continuing export growth. The "pronounced" recovery concept is defined by the staff as involving an export growth rate of more than twice the rate of decline in the shortfall year. Furthermore, we remain concerned about the incidence of overcompensation.

Of the various proposals presented in the staff paper, we could support the application of "projection limits," which, we believe, would address most of our concerns. It is not clear, however, that this would fully address our problems regarding overcompensation and the extension of compensatory financing when there is a rise in exports in the shortfall year.

Beyond the control issue

My authorities have been concerned for some time about the practical difficulty in judging when developments which have contributed to export shortfalls are really "beyond the control" of the authorities. Therefore, we welcome the indication in the staff paper that henceforth the staff will give more explicit attention to the possible effects of overvalued exchange rates. We recognize the difficulties in attempting to quantify precisely the effects on the shortfall of those actions which are within the control of the member country. But we also believe that the staff should make judgments about the extent to which other policies of the member contribute to the shortfall. Even where it is difficult to quantify with precision the effects of such policies, judgments can be made, perhaps based on rough estimations.

Alternative approaches

Concerning several alternative approaches explored in the staff paper, such as the deductible approach, the use of formulas based only on past export earnings, and the use of real (rather than nominal) calculations, we are not sure how useful adoption of these techniques would be. However, one or more of them could prove useful in addressing the conerns which may be missed by the "projection limits" approach. We would, therefore, welcome further exploration of these options toward that end.

Other issues

On some other issues raised in the staff paper, we do not believe that the compensatory financing facility should be limited to primary commodities; we agree that duplication of compensation in successive compensatory financing purchases needs to be avoided; we would not support any change in the current approach to the cereal facility (in the context of retention of the existing compensatory financing facility); and we agree with continuing current procedures as regards the question of import content.

Concessional compensatory financing facility

The staff paper contains an interesting analysis of the French proposal for providing compensatory financing facility assistance on a concessional basis to low-income countries. The proposal reflects rather widespread concern about the continued reliance of some of those countries on Fund credit with market-related terms. We share this concern and appreciate the need to find ways to address it while remaining faithful to the role of the Fund as a monetary institution providing temporary balance of payments financing. It appears to us that the Managing Director's proposal to enhance substantially the structural adjustment facility represents a major initiative to address these concerns, building on the concept and purposes of the French proposal. Given this, and the limits on financial assistance resources available to subsidize concessional financing for this group of countries, it is not clear that further pursuit of a concessional compensatory financing facility is necessary or feasible at this time.

Contingent use of the compensatory financing facility

The staff paper also raises the possibility of making modest changes to the compensatory financing facility to give it a contingency thrust. We believe that a more fundamental transformation of the compensatory financing facility into an external contingency facility would be more effective than trying to make modest changes to the compensatory financing facility.

Compensatory financing facility and extended contingency facility as complementary facilities

I recognize that some members may be attracted to the idea of creating a contingency facility in addition to the existing compensatory financing facility. My authorities do not believe that such an approach is either practical or desirable. It would have unacceptable effects on the Fund's liquidity position and exposure to many members, possibly aggravating the already grave problem of arrears to the Fund. It would also raise major questions concerning a possible shift of the Fund toward special facilities focusing on specific aspects of the balance of payments, rather than providing general balance of payments financing. Finally, it would fail to correct the numerous problems in the operation of the existing compensatory financing facility. In contrast, we believe that the proposal made by Secretary Baker would not only address those problems, but also provide greater assurance that sound economic adjustment and reform programs are not derailed by unexpected external developments.

External contingency facility

The following text contains a description of the proposed external contingency facility--in the numbered paragraphs--which is identical to that in the informal paper which I circulated to Executive Directors and to management on October 9, 1987, and some additional comments designed to provide additional background on various elements of the proposal.

1. The external contingency facility would provide additional Fund financing in support of Fund-approved programs in the event that unforeseen adverse external developments occurred during the course of a program which significantly increased the net balance of payments financing need--and thereby threatened the viability of the program. The external contingnecy facility would be available for countries with stand-by or extended arrangements, or for countries with arrangements under the structural adjustment facility.

The external contingency facility proposal is intended to provide greater assurance that the financing of Fund-supported programs would remain adequate in the face of an uncertain external environment, when unforeseen events can cause major disruptions to the program. While financing from the compensatory financing facility has provided some additional financing support to member countries that have encountered debt problems in recent years, it is poorly integrated with the overall balance of payments and debt strategy and is not directly supportive of their adjustment efforts and overall financing needs. This is because: (1) it only compensates for shortfalls in export values; (2) the shortfall is calculated off a trend line that has little relation to the country's overall financing problems; (3) there is considerable delay before compensatory financing is provided; and (4) the financing is made available in a single tranche, instead of as continuous financial support for the program, so that it often does not effectively promote economic adjustment and reform efforts; and (5) the lack of phasing of disbursements can have the effect of aggravating the Fund's arrears problem.

2. Unforeseen external developments which could trigger use of the external contingency facility

a. A net increase in balance of payments financing needs could arise from any of the following factors (or a combination of these factors), which tend to be, by their very nature, outside the control of individual member countries:

- A shortfall in export earnings from the initially estimated amount as a result of slower than expected export market growth or lower than expected world export prices.

- Higher than expected world import prices.

- Higher sustained interest rates above the initially assumed level.

b. Net external financing needs arising from natural disasters would also be included in the calculation.

Selection of the above external variables aims at including the major external developments which pose potential threats to the adequacy of financing of Fund-supported programs. The coverage comprehends shortfalls in export earnings, as does the current compensatory financing facility, but such shortfalls can be viewed as only one of a number of adverse exogenous factors which could be a basis for contingency financing. Thus, the coverage of the new facility is broader than under the existing compensatory financing facility, notably because of its inclusion of import prices and of interest rate movements. These variables are, by definition, seldom determined by policies or developments in individual borrowing member countries. Therefore, the Board would be largely relieved of having to determine what is, and what is not, "outside the control" of the authorities.

The new external contingency facility could come into play more promptly than the existing compensatory financing facility, in light of the calculation approach inherent in the compensatory financing facility. Even with the six-month forecast feature in the compensatory financing facility, the delay between the middle of the shortfall year (the earliest point at which a shortfall calculation can be made) and the date of approval of a compensatory financing facility drawing has averaged nearly 11 months in the period 1983 to date. In contrast, the external contingency financing calculation would normally be made at the six-month review of a Fund-supported program, so that additional financing could be available at the time the Board approves completion of the review. In exceptional cases, it could be sooner. In any event, it is expected that financing would come into place with an average lag significantly shorter than that of the compensatory financing facility.

Application of the interest rate feature of the external contingency facility will need to be examined carefully. We recognize the reservations that some Directors may have about Fund financing directly linked to interest rates. However, we believe that an approach can be found to calculate the interest rate component of the formula which would provide scope for the Fund to play a constructive role in helping countries to cope with interest rate fluctuations, while not trying to absorb the full impact of interest rate changes. It needs to be borne in mind that financial assistance under the external contingency facility is not intended to provide a complete offset to all changes in these external variables, but merely to cushion the adjustment effort until the external environment improves and/or until additional adjustment action and financing can come into play.

The use of external contingency facility financing for natural disasters would not preclude use of the existing emergency assistance arrangements.

We believe that the external contingency facility approach would generally take care of most cases now covered by the cereal facility. However, if further analysis showed that this would not be the case, consideration could be given to ways to ensure that the objectives of that facility are met, and that cereal importers could continue to benefit from the new facility, as they have from the existing one.

3. Calculation of net additional balance of payments financing needs

a. Activation of the facility would be based upon the negative impact of changes in the above factors, to the extent that they are not offset by improvements elsewhere in the balance of payments.

b. In order to avoid activation of the facility due to inconsequential movements in these variables, there would be a minimum threshold level. This threshold could be set as a certain percent, perhaps 10-15 percent, of one of the following: (1) the initially calculated current account deficit; (2) the initially calculated overall "financing need" (this would require a standard definition and methodology for calculating the "financing need"); or (3) the member's Fund quota.

c. An increase in the net financing need due to a shortfall in expected capital flows would not be a basis for activation of the external contingency facility.

d. The net change in the financing need would be calculated as the deviation from original program projections for the factors in (1) above. The original assumptions would normally be made for not more than 12 months at a time. However, assumptions for up to 18 months could be made for programs of this length, if the financing for the entire program period has been arranged at the outset of the program.

e. As a general rule, an initial calculation of the estimated net effect of the above factors for the full program period would occur at the time of the first review, along with a re-estimation of the overall balance of payments. The calculation of the net effect of external developments should be based on a minimum of three months additional data, beyond those available when the original assumptions were made.

f. At the time of such a review, agreement would be reached on any additional policy measures that may be needed to preserve the viability of the program.

g. In exceptional cases, the external contingency facility might be activated at an earlier stage, if a substantial increase in the net financing need posed a major threat to the program.

h. Recalculations of the net effect of changes in the above factors would be made quarterly. To the extent that the recalculations suggest a reduction in the estimate of the additional financing need, then further external contingency facility drawings could be adjusted from the levels originally intended, depending on the size of the remaining additional financing need and available access. If favorable developments were large enough to eliminate any remaining additional financing need, no subsequent external contingency facility drawings would be made. If positive developments more than fully reversed the initial adverse effects, consideration would be given to raising foreign reserve targets.

Basing the calculation of the net increase in financing needs on original program assumptions is not intended to alter in any way the manner in which such assumptions are currently made or to suggest that they should be overly optimistic or overly cautious.

Particular consideration needs to be given to the proper "threshold" to be used to avoid activation of the facility in the event of relatively minor movements in the four variables. A case for using the current account deficit as the base can be made based on the desirability of preserving the level of real economic activity contemplated in the program and on the understanding that the Fund cannot be expected to offset shortfalls in the capital account. Alternatively, since the intent of the external contingency facility is to help cushion against erosion in the overall level of financing which was considered necessary at the beginning of the program, there is some logic to calculating the threshold as a percentage of the initial "financing need." However, this could be the most complicated of the three options in that it would require a uniform methodology for calculating the "financing need." Finally the simplest approach would be to base the threshold on the member's quota. Further consideration needs to be given to this matter.

As suggested above, it would be important at the time of the program review and external compensatory facility disbursement to consider the need for additional policy changes in order to help ensure that the program does, in fact, remain viable.

4. Access and disbursements

a. Cumulative access would be increased from the current maximum of 83 percent under the compensatory financing facility to 100 percent of quota.

b. External contingency facility access would be additional to access under other facilities.

c. Normally no more than 25 percent of quota would be disbursed in one external contingency drawing.

d. External contingency facility disbursements would be simultaneous with those scheduled under the related stand-by or extended arrangement. Appropriate external contingency disbursement arrangements would also have to be made for countries with structural adjustment programs.

It is worth noting that the proposed 17 percent of quota increase in external contingency facility access (100 percent) over compensatory financing facility access (83 percent) would potentially provide SDR 1.5 billion in additional access for the 15 major debtors and SDR 5.8 billion for all developing countries as a group. Two other important features relating to access that need to be borne in mind are: (1) the fact that broader coverage of external variables could make more countries eligible than under the compensatory financing facility; and (2) the proposal for a transitional arrangement whereby all countries would be allowed up to 50 percent of quota access, regardless of their present use of the compensatory financing facility. For the 15 major debtor countries, for example, the 50 percent transitional access, given compensatory financing facility outstanding as of August 31, 1987, would amount to nearly SDR 1 billion.

The question of timing of external contingency facility drawings for countries operating under structural adjustment arrangements is complicated by the absence of tranching under the existing structural adjustment facility. Thus, consideration would have to be given to the most appropriate approach for use of the external contingency facility in conjunction with a structural adjustment arrangement.

5. Financing and transitional features

a. The external contingency facility would be financed from the Fund's general resources, although consideration could be given to financing external contingency facility drawings partly from borrowed resources in current circumstances.

b. Consideration would be given to possible avenues for catalyzing parallel contingency financing from other creditors and donors.

c. Appropriate transitional arrangements would need to be made. For example, all member countries, regardless of current outstanding compensatory financing facility drawings, could be assured of initial access under the external contingency facility of at least 50 percent of quota, with any excess above the normal 100 percent of quota limit reduced by subsequent compensatory financing facility repurchases.

The source of financing for the external contingency facility would, of course, determine the interest rate and maturity terms for external compensatory facility repurchases. Given the general consensus that quota resources should be the principal source of financing of Fund credit, general resources should be the main source of financing of the external contingency facility. However, there may be circumstances in which it might be useful to consider the use of borrowed resources.

A strong effort should be made to enlist the cooperation of other creditors, in particular the commercial banks, in providing parallel contingency financing in appropriate circumstances, i.e., when bank financing is a large proportion of the total. Consideration could also be given by the World Bank as to how it could support this effort to help countries cope with unexpected adverse external developments.

Mr. Nimatallah made the following statement:

The compensatory financing facility has been with us for about 25 years. Throughout this period, it has proved to be very useful and helpful, both to individual countries that have used it, and to the international monetary system as a whole. The compensatory financing facility has provided members in a timely fashion with the necessary resources to maintain their import capacity in the face of temporary shortfalls in export earnings. The facility has also played its role side by side with other Fund facilities in promoting the broader objectives of the Fund. The important role played by this facility has been recognized by the Executive Board in a number of reviews. Most recently, at the occasion of its March 1987 meeting, the Executive Board has again reaffirmed its commitment to the basic objective and features of the facility. In this regard, I need only quote from the staff paper before us:

> The consensus at the Board meeting was that the compensatory financing facility was an important and useful facility, that compensation for export shorfalls should remain an essential activity of the Fund, and that the basic features of the facility should remain unchanged.

Nothing in economic or financial developments since that time would justify altering this view. On the contrary, recent developments in financial and exchange markets have demonstrated how interdependent our economies have become. They also underline the need for, and the wisdom of, maintaining a compensatory financing facility-type facility for helping countries adapt, in an optimum way, to externally caused fluctuations in their export earnings that are beyond their control.

Two types of practical concerns have, however, been recently raised with respect to the functioning of the facility. One is the emergence of overdue obligations associated with compensatory financing facility drawings and the more general concern of safeguarding the revolving character of Fund resources. The other relates to the perceived disincentive to adjustment presumably linked to the lumpiness of compensatory financing facility disbursements. I would like to address these two issues in turn.

On the emergence of overdue obligations in relation to compensatory financing facility drawings, the basis underlying this concern is the apparently higher incidence of overdue obligations associated with compensatory financing facility purchases as compared with stand-by arrangement and extended Fund facility purchases. Indeed, the staff paper before us shows that, while outstanding compensatory financing facility credits represent only 30 percent of outstanding stand-by arrangement and extend Fund facility credits, overdue obligations on the compensatory financing facility represent as much as 70 percent of overdue obligations on stand-by arrangement and extend Fund facility credits. A closer look at the facts reveals, however, that, by and large, the bulk of overdue payments on account of compensatory financing facility drawings occurred in cases in which countries had stand-by arrangement or other Fund-supported programs in place at the time of the compensatory financing purchase. In other words, insisting on a program with the Fund as a condition for compensatory financing, does not necessarily secure the revolving character of Fund resources. Evidently, the Executive Board, in its wisdom, had realized this very fact when it formulated the 1983 guidelines on cooperation. Indeed, according to these guidelines, an arrangement with the Fund is not a necessary condition for use of the compensatory financing facility, even beyond 50 percent of quota.

At the same time, I recognize the need to differentiate between, on the one hand, payments imbalances due only to temporary shortfalls, and, hence, not requiring basic policy changes; and, on the other hand, protracted external imbalances attributable to longer-term causes, and, hence, requiring fundamental adjustments, with or without Fund-supported programs. In these latter cases, the need for a program of adjustment is there, whether or not the country was facing a shortfall in export earnings. The occurrence of a shortfall only exacerbates the country's economic situation.

The second concern relates to the perceived disincentive to adjustment presumably linked to the way compensatory financing facility resources are disbursed. The lumpiness of disbursement, it is feared, may lead to a relaxation of the adjustment effort. While this may have been true in some cases, it is not necessarily always so. Not only is the adjustment effort not relaxed in most cases, but also, as the staff points out, substantial early financing from the compensatory financing facility has encouraged the implementation of prior action in some cases. Furthermore, timely disbursement of much needed compensatory financing facility resources has, in my view, reinforced the incentive to adjust and helped to avoid interruption in adjustment and growth in other cases.

In view of the preceding discussion, it should be clear that the solution to the problem of overdue obligations associated with compensatory financing drawings and of the lumpiness of the drawings, as a disincentive to adjust, does not require a fundamental rethinking of the present approach. In particular, I cannot agree with those who feel that these concerns could only be met through a radical departure from the spirit of present guidelines on the compensatory financing facility, nor can I agree with those who insist on a program with the Fund, in every case, as a necessary condition for compensating shortfalls.

This kind of approach suffers from a fundamental flaw. As it was proposed, it ignores the possibility that there are some countries that can be helped but do not necessarily need an adjustment program, let alone a Fund-supported program. What I have in mind here are countries that encounter temporary shortfalls in their export earnings but are otherwise following sound policies and cooperating with the Fund, and where the question of the viability of the balance of payments does not arise. While conceding this flaw, proponents of this approach have argued that only a few such countries would be left out. Even if this were true, and even if only one member were to be excluded through no fault of its own, this would still be inconsistent with the cooperative nature of this institution.

What is needed, therefore, is some adaptation and flexibility within the 1983 guidelines on cooperation to enable the Fund to meet compensatory financing requests on a case-by-case basis. In this respect, I agree with the staff that where a member's external difficulties were exclusively shortfall related and did not require policy changes, maximum access to the compensatory financing facility should continue to be assured.

As regards cases where temporary shortfalls occur within longer-term payment difficulties, I believe that the Board can adapt the 1983 guidelines to introduce some changes in access and possibly some phasing of disbursements. But, in introducing that, the Board should:

(a) pay due regard to the quick-disbursing nature of the compensatory financing facility; and

(b) ensure that a lower-conditionality compensatory financing facility tranche remains available.

With this in mind, I would like, now, to turn to the specific proposal made by the staff.

The staff proposal includes:

1. reducing the lower tranche from 50 percent of quota in outstanding purchases to, say, 33 percent;

2. reducing access availability on approval of a stand-by arrangement from, say, 83 percent to, say, 50 percent; and

3. reserving a certain level of compensatory financing access, say, 33 percent of quota, for disbursement during the course of a stand-by arrangement subject to the arrangement remaining current.

While I am prepared to examine the idea of a reduction in the lower compensatory financing facility tranche with an open mind, I would like to see more flexibility on the other tranches and on conditionality. For example, I am aware that there are a number of countries that are currently at or beyond 50 percent in outstanding compensatory financing purchases. I believe that we should let these countries have some access to compensatory financing facility resources as they enter into an arrangement with the Fund. I think it is also important to reserve a portion of compensatory financing facility access for later disbursement. Taking these two elements together, one could envisage a possibility of raising the limit of the second compensatory financing facility tranche somewhere above the level proposed by the staff, and reducing the third tranche accordingly. Alternately, one could envisage accepting staff-proposed limits, provided more flexibility is introduced in the use of the third tranche. For instance, the third tranche could be used, in part, at the time of entry into an arrangement and with the remaining compensatory financing facility resources being disbursed at a later stage in the program. This would avoid unduly complicating the adjustment effort of members when compensable shortfalls are large in relation to early available access.

On the issue of conditionality, I feel that the conditions for releasing the last portion should be more flexible. Specifically, disbursement of the final portion might better be linked to the overall performance under the program, rather than to compliance with rigid performance criteria. The idea, here, is for the Fund to be helpful to members in a timely fashion, and in a flexible way.

On introducing a contingent mechanism, either within the compensatory financing facility or as a separate facility, I would ike to emphasize, at the outset, that I am not, in principle, against external contingency mechanisms, as such. I would also note that the staff has already been able to introduce the idea of contingent access to the compensatory financing facility in the case of a country that has an arrangement with the Fund, be that a stand-by arrangement, structural adjustment arrangement, or extended arrangement. I find the staff approach helpful, as it attempts to combine access under the two mechanisms of facing either export shortfalls, or contingent export deviations, or both. There are, of course, a multitude of possibilities that range from providing for contingent access to compensatory financing facility resources only when traditional shortfall conditions are absent, to circumstances that would provide access in the context of a program. Either of these purchase could be classified as purchases under the compensatory financing facility.

Without agreeing or disagreeing with the staff attempt, I would point out that if it proves necessary that contingent use of Fund resources is needed, the staff approach would permit such use under the existing facility. As the staff also notes, of course, rules, especially on access limits, would have to be devised to allow traditional and contingent use of the compensatory financing facility to work together in a mutually supportive way.

The U.S. suggestion of replacing the compensatory financing facility with an external contingent facility raises a number of concerns. First, by design, it would apply only to members entering into a stand-by or other arrangements with the Fund. Thus, members that do not need an arrangement with the Fund would be automatically excluded; there would be no room for a purchase by a member with a conventional export shortfall. This, in my judgment, is inappropriate, unfair, and discriminatory.

The second concern is the failure of the proposed facility to cover only future possible contingencies, and not to cover early and existing problems of shortfalls. As the staff notes, the compensatory financing facility could be adapted to accommodate both. Operationally, both the compensatory financing facility and a contingent mechanism would be based on a shortfall that has to be calculated according to a certain formula, with procedures that resemble those of the existing compensatory financing facility. Not only that, but I can even imagine that the time consumed for calculation cannot be much less.

The third concern is about the inclusion of the coverage of interest rate fluctuations, in addition to export revenue deviations to compensate, and I quote: "for higher sustained interest rates above the initially assumed level." I do not want to be misconstrued to be standing against including interest rates, in principle, in the coverage. However, I have the following questions:

1. Given the magnitude of the external debt of potential users, the question of the adequacy of Fund resources is very relevant. Knowing that there is a volume of close to $1 trillion of external indebtedness by developing countries that has to be serviced each year, it is clear that an increase of 1 percentage point in interest on that annually could theoretically translate into as much as $10 billion. Furthermore, the inclusion of interest rates could result in a greater bunching of demand from

all members on this type of facility than under the compensatory financing facility. My point, however, is that I do not find it consistent to increase the coverage of the facility without increasing resources in line with this potentially large coverage. It is hard to imagine, therefore, proceeding with this enlarged coverage without a commensurate increase in the Fund's own resources. The alternative, of course, would be to discriminate against certain countries, and limit the facility to a few, which would simply be unacceptable.

2. My next question is concerning the mention of the word "sustained." I take it that it means not temporary. Then, are we talking about temporary assistance that is expected to be reversed, or is it continuous financing at the cost of adjustment? If it is meant to be the latter, then we are talking about a fundamental deviation from the rules which emphasize financing short-lived difficulties and adjusting to longer-term problems.

3. My next question concerns the expression of "initially assumed" interest rates by the Fund. Now, the Fund making assumptions and projections about commodity prices is one thing, but I am not sure that interest rate assumptions by the Fund are appropriate as a threshold point beyond which members should be compensated. I can see difficulties arising from the Fund taking a position on present and future interest rates. The Fund has been careful to avoid that. Very importantly, it is not clear to me how far interest rates have to increase before the Fund can assist and then know when to stop.

4. Another question is the issue of "beyond the control" of a country. I am not clear to what extent the increase in interest rates would be truly beyond the control of the members concerned. There are, for example, various mechanisms in the market that would enable one to hedge against interest rate fluctuations.

Let me now turn to the more general issues about the proposed external contingency facility which need to be addressed:

(a) There is the question of defining financing needs. If I understand the purpose of an external contingency facility, it is to provide timely assistance to members encountering external shocks in the course of a program. This would mean that the facility would have to operate quasi-automatically, and be triggered by deviations of certain objective indicators from their assumed path. I understand, however, that the U.S. proposal envisages basing the trigger on overall financing need which would require an in-depth assessment of balance of payments developments, which would take time. This relates to my earlier point that assessing eligibility is likely to be a process just as lengthy as determining eligibility under the compensatory financing facility.

(b) There is also the related issue of "temporary" versus "permanent" disturbances that I have touched upon in relation to interest rates. What is meant precisely by a "temporary" deviation is, in practice, likely to be a difficult question. Do we want to regard a temporary disturbance as something that would have to be reversed during the course of a program, for example? If not, how long after the expiration of a program should one allow for reversal? A related question is that of the speed of implementation of new adjustment measures if the deviation is not expected to be temporary. Would access to the external contingency facility be permitted to provide some room for maneuver in the initial stages, in the expectation that further adjustment measures would be implemented at a later stage?

(c) I would also like to touch upon the question of cooperation with the Fund. It is not clear to me whether a member would be expected to have a stand-by or extended arrangement with the Fund, or whether a structural adjustment arrangement would also qualify. Also, would we want to deny access to such a facility to a member embarking on a shadow program with the Fund under, say, the procedure for enhanced surveillance?

I would not want to go beyond these questions at this stage, but my point is that there are many complications and potentially difficult ramifications behind replacing the compensatory financing facility with an external contingency facility. I think that it would be more prudent to search for an alternative, either in keeping the contingency facility separately, or combining it with the compensatory financing facility. I therefore invite the staff to continue their work in this direction and present to the Board, in the next paper, the two alternatives with a clear analysis of the pros and cons of each. In the meantime, I ask Mr. Dallara and his authorities to be more pragmatic, and go along with either a contingency mechanism alongside with the compensatory financing facility, or a combined compensatory financing-external contingency facility, for a trial period of three years or so. At the end of that period, a review can be conducted. I believe that much can be gained from this gradual approach, and the Board will by then be in a much better position to take the most appropriate decision.

His statement was not meant to cover all the issues that had been raised in the staff paper, Mr. Nimatallah continued. He generally agreed with the staff's discussion of the issues that he had not addressed in his opening statement.

He agreed with Mrs. Ploix that member countries that were eligible to use the structural adjustment facility should also be eligible for concessional financing under the compensatory financing facility, Mr. Nimatallah said. He wondered whether the Fund could establish a subsidy account specifically for that purpose. At present, it seemed that establishing such an account would be difficult. Nevertheless, the staff should examine the possibility of using a small part of the intended subsidy account for the enhanced structural adjustment facility for the purpose of subsidizing compensatory financing by member countries that were eligible to use the structural adjustment facility.

He continued to feel strongly that the compensatory financing facility should be maintained, although it could be modified in certain ways, Mr. Nimatallah commented. In addition, he continued to see no need to introduce a contingency mechanism at the present stage. If such a mechanism were to be introduced, it could be combined with the compensatory financing facility or exist separately from it. However, an external contingency facility should not replace the compensatory financing facility; the new facility should be a supplement to, not a substitute for, the compensatory financing facility. Given the separate objectives and functions of the compensatory financing facility and an external contingency facility, the latter warranted a separate discussion, perhaps outside the discussion on the review of the compensatory financing facility.

Mr. Goos made the following statement:

I approach today's preliminary discussion of the issues before us on the basis of three general propositions. First, the Fund should limit its financial assistance to cases in which balance of payments viability is expected to be restored in the medium term as a result of either self-correcting forces or appropriate adjustment policies. This proposition flows from the overriding need to safeguard the temporary use of the Fund's general resources and, hence, to avoid the emergence of arrears. Second, the Fund should use its resources in a manner that is supportive of the restoration of balance of payments viability. Third, we should avoid a proliferation of special facilities as opposed to the traditional focus of the Fund on general balance of payments assistance.

Review of the compensatory financing facility

Against the background of the above considerations, I feel that the analysis and proposals presented in the staff paper could substantially alleviate our concerns about the current operation of the compensatory financing facility--concerns which we have repeatedly stressed in the past and which are adequately presented in the paper.

1. Conditionality and related issues

I could support the thrust of the proposed modifications to phasing and conditionality inasmuch as in cases of nonviable payments positions they would establish a closer link between compensatory financing disbursements and actual adjustment.

However, I am concerned about the lean conditionality proposed for the initial tranche of compensatory financing access, which--as the staff points out on page 13--could give rise to even "greater risk of Fund exposure" than to date. Strict interpretation of the requirement to protect the Fund's resources would suggest that in "non-viable cases" there is little room for a less stringent cooperation requirement than the one proposed for the higher tranches. I, therefore, would have to insist, as a minimum, on clear indications--preferably underlined by concrete action, including approval in principle of Fund arrangements--that the members in question are willing to cooperate with the Fund in seeking appropriate solutions. In any case, high standards should be applied in assessing the credibility of the willingness to cooperate. Moreover, the size of the initial tranche should not exceed 25 percent of quota.

Regarding the cooperation requirement for the higher tranches, it appears difficult to allow for compensatory financing disbursements on the basis of Fund arrangements that have been approved "in principle" only. However, if combined with the actual implementation of strong prior actions, one could perhaps consider access on an exceptional basis.

Eligibility of structural adjustment arrangements and lower tranche stand-by arrangements should be assessed on a case-by-case basis. To the extent that such arrangements could be expected to restore medium-term viability (such as in less severe cases of payments problems) access to the higher tranches should be granted. I see little justification for a presumption that such arrangements should be generally eligible or ineligible for access to the second tranche.

2. <u>Issues of implementation</u>

The basic features of the current procedures for calculating export shortfalls should be maintained, including the practice of nominal calculation of the shortfall in total exports and the exclusion of their import content. However, I could support the proposed introduction to the existing formula of a ceiling on export projections in order to contain overcompensation. A ceiling of 20 percent would appear appropriate in present circumstances. Also, the staff's recommendation in regard to overcompensation in successive purchases could help alleviate our concerns.

Regarding the criteria of "beyond the control" I would strongly endorse the views expressed by Mr. Dallara. And like him I also could not support any liberalization of the cereal facility, the establishment of which was acceptable to us only because of its integration with the compensatory financing facility.

3. Concessional compensatory financing

I have serious reservations about the creation of additional Fund facilities aimed at specific problems in particular when such problems are not of a monetary character. While appreciating the objectives behind the proposal of concessional compensatory financing, I feel that those objectives could be met in a more appropriate manner through channels outside the Fund.

Establishment of an external contingency mechanism

In view of the similarity of the fundamental issues that arise from the contingency proposals made by the staff and the U.S. authorities, I will assess those issues on the basis of the proposed external contingency facility.

Today's uncertain external environment undoubtedly puts a high premium on efforts aimed at protecting ongoing programs against unexpected developments and at promoting adjustment and reform. I therefore welcome the thrust of the contingency proposals.

Nevertheless, we continue to have substantial doubts about the usefulness and appropriateness of contingency mechanisms in the context of the Fund. These doubts reflect in particular the following concerns:

- Linking Fund financing to specific indicators or triggers would shift the Fund's focus from the overall balance of payments to specific aspects of external payments problems.

- Such mechanisms could weaken the judgmental approach to the assessment of existing adjustment and financing needs.

- Contingency mechanisms would introduce a greater degree of automaticity in Fund financing, whereas the current compensatory financing facility review clearly aims at reducing such automaticity.

- Like any insurance against risks, such mechanisms could raise moral hazard problems both on the part of borrowers and creditors--or, to put it in Mrs. Ploix's words, they could lessen the (perceived) need for adjustment.

- They could create risks for the design of adjustment programs by encouraging the adoption of unduly optimistic baseline scenarios, thereby probably also complicating program negotiations and reviews.

- Related to the above concerns, and perhaps even more important, such mechanisms could entail that the Fund's basic mandate to foster orderly adjustment and to protect the adjustment path against disruptive developments--would be transferred to a special contingent facility, thereby shifting the general focus of Fund arrangements toward the pursuit of short-term growth and longer-term development targets.

- The proposed mechanisms could create substantial strains on the Fund's financial and liquidity position, thereby threatening to erode further the quota-based character of this institution.

The above concerns are reinforced by the likelihood that strong pressures might emerge to expand the number of the trigger variables envisaged under the proposed external contingency facility. Would it not be consistent with the logic of the underlying approach to include additional variables, such as external remittances and grants or increases in imports resulting from unexpected shifts in the savings/investment balance in response to structural reforms prescribed by the Fund? What about unexpected external financing needs arising from weather conditions short of natural disaster?

At the same time, Mr. Nimatallah has raised a number of important questions indicating that the variables proposed for inclusion in the external contingency facility might already be too many. In this regard I have serious reservations about the explicit inclusion of interest rates. The implied need for the Fund to make projections for the level and sustainability of such rates raises fundamental concerns inasmuch as such projections could give dangerous signals to the markets. Moreover, explicit compensation for interest rate increases appears difficult to reconcile with the existing debt strategy and the role of the Fund. In the final analysis, it would be tantamount to bailing out commercial banks and other creditor groups, it would ease the pressure to contain or reduce interest rate spreads, and, more generally, it would weaken the efforts to tackle the underlying causes of high or increasing interest rates.

In sum, I wonder whether it would not be more advisable to try to pursue the basic idea of the proposed external contingency facility in the framework of comprehensive program reviews without explicit reference to specific variables while at the same time providing for the possibility, under appropriate safeguards, of a limited increase in the Fund's financial support for stand-by and extended arrangements.

In conclusion, it appears that the contingency proposals need much further study and examination in order to forestall potentially serious repercussions on the effectiveness of the Fund. While we are prepared to participate in further discussions with an open mind, we probably could not accept any explicit inclusion of interest rates in contingency mechanisms. Moreover, we would have to insist on effective conditionality, as well as on the elimination of the compensatory financing facility if a separate contingency mechanism were to be created. Otherwise, we would rather opt for maintaining the compensatory financing facility, perhaps in a modified form along the lines proposed by the staff.

Finally, I am looking forward to an exchange of views on the many remaining issues raised in the statement of the staff representative.

Mr. Finaish made the following statement:

I wish to commend the staff for the high quality and comprehensiveness of the papers before us. I will try to address the issues in the same order as they appear in the main document; but, first, I will make a few general remarks.

As Mrs. Ploix and Mr. Nimatallah have stressed in their statements, it is important not to lose sight of the basic function that the compensatory financing facility is supposed to perform. This is particularly so during a period when the preoccupation with the widespread balance of payments difficulties of members may have led some to underestimate the constructive role which the compensatory financing facility continues to play. While it is understandable, and indeed necessary, that we look for ways to strengthen the role of the compensatory financing facility in supporting adjustment programs to deal with underlying imbalances, it is crucial that we preserve the Fund's ability to provide timely assistance to members experiencing temporary shortfalls in their export income which are caused by exogenous factors.

In trying to improve the manner in which compensatory financing purchases are integrated into a Fund-supported adjustment program, one should guard against exaggerating the link between the timing of disbursement under the compensatory financing facility and the motivation of the member to implement the program policies. Presumably members adopt and implement adjustment policies because they believe that such policies are needed to improve their economic and financial performance. If this was not the case, and if the motivation of members was limited only to the Fund's financial support, then the basic premise of Fund-supported adjustment program would need to be re-examined.

One should also guard against excessive preoccupation with the problem of overdue obligations--in this case, overdue compensatory financing facility repurchases. This does not mean that the concern about the revolving character of Fund resources is not a legitimate one. Certainly, when financial assistance is provided to a member, a judgment has to be made as to that member's ability to make repurchases when they become due. This, of course, is already being done. But there is little doubt that in the final analysis, the best guarantee for repayment is the member's success in adopting and implementing the needed policies. In many cases, the timely financial assistance provided under the compensatory financial facility can play a positive role in giving the member the needed cushion in taking strong measures, often in the form of prior action, at the outset of a program. Thus, it could be argued that quick disbursement under the compensatory financing facility actually reduces the probability of arrears in the future.

I will now comment on the specific conclusions and modifications recommended by the staff.

Conditionality and phasing

We agree with the staff that if the underlying balance of payments position of the member is considered to be sound and the difficulty is essentially related to the export shortfall, access up to the quota limit should be assured.

In cases where the export shortfall is superimposed on underlying imbalances which could be corrected by policy adjustments, we continue to believe that once the member adopts corrective policies which would normally be considered sufficient for an upper credit tranche arrangement, immediate and full disbursement under the compensatory financing facility should be assured. This would be consistent with the purpose of the facility and would enable the member to make the purchase at the time when it is needed most. In the past, there has been a great deal of discussion on the question of phasing of compensatory financing purchases, and the staff appears now to have reached the conclusion that some form of phasing could be useful. We are not convinced that the arguments for phasing outweigh those against, and we continue to oppose the phasing of disbursements. However, if the Board's preference is for phasing, we would be prepared to consider it provided that the question of access limits is addressed simultaneously. In our most recent discussion of access limits under the compensatory financing facility, the staff acknowledged that an argument could be made for raising the quota limits but nevertheless recommended the maintenance of the present limits pending the comprehensive review of the facility. It is still our expectation that the issue of access limits will be addressed at some point in this ongoing review. Although the questions of access limits and phasing are not directly related, they could be combined in a manner which satisfies those who favor phasing as well as those who are opposed to any reduction in the financing available to the member at the outset of an adjustment program. For example, the three-tranche scheme recommended by the staff could be applied with modified limits for the three tranches which correspond to a higher cumulative limit. One possibility could be to set the first tranche at 33 percent of quota as suggested by the staff and to raise the second tranche to the current cumulative limit of 83 percent of quota. The third tranche would then be equal to the increase in the cumulative limit which the Board may agree on.

As to the type of arrangement which can qualify a member to draw on the higher tranches, in our view a structural adjustment arrangement, a first credit tranche stand-by, or an upper credit tranche arrangement approved in principle, should be considered sufficient. What is important is for the member to demonstrate its willingness to adopt the measures needed to deal with its underlying balance of payments difficulties. In many low-income countries, the structural adjustment facility may be the most appropriate framework for adjustment. Those countries, many of which are exporters of primary commodities, should not be penalized for adopting the adjustment strategy which best fits their circumstances. Moreover, at a time when the Fund is seeking to enhance the status of--and the available resources to--the structural adjustment facility, it would be counterproductive to give the impression that the Fund has less confidence in this facility than in stand-by arrangements. As to arrangements approved in principle and lower credit tranche stand-by arrangements, as long as the Fund is satisfied that the policies adopted by the member are adequate, access to the higher tranches should be assured. While we recognize that the adequacy of policies cannot be fully assessed unless the financing picture is clear, we believe that the risk involved does not outweigh the cost of withholding timely assistance to a member which has shown willingness to do its part, and whose policies have been endorsed by the Fund.

Formula for calculating shortfalls

The staff has considered a number of alternatives with a view to meeting some of the concerns which have been raised by Directors. While we understand some of these concerns, we find all the alternative methods to be inferior to the one currently being used.

For example, applying a deductible factor or projection limits would be too arbitrary. On the other hand, extrapolating past export earnings would be too mechanical and would ignore any information or judgment which the Fund may have on the future course of export prices.

As to the choice between nominal and real calculations of the shortfall, we agree with the staff that the current method should be maintained.

We also agree with the staff that it would be undesirable to limit compensation to shortfalls on account of primary commodities only, since this would, among other things, be discriminatory. Of course one would expect primary commodity exporters to be the most frequent users of the compensatory financing facility, since their export earnings tend to fluctuate more than exporters of manufactured goods. Indeed as the staff paper notes, exporters of energy products, for example, have the highest index of export instability--roughly twice that of the exporters of manufactures.

Over- or undercompensation in successive purchases

We can go along with the staff's proposal of adjusting the compensable shortfall of a second purchase which falls in the projection period of an earlier purchase involving over- or undercompensation. Although we recognize that shortfalls following undercompensation are less likely to occur, we nevertheless consider the question of symmetry as one principle. We could also consider adjustments to compensable shortfalls which are beyond the projection period of an earlier drawing that has not yet been fully repurchased. However, here too we attach importance to the principle of symmetry between over- and undercompensation.

The cereal decision

We are in favor of separating the cereal decision from the compensatory financing facility both in order to simplify its administration and to increase its potential usefulness. We are not fully convinced that a joint access limit is warranted, and, therefore, our first preference is for separate facilities with separate access limits. If the Board did not favor the establishment of a separate cereal facility, we would support the elimination of the 3-year rule as a second best alternative.

Other issues

On the whole, we find the current method of determining the responsibility for the shortfall to be largely satisfactory. We would, of course, welcome any possible improvements in the staff's analysis of the responsibility for the shortfall in individual cases, including the role of the exchange rate. One should keep in mind, however, that what is relevant here is not the trend of exports but the shortfall from that trend. Thus, any attempt to quantify the contribution to the shortfall of a particular policy variable, such as the exchange rate, is likely to prove almost impossible. In the final analysis, what is crucial is the judgment that the shortfall is or is not largely due to factors beyond the member's control.

Regarding the import contents of exports, we agree with the staff that the current procedure should be maintained both for conceptual as well as practical considerations.

Concessionality

During our discussion last spring we noted with interest the proposal outlined by Mrs. Ploix to improve the terms of compensatory financing provided to low-income countries, and thus increase the accessibility and usefulness of the facility to a group of countries which are particularly vulnerable to fluctuations in export income. We welcome the staff's analysis of this proposal, including the amount of resources which would be needed to make compensatory financing facility money more concessional. We hope that this proposal will receive enough support from other industrial countries. If such support did not prove possible at this time when the efforts are concentrated on enhancing structural adjustment facility resources, the matter could be considered again at a more appropriate time in the future.

Contingent use of the compensatory financing facility

The staff has provided a useful initial discussion of how to enhance the role of the compensatory financing facility in support of adjustment programs. On the whole we found the staff's analysis broadly satisfactory, although a number of questions on modalities have not been fully addressed by the staff. Presumably this will be done at a later stage after assessing the Board's reaction to the idea of using the compensatory financing facility for program contingencies. Mr. Dallara has also provided a useful elaboration on the U.S. proposal made during the 1987 Annual Meetings to establish a broader contingency mechanism for Fund-supported programs. Here, too, there are a large number of operational questions which need to be examined carefully, as is amply shown in the staff's opening statement. In our view, it would be premature to comment on all those issued at this time; the staff has not yet had the chance to examine them in full; and one would hope that today's initial discussion of the contingency mechanism will enable the staff to narrow down the issues and options to a manageable level so that a more focused Board discussion can take place at a later stage.

At this time, I will therefore limit myself to a broad outline of our views on the question of contingencies.

We strongly support the idea of building into Fund-supported programs a mechanism which enables members to meet contingencies brought about by exogenous factors. In many cases, adjustment programs provide very little room for maneuver which makes them quite vulnerable to such factors. In our view, any procedure that increases the ability of a program to withstand external shocks would be very helpful in reducing the likelihood of interruptions which often prove difficult to overcome.

The staff has limited its discussion to one type of contingency, namely, a shortfall of exports from their expected levels. This is, of course, understandable, since the issue is being addressed within the framework of the compensatory financing facility which is basically concerned only with export shortfalls. The G-24 and U.S. proposals, on the other hand, are much wider in scope, as they cover a much broader range of contingencies.

While we find attractive many of the elements of the U.S. proposal, we fail to see the logic for the suggestion that the proposed external contingency facility should replace the existing compensatory facility. The two facilities clearly perform different functions. If the external contingency facility were to replace the current compensatory facility, then the Fund would not be able to provide assistance to members experiencing temporary shortfalls but whose policies were basically appropriate. Even in cases in which a Fund-supported program is in place, a shortfall from a medium-term trend--which is currently compensable under the compensatory financing facility--would not entitle the member to draw on the external contingency facility as long as the shortfall was not associated with an error in the export forecast. As these examples indicate, situations can arise in which a legitimate need for quick-disbursing Fund assistance will not be met under the external contingency facility.

Given the separate objectives and functions of the two facilities, the contingency mechanism proposed by the United States warrants a separate discussion, perhaps outside the current review of the compensatory financing facility. It would still be possible, of course, to consider the merits of establishing a joint access limit for the two facilities, although at this time we are inclined in favor of separate access limits.

As to the staff's own contingency proposal, we find most of its elements to be broadly reasonable, although as I stated earlier it is much narrower in scope than the mechanisms proposed by the Group of Twenty-Four and the United States. We are in broad agreement with the staff's views on coverage, reversibility, and cooperation with the Fund, but there are clearly many other questions on modalities which need to be addressed more fully at a later stage.

In conclusion, it is our hope that this ongoing comprehensive review of the compensatory financing facility and the good deal of interest it has generated will eventually result in a stronger compensatory financing facility, and one which is less subject to the doubts and pressures experienced in recent years.

He hoped that the present review would result in a stronger compensatory financing facility whose role would be fully endorsed by the entire membership, Mr. Finaish continued. Supporters of the compensatory financing facility had been on the defensive for some time. Doubts and concerns had been frequently expressed by some Executive Directors when requests for compensatory financing had been discussed by the Executive Board, and some requests had never been brought to the Executive Board's agenda. The uncertainty about the facility might have led to the inconsistency between the spirit of the 1983 guidelines on the use of the facility and the actual implementation of those guidelines, particularly with respect to the facility's lower tranche. As a result, the facility had not been able to perform its intended role in the most effective possible manner. Therefore, it was desirable to reach a consensus on the various issues. That task obviously would not be easy, given the current divergence of views on a number of the issues, but he hoped that the present discussion would move the Executive Directors closer to accomplishing that task.

Mr. Mawakani made the following statement:

My constituency strongly opposes any modification that would change the special features and the main goal of the compensatory financing facility. We also strongly oppose any change that is aimed at linking drawings under the compensatory financing facility to drawings under other facilities, thus increasing the conditionality associated with the compensatory financing facility.

The compensatory financing facility has unique features that make it very appropriate to perform its stabilizing role associated with balance of payments difficulties resulting from temporary shortfalls in export earnings. Experience has shown that it has performed that function well. If any change is needed in this facility, it is in the direction of increasing the scope and access of member countries to the facility.

Mrs. Ploix and Mr. Nimatallah have reviewed the purpose and function of the compensatory financing facility and have emphasized its unique features. They have convincingly made the case that these special features--low conditionality, simplicity, and quick disbursement--must be preserved. I share those views and will therefore not repeat their arguments.

I will now turn to the different issues that are covered in the paper.

I was disturbed by the staff's approach to phasing and conditionality. After stating the views expressed by the Executive Directors at our previous meeting on the compensatory financing facility, and reminding us in the first paragraph of EBS/87/165 that the consensus at the Board meeting was that the basic features of the facility should remain unchanged, the staff then proceeds to make suggestions aimed at changing these basic features. The staff describes ways to increase conditionality and the possible ways that phasing of purchases may be introduced while in Supplement I, Annex II, after an empirical analysis of instability associated with shortfall earnings, the staff concluded on page 14, "For most of these countries, phasing leads to considerably increased instability when compared to unphased access." Further down on the same page, the staff writes, "The main conclusion to be drawn from the above findings is that the compensatory financing facility has performed a clear role in stabilizing fluctuations in foreign exchange earnings of developing countries. The reason for this has been the availability of substantial compensation close in time to shortfall in earnings." It is then quite surprising to find the staff describing in the main paper a system that contradicts its own findings. It is unfortunate that so much resources are used to develop these schemes and scenarios when it is not evident at all how they will improve the facility.

Moreover, I fail to see how a system of phasing would better safeguard the revolving character of Fund's resources. It is often argued, and without much proof, that front-loading undermines the incentives for a country to follow through on its adjustment program. In fact, the opposite may be true: the availability of the right amount of financing at an early stage that may reinforce the incentive to adjust. We should keep in mind that future economic growth is dependent on today's investment, and that very often countries have had to cut much needed imports because of a temporary shortfall in earnings, thus adversely affecting their growth potential.

The formal linkages between drawings under the compensatory financing facility and drawings under other facilities that is being suggested would be unacceptable, as they go against the spirit of the 1983 guidelines on cooperation. As was mentioned by many Directors, including myself, during the previous Board discussion on compensatory financing facility, the guidelines do not formally establish a linkage between conditionality under the compensatory financing facility and that under other facilities. Furthermore, as made clear in those guidelines, the existence or adoption of an arrangement is not a prerequisite for use of Fund resources under the compensatory financing facility, and it has not been demonstrated that there is any need to change them. Moreover, linkages will remove the most important feature of the compensatory financing facility--its quick-disbursing character--thereby interfering with the timing of compensatory financing assistance that should take place at the time of the shortfalls. From the present staff paper and the previous one, the conclusions that one can draw is that it is the linkage that has been drawn in practice that is preventing more countries from drawing under this facility. To me it is very clear that the change that we need goes in the opposite direction to what is being proposed. In fact, the usefulness of the compensatory financing facility would be greatly enhanced if purchases were made proportional to actual shortfalls instead of being a proportion of quotas.

With regard to the emergence of overdue obligations in relation to compensatory financing facility drawings, Mr. Nimatallah has demonstrated in his statement that "The bulk of overdue payments on account of compensatory financing facility drawings occurred in cases where countries had stand-by or other Fund-supported programs in place at the time of the compensatory financing purchase." Linking the compensatory financing facility to a stand-by arrangement, therefore, does not prevent overdue obligations. This fact also reinforces our belief that the cooperation requirement does not mean that the country should have a stand-by arrangement with the Fund. A strong indication that the appropriate measures will be taken to address the balance of payments problems together with normal relations with the Fund should be enough to satisfy this requirement.

Many of the poorest countries would be able to better benefit from the compensatory financing facility if conditions were more concessional. It is in this regard that we strongly support Mrs. Ploix's proposal to provide low-income countries with access to compensatory financing at concessional terms. This proposal is worthy of the full support of the Board. A system that would subsidize interest rates for those countries would not be very costly and could be taken care of through a Subsidy Account. Either scheme as discussed in the supplement would be agreeable to us, but to be really meaningful, the terms should be similar to that of the structural adjustment facility.

On the subject of the creation of a contingency mechanism, we fully support this mechanism in the context of Fund-approved programs. There is a need for such a contingency mechanism, and the Group of Twenty-Four has made some excellent proposals on this subject that I agree with. Most important, it would be established to support Fund programs in the event of unforeseen exogenous developments. It would be activated if events beyond the control of the authorities were to develop in the course of an adjustment program. As Mr. Ortiz said during our previous discussions on the compensatory financing facility, the contingency mechanism will be forward looking, compared to the compensatory financing facility, which is backward looking. The compensatory financing facility is meant to compensate for a shortfall that has already occurred, while the contingency mechanism would be aimed at ensuring against unforeseen exogenous developments. Therefore, the contingency mechanism cannot replace the compensatory financing facility.

In the buff statement 87/224, the staff has raised some very important issues concerning the functioning of a contingency mechanism. These issues are wide ranging and would have very important implications on the functioning of Fund programs. More analysis by the staff on the issues raised is needed. I would suggest therefore that these issues be examined at our next Board discussion on program design and conditionality.

On the other issues covered in the paper, our position has not changed.

On the current method of calculating shortfalls, I do not feel that there is any necessity to change it. Experience shows that it has been generally appropriate for its purpose and has the necessary flexibility. Above all, it is simple and practical. The few suggestions that are made by the staff all have some drawbacks that would introduce more complexity to the system without bringing much improvement to the calculation.

On the matter of overcompensation, we continue to believe that this can be easily taken care of by a provision which calls for early repurchase in such a case.

With regard to the cereal decision, our preference would be for a separate facility.

In sum, my authorities do not agree with the thrust of the staff paper, which gives the impression that the overriding objective of the present review is to protect the Fund's resources at the expense of the equally important objective of helping member countries cope with their balance of payments difficulties arising from temporary export shortfalls. The staff paper also provides us with an interpretation of the 1983 guidelines on cooperation that is unacceptable to my authorities. At a time when world economic conditions are difficult and capital inflows to developing countries have been significantly reduced, we should not be studying ways to make access to Fund's facilities more difficult. Instead, we should try to find ways to improve the flows of resources to developing countries. We need to have a global outlook, and our policies should be such that they improve world economic and financial conditions instead of hamper them.

Mr. Ismael made the following statement:

The compensatory financing facility continues to have a useful role in meeting short-term balance of payments needs arising from exogenous factors. Therefore, the facility should be retained in its present form. I recognize that the purpose of the proposed external contingency facility is somewhat different from that of the compensatory financing facility; therefore, I agree with Mr. Mawakani that there is merit in establishing the proposed facility as a separate facility and not as a replacement for the compensatory financing facility.

The proposed external contingency facility would effectively deny access to member countries facing export shortfalls if those countries did not enter into a stand-by arrangement. Therefore, the proposal fails to recognize the critical distinction between situations characterized by short-term payments difficulties caused only by temporary export shortfalls and situations in which export shortfalls may be superimposed on longer-term payments problems. A large number of countries have payments problems that are merely temporary and may not require major changes in economic and financial policies. It would be unfair to deny access to those countries that did not have a stand-by arrangement. If introduced, the external contingency facility should be a separate facility that complements the existing compensatory financing facility in order to promote growth in countries undertaking adjustment. An external contingency facility is conceptually and operationally different from the compensatory financing facility, as Mrs. Ploix clearly noted. The latter is designed to stabilize export earnings, while the former should be aimed at enhancing the Fund's role in the debt strategy. An external contingency facility with broad coverage would undoubtedly be useful in helping member countries to overcome their present payments difficulties. Indeed, the idea is not new, as both the Group of Twenty-Four and many Executive Directors have argued for many features of such a facility in the past.

Some Executive Directors are opposed to the present compensatory financing facility on the ground that there is a secular structural decline in commodity prices. Available evidence suggests that there is little substance to this argument. The September 5-11, 1987 issue of The Economist states on pages 16-17 that during the past year commodity prices have increased by 19 percent in U.S. dollar terms and by 12 percent in SDR terms according to the magazine's index of commodity prices. The rise in the nonfood agricultural part of the index--cotton, rubber, timber, and other items--is even much sharper, namely, 48 percent in U.S. dollar terms and 39 percent in SDR terms. Since these commodities require long gestation periods or substantial fixed investment, fluctuations in prices and output can sometimes be large and prolonged. The Economist therefore warns that it is important that the price movements should not be mistaken for a trend. The recent staff working paper entitled "The 1984-86 Commodity Recession: An Analysis of the Underlying Causes" (WP/87/71), concludes that "much of the decline in commodity prices in 1984-86 can be explained by supply and demand factors that are reversible, rather than by long-term structural and irreversible factors." This perception of commodity prices seriously undermines the rationale for the proposed changes in the compensatory financing facility.

Some Executive Directors have used the emergence of overdue financial obligations to the Fund as an argument in favor of the proposed fundamental changes in the compensatory financing facility. In fact, as Mr. Nimatallah has explained, the issue of overdue obligations is not peculiar to the compensatory financing facility; it is a more general problem that is applicable to all uses of Fund resources. Therefore, the question of arrears should be kept separate from this review.

I will now comment on specific issues raised in the staff paper. First, my authorities wish to retain the lower compensatory financing facility tranche at 50 percent of quota with increased flexibility to make the facility more readily accessible in cases in which export shortfalls are temporary and the underlying balance of payments position is basically sound. In such cases, access should be assured as long as the member is making reasonable efforts to overcome its payments difficulties. It must be emphasized that access should be fairly liberal, as it was before 1983.

The full 83 percent of quota should be made available on the approval of a stand-by arrangement or if a member country has policies that would qualify it for such an arrangement. There is no need to hold anything back in reserve for a later purchase, especially if an external contingency facility is introduced separately from the compensatory financing facility to underwrite economic growth in member countries. I agree with Mrs. Ploix that the phasing proposed by Mr. Dallara, Mr. Nimatallah, and Mr. Goos would result in a new tightening of conditionality as well as in an effective reduction in access. However, if the Executive Board agrees to an increase in the access limits under the compensatory financing facility, I would be willing to consider phasing--for example, along the lines suggested by Mr. Finaish.

Meanwhile, I feel strongly that maintaining the lower tranche at 50 percent of quota with ready access would be essential to preserve the key features of the compensatory financing facility that were most useful to members before restrictions were introduced under the 1983 guidelines. These features were aptly characterized by Mrs. Ploix as "automaticity, low conditionality, and simplicity." In addition, the Interim Committee agreed only recently to maintain the overall access limit, with an implicit understanding that the lower tranche is to be 50 percent of quota. In this connection, I agree with the staff that a distinction must be made between compensatory financing requests that arise from short-term payments difficulties limited only to temporary export shortfalls, and requests involving temporary shortfalls that are superimposed on longer-term payments problems. In the former case, the effective restriction of access for countries without a stand-by arrangement, as has happened since 1983, would not be justified, since the countries' temporary difficulties could turn around very quickly. A good example is Malaysia: the staff expectations of the medium-term balance of payments changed dramatically between the 1986 and 1987 Article IV consultations. Indeed, the latest expectation of the Malaysian authorities is a current account surplus of about 3 percent of GNP in 1987, compared with the staff's projected deficit of 8.7 percent during the 1986 Article IV consultation.

Second, the introduction of an upper limit on export growth is likely to introduce undue rigidity, especially if global inflation were to be reignited. A more important factor may be volatile currency values, which can lead to vastly different growth rates depending upon the currency used to calculate exports. Like Mr. Finaish, I support the proposal to establish a separate cereal facility or the deletion of the three-year rule. I also support in principle an adjustment for overcompensation arising in successive compensatory financing purchases or subsequent purchases.

Third, my authorities have an open mind on the idea that compensatory financing may be provided on concessional terms to countries that are eligible to use the structural adjustment facility. However, we should be cautious and avoid introducing too many complications into the compensatory financing facility. In addition, the issue of an interest subsidy for low-income countries should be examined for all uses of Fund resources and not just for compensatory financing. Another issue that should be further explored is whether or not the low-income countries can be better assisted in other ways, such as less stringent structural adjustment facility conditionality and increased access to the resources under that facility. In this manner the different facilities can be better managed, without a proliferation of subsidy accounts.

Mr. Kafka made the following statement:

This is a preliminary--or even "pre-preliminary"--discussion on the compensatory financing facility and the U.S. proposal to establish an external contingency facility. A number of Executive Directors have submitted gray statements, and my comments, too, are preliminary. The staff paper discusses a series of reform proposals, particularly to augment the conditionality of, and to institute phasing in, the compensatory financing facility. If these proposals are accepted, the compensatory financing facility as we know it would be altered even more than was achieved in 1983, as the facility would be transformed into essentially an adjunct of stand-by or extended arrangements. The staff paper claims that immediate maximum access to the compensatory financing facility irrespective of the existence of financial arrangements with the Fund would still be available under certain conditions. This statement is correct but unconvincing. Recent experience and the thrust of the staff paper suggest that the remainder of the independence and automaticity of the compensatory financing facility would vanish if the proposals in the staff papers on conditionality and phasing were adopted.

The proposals are based on a selection of the opinions that were expressed by Executive Directors during the previous discussion on the compensatory financing facility, on March 3, 1987. However, a table prepared by the staff (Annex I) shows that none of those opinions was supported by a majority of the voting power. Many of the opinions were not included in the Chairman's summing up of that discussion, because the support for them was so small. It is curious, however, that none of what might be called the "liberalizing" proposals made during the previous discussion on the facility are even discussed in the latest staff paper despite the support that was given to those proposals.

The U.S. proposal is to replace the compensatory financing facility by an external contingency facility that would be available only to countries having a financial arrangement with the Fund; the subordination of the new facility to such arrangements would be formal and complete. However, the new facility would cover a wider range of events than the compensatory financing facility--including the cereal and buffer stock facilities--and it would increase the total allowable compensation from 83 percent to 100 percent of quota and, temporarily, to 133 percent under certain circumstances. Therefore, the U.S. proposal, compared with the staff proposals, offers a trade-off between greater access and the total subjugation of access to the conditionality of stand-by or extended arrangements and to phasing. In this connection, a question of some practical importance arises. An external contingency facility--or, perhaps, only parts of it--would require approval by an 85 percent majority of the total voting power if the facility, or parts of it, were to float. Would floating be necessary for an external contingency facility subject to upper credit tranche conditionality and phasing? What would be lost by eliminating the floating of the facility? What would be the operational effect if decisions on an external contingency facility would require an 85 percent majority? At some point, these matters will have to be discussed.

The staff proposals concerning conditionality and phasing under the compensatory financing facility should be rejected without exception. In this connection, my position is very close to that of Mrs. Ploix, Mr. Finaish, and Mr. Nimatallah in particular. I especially agree that access to the compensatory financing facility should be automatic, should involve low conditionality, should eschew phasing while retaining the present access, and should be simple while the facility retains its particular specificity.

I support the wider coverage of the external contingency facility under the U.S. proposal in comparison to the present compensatory financing facility. This approach is already reflected in the G-24 proposals and has been supported by some other Executive Directors during this discussion. However, support for wider coverage must not be at the expense of the independence of the compensatory financing facility.

The staff paper includes a set of modifications of the present compensatory financing facility to meet three alleged needs, namely, greater safeguards for the revolving character of the Fund's resources, operational flexibility, and use of the facility to support stand-by arrangements and contingent financing. In making its first point, concerning safeguards, the staff makes a great deal of the supposed risks posed by the present design of the compensatory financing facility. The paper shows that compensatory financing repurchases that are overdue are a higher proportion of total compensatory financing than overdue purchases under the credit tranche policies in relation to total purchases under those policies. The apparent conclusion to be drawn is that compensatory financing facility repurchases are more liable to fall into arrears than credit tranche repurchases. However, strictly speaking, this conclusion does not flow from the data cited by the staff; such a conclusion could be justified only if repurchases of compensatory financing drawings in the absence of stand-by arrangements gave rise to more arrears proportionately than compensatory financing drawings with stand-by arrangements. However, since there have recently been few compensatory financing drawings without stand-by arrangements, a meaningful conclusion is impossible to draw. The questionable meaning of the staff's discussion on this matter is indicated by the fact that, according to the staff, the bulk of the overdue financial obligations--whether under the compensatory financing facility or the credit tranche policies--is due to only a small number of member countries.

The present compensatory financing facility guidelines are more than cautious in giving countries access to the facility. For the present lower compensatory financing facility tranche, the Fund must--as has been the case since the introduction of the facility--be satisfied that the member will cooperate with the Fund to find, where necessary, appropriate solutions to its balance of payments difficulties. This guideline has since 1983 been interpreted to imply, first, good faith discussions of the member's policies and, second, prior action, thereby giving reasonable assurance that appropriate corrective action will be adopted whenever the Fund considers that the member's policies are seriously deficient or the member's recent record of cooperation has been unsatisfactory. The Fund clearly already has the means under the present guidelines to refuse risky drawings; in fact, the scales may already be weighted against a country's receiving access even in cases when such access should be made available.

For access to the upper credit tranche of the facility, there has always been an additional criterion, namely, that the member has been cooperating with the Fund. In addition, since 1983, this criterion has implied evidence of cooperation, such as a satisfactory balance of payments apart from the export shortfall, or the existence of satisfactory performance under an arrangement with the Fund, or the adoption of such an arrangement. Even in the absence of the first of these pieces of evidence of cooperation, the latter two are not supposed to be a prerequisite for either a lower or even an upper tranche drawing under the compensatory financing facility, provided, however, a member's policies are deemed to meet the criteria for approving a stand-by arrangement. In this connection, it is useful to note that Table 1 of the staff paper shows that in the previous two years, four out of six lower-tranche drawings occurred in the absence of a stand-by arrangement; however, the table does not show whether discussions were not simultaneously held to establish a stand-by arrangement. Since 1982, only one drawing has taken place--in 1985--in the upper compensatory financing facility tranche when a stand-by or extended arrangement did not exist or was being approved concurrently. Moreover, the recent case of Argentina shows that the concept of "adoption" of a stand-by arrangement has been interpreted very narrowly, to the exclusion of approval in principle of an arrangement.

Therefore, adequate safeguards already exist, and there is no need to increase the conditionality on compensatory financing or to introduce phasing. In their opening statements, Mrs. Ploix and Mr. Nimatallah spelled out the reasons for maintaining the present character of the compensatory financing facility. The proposals on conditionality and phasing in the staff paper are also designed to "restore operational flexibility" to the compensatory financing facility. Paradoxically, this purpose is to be achieved by reducing access to the lower compensatory financing facility tranche by dividing it into two parts. This procedure is supposed to make it easier to give access to the lower part of the lower tranche, as such access would not have to be delayed until negotiations on a stand-by arrangement are completed.

Under the proposal discussed by the staff, the lowest tranche would be available "in the early stages of discussion on a program" supported by a stand-by arrangement. Presumably, this condition would not be required if the balance of payments problem was due exclusively to an export shortfall outside the member country's control. Even if that presumption is correct, it seems that, if anything, the proposal would reduce rather than increase, operational flexibility, since nothing at present prevents a drawing up to 50 percent of quota from being made in the absence of any discussion on a stand-by arrangement. The staff has explained in an unpublished memorandum that the purpose of its proposal is to make part of the lower tranche available in cases in which it otherwise would not be available under the present guidelines. However, I fear that the provision would be given a restrictive interpretation, thereby preventing access even to the lowest compensatory financing facility tranche except in the context of the discussion of a stand-by arrangement, something that is not required at present. The staff has also argued that splitting the lower tranche would avoid "large disbursements," namely, the entire 83 percent or 50 percent of quota, once a stand-by arrangement has been approved. This practice would make no obvious sense; if there is no balance of payments need, the 83 percent of quota will not be made available, and if there is such a need, the full 83 percent should be made available.

The staff has suggested that access to the upper part of the lower tranche should become available on the approval of an arrangement with the Fund. The staff also suggests that one might consider permitting additional drawings up to 50 percent of quota in the case of approval in principle of a stand-by arrangement or of outright approval of a lower credit tranche stand-by arrangement. These are hardly proposals for increases in flexibility, for the same reasons that I have mentioned.

As to the "final" tranche of the compensatory financing facility--the upper tranche under the present facility--the staff discusses the proposal that access would require compliance with the terms of a stand-by or extended arrangement as ascertained by a special review. This proposal would also provide for a further effective--not just formal--tightening of the compensatory financing facility.

In sum, the proposals discussed by the staff under the heading of conditionality are unwarranted, unnecessary, and counterproductive. The cooperation requirements under the 1983 decision are more than adequate to safeguard the Fund's resources; going beyond them would imply inscribing into the Fund's guidelines a principle of total distrust of its members. The proposals discussed by the staff certainly would not contribute to "restoring operational flexibility" to the compensatory financing facility; only a retreat from the 1983 decision would do that.

The staff discussed in its paper, but drew no firm conclusions on two additional points, namely, the assessment of entitlement to drawings in relation to the shortfall conditions existing at each stage of phasing, and the possible phasing of drawings under the cereal decision. I need not comment on the staff's discussion on the assessment to be made at each stage of phasing, since the phasing itself is unnecessary. Such phasing would be particularly inappropriate for the cereal facility, which usually provides urgent assistance that is partly humanitarian in nature.

In its discussion of issues concerning the implementation of the compensatory financing facility, the staff examined the present approach to the determination of export shortfalls. This approach combines discretion--the so-called judgmental approach--with a simple formula. The staff makes three suggestions for modifying the formula to avoid compensation in cases that some Executive Directors--far from a majority--consider inappropriate. In quantitative terms, the problems are not impressive by the staff's own admission, and it is not clear why any changes in our approach is necessary.

The first suggestion for modifying the formula is the use of a deductible. The staff concludes on page 20 that a 3 percent deductible would eliminate net overcompensation and many of the problems associated with unusual patterns of export growth but would increase undercompensation. Another possibility envisaged by the staff is the application of an upper limit on the export shortfall projection. The staff suggests that any such limit should not be less than 120 percent, which would have effects similar to those of the 3 percent deductible. The limits would have to be revised from time to time in the light of world economic developments. Apparently the staff contemplates no lower projection limit.

The staff then examines four solutions to the problem of calculating compensation that are based only on past export receipts. Among those solutions, simple averaging seems to reduce both overcompensation and undercompensation. But, both simple averaging and extrapolation based on past figures are not likely to be sufficient, as experience shows. Calculating export shortfalls in real, as distinct from nominal, terms has the advantage of keeping compensation closer to balance of payments needs. But, at first sight, surprisingly, it does not make much difference, according to the staff's findings, whether the calculations are in real or nominal terms. The staff claims that calculations in real terms could result in compensation for import price increases only, rather than export receipt shortfalls, and that this result would go beyond the intent of the original decision on compensation. Therefore, a change in this respect might require an 85 percent majority, if the floating character of the facility were to be preserved. In addition, there are practical difficulties in the choice of indices; for many countries, import price indices are difficult to obtain. Nevertheless, this matter merits further study.

Another proposal would limit the coverage of the compensatory financing facility to primary commodities. This proposal is rejected by the staff, which concluded that, in developing countries, even exports of manufactures show less stability than exports of manufactures of developed countries. Of course, limiting the facility to primary commodities involves a number of practical problems as well.

The staff notes that there is no practical means of adjusting for overcompensation due to an overprojection of exports in the two postshortfall years; the correction would come too late--in fact, when repayments were already about to start. However, the staff suggests that overcompensation in cases of successive purchases could be dealt with by deducting the overcompensation based on excessive export projections for an earlier compensatory financing drawing from the compensation that would otherwise be payable under a later drawing. This method could be used not only in cases in which later shortfalls were overlapping with the projection of an earlier purchase, but also in cases in which no such overlap occurred but the earlier purchase was still outstanding. This proposal merits study, but the problem does not seem to be particularly significant.

Abolishing the three-year rule would make the cereal facility a separate facility, with one exception, namely, the "excess" cost of cereals could still be offset against "excess" export receipts. However, this difference would disappear if a joint limit were established for a separate compensatory financing facility and the cereal facility. I could accept making the cereal facility separate, with or without a joint ceiling. I would also accept concessional financing, if the resources could be found; one could argue that a cereal facility should have a larger claim on concessional resources than the compensatory financing facility or an external contingency facility in general, because the cereal facility is likely to involve humanitarian assistance.

It has sometimes been suggested that insufficient attention has been paid to the question whether requests for compensatory financing would compensate for shortfalls that are genuinely beyond the control of the member. As the staff shows, such an investigation would be particularly complicated. It is not clear to me why the staff claims that it would be easier to determine the effects of overvaluation rather than causes of shortfalls that are within the control of a member country. After all, overvaluation can rarely be clearly demonstrated. It is well known that purchasing power calculations can be very misleading; they are in effect the unthinking man's econometrics. In the end, one has to choose between giving the staff excessive discretion and sticking to the present practice; I favor the second alternative.

I agree with the staff that the difficulties it mentions on page 33 make an adjustment for the import content of exports impracticable.

The staff poses the question whether the use of the compensatory financing facility, as distinct from the cereal facility, should be available on concessional terms in certain cases. Concessionality could refer to the rate of charge and/or to the length of the repurchase period. On the basis of assumptions that do not appear to be unreasonable, the staff estimates the cost of a 3 percent subsidy and a 5-10 year repurchase period at about SDR 100 million a year. The question is whether the compensatory financing facility is the best target for SDR 100 million a year in grants.

The staff also examines contingent use of the compensatory financing facility in order to protect stand-by or extended arrangements against inaccurate projections of export receipts. The staff finds that such protection could have been applicable in about half the stand-by arrangements concluded between 1982 and 1986.

As to the U.S. proposal, there is no justification for eliminating the present compensatory financing facility as an essentially independent facility--in other words--as a facility whose use is not tied to a stand-by or extended arrangement. The compensatory financing facility should continue essentially as at present; of course, I would like to see access to the facility increased and, in contrast to recent developments, made again even less subordinate than at present to the existence and observance of the terms of financial arrangements with the Fund.

The Fund should avail itself of the suggestions made by the United States to offer protection against contingencies not foreseen under the compensatory financing facility to countries that maintain a financial arrangement with the Fund--either a stand-by arrangement, extended arrangement, or structural adjustment arrangement. This broader protection could be handled in different ways, but there is no need to do so through a special facility, especially one that would float. Contingent financing beyond compensatory, cereal, and buffer stock financing could therefore be dealt with as a part of a financial arrangement, and this could be accomplished in a variety of ways.

Mr. Sugita made the following statement:

Today we have the somewhat difficult task of commenting both on a detailed review of the existing compensatory financing and the proposed new facility, of which only a broad outline has been presented. An additional difficulty is that the latter is to replace the former. In the circumstances, I will offer only basic and very preliminary views on these two facilities.

As a result of the changes in the world economic outlook in the 1980s, most countries making compensatory financing purchases face long-term balance of payments difficulties requiring adjustments, rather than temporary export shortfalls that the compensatory financing facility was originally intended to address. This development is reflected in the fact that most compensatory financing purchases have recently been associated with stand-by arrangements. Recognition of this change seems to point to the need to transform the present facility into one that would more effectively complement and support the growth-oriented adjustment policies of countries facing protracted balance of payments difficulties.

As has been frequently pointed out, a fall in exports is only one of possible unexpected developments that cause the derailment of an adjustment program, and broader contingencies may have to be addressed in order to ensure effective implementation of the program. In addition, the present tranching and phasing policy for the compensatory financing facility has not been instrumental in helping members to continue programs in the face of unexpected developments.

These considerations lead my authorities to tentatively conclude that the external contingency facility proposed by Secretary Baker would be preferable to minor changes in the present facility. As to the details of the new facility, while I broadly support the general outline presented by Mr. Dallara, I wish to reserve my final position until a more concrete proposal has been worked out. The staff should make in-depth studies and formulate a proposal before long. One consideration that may be taken into account in such studies is the need to deal with a situation in which balance of payments difficulties arise from a genuinely temporary export shortfall. Including a way to deal with such a situation under the external contingency facility might go some way toward alleviating the concern about the replacement of the compensatory financing facility.

Given the basic orientation of my authorities with respect to the two alternatives, I will refrain from elaborating on the specific points raised in the staff paper. However, if some feature of the present compensatory financing facility is to be maintained, it is important to ensure that compensation in cases of a steep downward or strongly rising export trend is not allowed. I welcome the direction that the staff has followed in this respect and encourage further study.

Mr. Abdallah made the following statement:

I found it useful to review the Chairman's summing up of the preliminary discussion on the compensatory financing facility in March 1987 to place the recommendations that we are now being asked to consider in proper perspective. I noted from the earlier discussion four points that provide broad parameters for our discussion today: there would be no major overhaul of the compensatory financing facility; there was a strong desire to maintain the facility's present character; the access limits would at least be maintained; and the test of cooperation did not require a member country to conclude a stand-by or other arrangement with the Fund. In light of these observations, the present staff paper is very disappointing: the proposals seem to be pushing in the opposite direction, coming down squarely on the side of greater conditionality and of promoting practices that will effectively lead to a fundamental change in the character of the compensatory financing facility. If key elements of the staff's proposals are adopted, the facility would retain its present name, but little else would be left of the original concept of the facility. In any event, the reasons that are given for overhauling the facility are not convincing.

The fundamental question is whether we should keep the compensatory financing facility, and if so, what its role should be. I believe that the facility is definitely needed, that it should maintain its central character--namely, timely disbursements to compensate for temporary shortfalls in export earnings--and that modifications should be aimed only at improving its operational efficiency, keeping in mind the need to avoid unnecessary complications. I agree with Mr. Nimatallah that nothing since our discussion in March 1988 justifies changing this view. I do not support changes that will effectively kill the compensatory financing facility as we know it.

The major function of the facility is to stabilize export earnings in order to help maintain the import capacity of countries that face a temporary shortage of foreign exchange. In this connection, the timeliness of compensatory financing is a key factor in the facility's favor. The analysis in Annex II of EBS/87/165, Supplement 1, supports this views. It points out that the compensatory financing facility has indeed done what it was intended to do, namely, stabilize fluctuations in foreign exchange earnings of developing countries, because purchases have followed closely on the appearance of shortfalls in earnings. The related conclusion is that phasing of purchases is likely to reduce the facility's effectiveness. It is for this reason that I find it difficult to accept the three-tier access proposed by the staff. I am particularly concerned about the proposal to reduce the lower tranche from 50 percent of quota, because it gives the impression of a greater interest in mechanical fine-tuning of the facility rather than its basic role in providing compensation. Such compensation cannot effectively perform its function if the limits on it are too low.

However, the staff paper suggests that what is lost in the effectiveness of the stabilization role of the compensatory financing facility can be made up by the gains from increased incentives to adjust that would be associated with phasing. The corollary assumption is that lump-sum purchases reduce a member country's commitment to adjustment. On page 13 of EBS/87/13, which was considered during the previous discussion on the facility, it is clearly stated that "members using the compensatory financing facility have, on average, not allowed their adjustment efforts to weaken." The contrary inference in the present paper cannot therefore be based on incontrovertible evidence. Experience has shown that in many countries--spanning different income levels--pursuing adjustment, the absence of financing, not its timely availability, is the factor most likely to derail or postpone the adjustment effort. Finding ways in which to increase a member's commitment to the adjustment process deserves serious attention. However, this issue goes far beyond the confines of the compensatory financing facility.

There is agreement that, before accepting a request for compensatory financing, the Fund must be satisfied that a member's policies are appropriate to deal with its balance of payments problems. This "test of cooperation" is meant to meet the legitimate need to preserve the revolving character of the Fund's resources. A Fund-supported program is taken as clear evidence that a member is cooperating with the Fund to find solutions to its economic and financial problems; however, a program must not be a precondition for access to the compensatory financing facility. In my view, a favorable assessment by the Executive Board of a member's economic policies, satisfies the test of cooperation, whether or not a stand-by or an extended arrangement is in effect.

This approach provides operational flexibility while meeting the Fund's legitimate concern about protecting its resources. In any event, such protection cannot be assured solely by a stand-by or extended arrangement. More than half of the compensatory financing purchases in 1981-86 that resulted in overdue obligations were accompanied by a stand-by or an extended arrangement. A country's ability to service its external debt or attain a viable balance of payments position involves complex factors, not all of which can be adequately catered to in a Fund-supported program. Thus, the staff's proposals will make the test of cooperation unnecessarily restrictive, and, on the basis of recent experience, the effect is likely to be a further reduction in the use of the compensatory financing facility.

With respect to low-income countries eligible to use the structural adjustment facility, the conclusion of structural adjustment arrangements must be accepted as fully satisfying the test of cooperation. I mention this because for a large number of these countries, a structural adjustment arrangement might be more appropriate to their circumstances than the traditional stand-by arrangement.

While I agree that it might be necessary to increase the efficiency of the operation of the compensatory financing facility, I would stress the need to keep the formula as simple as possible. I oppose the application of a deductible factor, which is likely to penalize small, low-income countries.

I strongly endorse the French proposal for concessional terms on the rate of charge on outstanding purchases and for an extension of the maturity period for repurchases under the compensatory financing facility by low-income countries. A repurchase period similar to that under the structural adjustment facility is most advisable. Management should give prompt attention to this matter. The need for a special subsidy account raises the question of finding the resources to make such an account operational. The staff has estimated that, at a rate of charge of 3 percent, SDR 80-100 million a year would be needed, a sum that is not prohibitively large.

Two steps should be taken at this stage. First, we should reach a consensus that concessional assistance is consistent with recent efforts to make the Fund more responsive to the special circumstances of low-income countries. Second, we should give management a mandate to approach the matter with the donor community in order to secure the needed resources.

The commentary in the staff paper on contingency financing is limited in scope, particularly given the fact that the Group of Twenty-Four had already provided some preliminary thoughts on a broader treatment of external contingencies in

Fund-supported adjustment programs. The U.S. proposal presented by Secretary Baker at the 1987 Annual Meetings and as elaborated by Mr. Dallara is also more wide ranging than the possible adaptations discussed by the staff. The present paper has raised a number of important questions that require further analysis. For now, three preliminary observations seem to be in order. First, as a general principle, I strongly support the concept of contingent financing to provide a cushion against unforeseen developments in the course of implementing an adjustment program. Such financing should not be limited to export shortfalls. Second, there is much to be said in favor of considering contingency mechanisms on their own merits, and the notion of such mechanisms should therefore be treated as something distinct from the compensatory financing facility, which is designed to deal with the specific problem of shortfalls in past export earnings. Third, effective operation of contingency mechanisms will require an increase in the resources of the Fund and therefore must be one of the considerations in determining the level of quotas under the Ninth General Review.

The usefulness of the cereal facility could be greatly enhanced if the facility had its own identity. Making it a separate facility will clearly demonstrate the Fund's intention of providing a specific type of emergency assistance, namely, the protection of food imports, in cases in which time is of particular importance, especially cases involving the low-income countries that periodically face serious food shortages. A joint limit on compensation under the two facilities should be greater than the 83 percent that is now in force under the compensatory financing facility.

In sum, the compensatory financing facility should be maintained in its present form for the foreseeable future.

Mr. Enoch made the following statement:

In principle, we welcome the U.S. proposals for an external contingency facility. We have ourselves been concerned in the past at the apparent fragility of some Fund programs to external shocks, and at the uncertainties and difficulties that always accompany a situation when a program is in difficulty. If these can be ameliorated, it will certainly be to the good. At the same time, we have also had reservations about the appropriateness of the compensatory financing facility to the economic conditions of today. The compensatory financing facility was introduced at a time when commodity prices were expected generally to move cyclically in the short term around a stable, or maybe upward, trend; today's conditions, in which most potential users of the compensatory financing facility have longer-term balance of payments difficulties, are perhaps rather different. I note that Mr. Dallara would like to replace the compensatory financing facility with the external contingency facility. While we would at this stage perhaps see some attraction in such an outcome, we are aware that there is considerable support here for the retention of at least some elements of the compensatory financing facility, and we are listening to the arguments with interest.

I therefore welcome this session, the informal nature of which seems a very sensible way to begin our consideration of the particular issues before us. There are some differences as to what we are actually discussing. It would seem that Directors' interventions will variously focus on the the compensatory financing facility, the external contingency facility, or a mixture of both. For my own part, I think it would be best to focus specifically on the proposed external contingency facility at this stage, given the potential implications of the U.S. proposal for the compensatory financing facility. We already have a very helpful and detailed staff paper reviewing the compensatory financing facility; it is important now that the similarly detailed work be undertaken on the proposed external contingency facility and on the implications of the new facility for the compensatory financing facility.

I would propose that work on the external contingency facility be broadly organized in three stages.

First, we need to clearly articulate the rationale for an external contingency facility so as to provide from the beginning definite guidance for the construction of any such facility and for the evolution of operational conventions, and we must confirm, if possible within the context of an analysis of past Fund programs, what scope there is for contingent financing which can be reasonably quantified and effectively addressed.

The results of this first stage should throw up, at least implicitly, the outline of the most appropriate mechanism to address the problem, although I will offer some tentative suggestions in a moment.

Finally, in fleshing out the details of an external contingency facility, we must examine how the Fund can accommodate such a scheme; this will involve looking at the implications of the external contingency facility for established facilities, including the compensatory financing facility, as well as the implications for the Fund's position overall.

The concept of an external contingency facility is attractive. Not least, it would reinforce the precautionary feature of stand-by arrangements, which is consistent with their original purpose. However, as the staff's statement usefully illustrates, there are many questions to be answered. Mr. Dallara's statement would seem to provide a broadly acceptable basis on which to proceed, but there are a number of issues raised in the staff statement on which I would like to comment at this stage.

Looking first at the coverage of the external contingency facility, the choice is between seeking to cover the shortfall in some aggregate, such as the balance of payments, relative to a baseline, or the shortfall in certain specified components of the aggregate. If we go for the specified components, we will probably argue which will be in and which will be excluded. However, it is paramount that the facility should only cover factors outside the individual country's control, and to ensure that is the case it is surely helpful that the particular factors which are likely to be outside the country's control are specified in advance. Specifying these factors carefully might also assist timeliness of response, as the factors can be selected, at least in part, on the basis of the rapid availability of data. We should not ignore the fact, however, that deterioration in the specified factors may be offset by improvement elsewhere in the balance of payments. In this context, it might be possible to take account of the overall position of the country in determining its particular external contingency facility financing needs. In any event, one would wish only to give compensation for the net effect of the unanticipated movements in the specified factors when some have been moving in a positive and some in a negative direction.

Which factors should be included in our lists? I have no problems over the selection of export prices and volumes, provided existing compensatory financing facility rules apply, or with import prices or natural disasters. As regards the proposal also to compensate for interest rate fluctuations, my authorities are now prepared to look at this closely. We do share the concerns in this area set out by Mr. Nimatallah; at this stage, however, we feel that if interest rate compensation is linked to a stand-by arrangement and has a 12-month time limit on compensation, after which rebasing takes place, this could go some way to alleviating the concerns. The probelm Mr. Nimatallah identifies of the excessive cost of covering interest rate contingencies might be covered by providing only partial coverage. We feel that, if commercial banks could also make parallel provision for more finance when interest rates rise, this would make the proposal much more presentable: we would not wish it to appear that the banks were being bailed out by the Fund. All these are subjects for further study by the staff. But one area which would be unacceptable to us would be for the external contingency facility to operate as a growth contingency mechanism. We do not see that growth should be identified in such a way separate from the various factors, both exogenous and endogenous, which bring, or fail to bring, it about.

On the issues of eligibility, as suggested in the staff statement, if we are dealing with countries which have a Fund program in place I cannot see that we can avoid working from a baseline scenario. The difficulties of establishing that external shocks are beyond the control of members suggests the need for the external contingency facility to be triggered by review rather than some automatic mechanism. Thus, the external contingency facility might be seen as a framework for the rapid identification, assessment, and response to external contingencies.

The criterion of cooperation with the Fund must be willingness to undertake necessary additional adjustment measures defined at the time of the review. In principle, this would seem not to exclude countries with enhanced surveillance or shadow programs. Similarly, it should not necessarily exclude a country with a structural adjustment arrangement. On the other hand, a member's need for the concessionality of the structural adjustment facility might in many cases seem to be inconsistent with the use of market-cost ordinary resources. Maybe instead structural adjustment facility contingencies could be handled within structural adjustment facility programs, and so at structural adjustment facility interest rates; or perhaps one might rely on the skewed enhancement of the structural adjustment facility to allow for greater contingencies. Moreover, in principle, we feel that, as with compensatory financing, some lower tranche external contingency facility drawings could be extended to countries without programs. Perhaps the staff could look at these points in some detail.

The concept of symmetry is one to which this chair attaches great importance and is one area where the U.S. proposals will need considerably more work. In theory, symmetry could be enforced by higher reserve targets, by reduced foreign borrowing, or by reduced borrowing under stand-by arrangements. Perhaps one might envisage early repayments from past drawings.

The staff also asks about an appropriate level of access. In order to determine this, it would be helpful to examinie historical experience, although current access levels will provide an important benchmark and access in individual cases must, as for all Fund resources, be within the repayment capability of members. If the compensatory financing facility is retained and an external contingency facility is introduced, there will presumably be trade-offs in the access limits of the two facilities. The phasing of access may be desirable, in principle, but the precise limits will depend on the level of total access and our review of past experience. The novelty of the external contingency facility suggests that the facility should be subject to frequent review, at least early in its life.

The financing of the external contingency facility and its impact on the Fund's liquidity are issues that we will have to throw back to the staff with a request for some illustrative simulations. In response to other questions raised by the staff, I would note that the external contingency facility should not finance prolonged adverse deviations from anticipated levels of performance. Here, I would support Mr. Dallara's suggestion that the assumptions of the baseline scenario only be made for no more than 12 months at a time. The outturn at the end of this period would then become the base for any new baseline scenario in the next period and would therefore incorporate persistent deviations from previously assumed levels. The question of "moral hazard" is one that to an extent is inherent in all Fund assistance. Our safeguard must be adequate assessment of the exogeneity of adverse developments as well as the requirement of additional adjustment measures.

There are two issues are in part procedural but have substance behind them and will, I believe, involve us in substantial work in the coming weeks. The first is the extent to which the objectives of the external contingency facility could be achieved without the difficulties inherent in devising a new facility, by instead elaborating on the contingency facilities within existing programs such as those that were introduced in 1986 for Mexico; and, on the other hand, whether those aspects of the compensatory financing facility which are undoubtedly of value and to which many chairs clearly attach considerable importance, can be safeguarded within the external contingency facility. The second is whether we do in fact have to choose at this stage between the external contingency facility and the compensatory financing facility, or whether we could perhaps retain the compensatory financing facility in some form, perhaps while using the external contingency facility on a trial basis. I would ask the staff to work on these issues now; we will be interested to read their findings, and the Board will return to these topics during our formal discussion.

Mrs. Filardo made the following statement:

This discussion is taking place at a time when the international economy is experiencing a severe financial crisis that could affect the prospects of developing countries, especially the highly indebted, primary producing countries. The economic situation of most of these countries has deteriorated dramatically despite the adjustment programs that they have implemented. The main reason for this outcome is the deterioration in the international environment, especially the acute decline in commodity prices resulting from the low growth and protectionist policies of industrial countries and, in recent years, the dramatic reduction in the access of developing countries to financial markets and the complex requirements for gaining access to official and multilateral lending. Therefore, in assessing the final impact of the current crisis on the world economy, it is crucial to analyze the future for developing countries as well as the Fund's role in the changing circumstances.

Although previous extensive reviews of the compensatory financing facility have generally resulted in a positive response to the needs of member countries, the recent concern about protecting the revolving character of the Fund's resources has been reflected in the discouragement of member countries from using the facility. This discouragement has taken the form of a proliferation of conditionality, phasing, and reviews under the compensatory financing facility.

I doubt whether this trend can be pursued in the medium term, since it is clear that in some cases external viability cannot be achieved unless growth rates are stepped up. It is also clear that structural reforms require not only an adequate macroeconomic policy framework, but also the availability of sufficient financial resources. The question remains whether the Fund should help member countries with problems that are long term in nature.

I will now make preliminary comments on issues raised by the staff and on the U.S. initiative. As to the compensatory financing facility itself, given the existence of both temporary shortfalls and long-term payments difficulties, a new scheme is being proposed on the basis of the following fundamental changes: the creation of three tranches; a reduction of access; a modification of the formula for calculating export shortfalls; and the introduction of a requirement to hold discussions on or to approve a stand-by arrangement as a prerequisite for gaining access under each tranche of the compensatory financing facility. In my view, the facility should continue to be governed by the 1983 guidelines, as the facility has accomplished its purpose, as Mr. Nimatallah and others have stated, namely, to provide member countries with resources in a timely manner to compensate for export shortfalls.

On page 3 of EBS/87/165, the staff stresses that the intensification of external payments imbalances in many primary producing countries since the beginning of 1980 "has meant that effective adjustment has been unavoidable." The use of the compensatory financing facility has been accompanied by measures that meet the test of cooperation and that provide reasonable assurance of balance of payments viability in the medium term, thus satisfying the 1983 guidelines.

The staff feels that, while the guidelines were designed to differentiate between payments imbalances that are attributable to temporary shortfalls and those that are attributable to long-term imbalances, in practice "the distinction is often difficult, and because of that, the guideline has been interpreted rather cautiously." As a result, use of the lower tranche of the compensatory financing facility has fallen sharply and, with one exception, access to the upper tranche has been accompanied by stand-by arrangements. The main reason for that interpretation is to protect the revolving character of the Fund's resources in view of the proliferation of overdue obligations to the Fund on account of compensatory financing facility purchases, which, indeed have increased substantially.

It is interesting to note that, according to the information provided in the staff paper, of the 52 compensatory financing facility purchases in 1981-86 that resulted in overdue repurchase obligations, 31 were accompanied by stand-by or extended arrangements. Thus, it is doubtful whether adding the conditionality of a stand-by arrangement explicitly to the conditionality on access to the compensatory financing facility will solve the arrears problem. In practice, the staff has given its own particular interpretation of the 1983 guidelines in applying them, and, as a consequence, requests to use the compensatory financing facility have been delayed until the approval of a new stand-by arrangement for the members concerned. Because of this constraint, member countries have refrained from using the compensatory financing facility. At the same time, the use of stand-by or extended arrangements has not prevented the appearance of overdue obligations.

The question remains how to achieve more flexibility in the operation of the compensatory financing facility. One consequence of the delay in the use of the facility resulting from the staff's rigid interpretation of the guidelines is that members generally request the maximum access to the facility, thereby weakening the incentive to adjust and raising the possibility that the revolving character of the Fund's resources will be adversely affected. To correct this distortion, the staff proposes phasing the use of the facility and suggests that three tranches should be used successively.

The supplement to the staff paper clearly shows that phasing disbursements would run counter to one of the central objectives of the facility, namely, providing compensation as closely as possible to the shortfall period to which the compensation is related in order to stabilize foreign exchange earnings. In Annex II, the staff stresses that its estimate of the magnitude of the risk involved is important. In this context, the staff analyzes two different schemes for phasing disbursements, namely, purchases over four and eight quarters. The staff concludes from this exercise that phasing hinders the stabilization process that the facility is designed to support. Therefore, phasing seems to be incompatible with the facility's main objective of stabilizing foreign exchange earnings of developing countries. Therefore, I oppose the introduction of additional conditionality or the adoption of phasing.

Nevertheless, I am willing to consider possible modifications of the formula. I recognize that no formula is perfect, but I oppose the utilization of any deductible factor or the application of projection limits, although I support the exploration or alternative formula calculations, such as the use of real values of export shortfalls. As the staff has noted, the main advantage of using real values would be the synchronization of compensatory financing with balance of payments needs, since shortfalls calculated in real terms would be larger than shortfalls calculated in nominal terms.

The arguments made by the staff against the use of real values are not satisfactory. For example, the staff refers to the practical difficulty in determining the most appropriate import price index. In my view, the selection of the index involves the same kind of problems as the calculation of the real exchange index and of export price projections. Therefore, the question remains how to cope with overcompensation or undercompensation. The staff believes that overcompensation is one of the most relevant problems in the use of the compensatory financing facility. While I agree that overcompensation should be corrected, it would be interesting first to explore what the results would have been if real values had been used in calculating export shortfalls. Undoubtedly, no overcompensation would have been registered if shortfalls had been calculated in real terms.

The compensatory financing facility should accomplish the purpose for which it was created on the basis of the 1983 guidelines, but the facility is not used frequently. In the present international environment, and given the systemic nature of imbalances in some developing countries, the appropriate response to the present uncertain environment should be to improve the facility. The scope of the facility should be expanded by adding new possibilities for access, such as a growth contingency, to reinforce programs that could be undermined by unexpected external developments. This approach is along the lines of the suggestions in the G-24 report and the U.S. proposals. However, the proposed modifications are meant to enhance the compensatory financing facility and not to substitute for it.

As the staff has rightly pointed out, "large deviations of actual developments from those assumed at the outset of the programs and failure to provide an effective and timely cushion against such unforeseen external developments can undermine the adjustment effort with negative consequences for growth-oriented adjustment over the medium term." This statement is made in recognition of the serious lack of financial resources available for developing countries. Therefore, multilateral institutions should step in and play an active role; otherwise, we would be promoting a situation that is not sustainable, mainly, one in which only adjustment need take place.

The proposed alternatives should be available not only to countries with stand-by, extended, or structural adjustment arrangements, but also to countries under enhanced surveillance and to countries that are implementing sound economic policies like the policies included in stand-by, extended, or structural adjustment arrangements. Otherwise, there would be discrimination in the treatment of member countries.

I agree with the staff that if the compensatory financing facility is expanded--for example, to include growth contingencies--proper criteria for permitting access would need to be defined, but in cases in which a country already has a stand-by, extended, or structural adjustment arrangement, the arrangement should be sufficient to meet the test of cooperation and to trigger the use of the facility. For other alternative uses of the compensatory financing facility, the current guidelines should remain appropriate.

As to the calculation of net additional balance of payments financing needs, at one point in his statement Mr. Dallara said that "an increase in the net financing need due to a shortfall in expected capital flows would not be a basis for activation of the external contingency facility." But Mr. Dallara also stated that "in exceptional cases, the external contingency facility might be activated at an earlier stage, if a substantial increase in the net financing need posed a major threat to the program." It is important to clarify the distinction between those two situations, particularly since, given the present conditions in financial markets, such a distinction could imply asymmetrical use of the new facility.

I support the French initiative with respect to concessional compensatory financing for low-income countries. Nevertheless, I recognize that the adoption of any such initiative would depend on the amount of financing that could be raised. It would be interesting to have a further comment on any negotiations in this area.

The G-24 report on the role of the Fund contains a section on contingency mechanisms that I strongly support and which answers some of the questions posed by the staff in its opening statement. Many of these questions need to be examined by the staff and discussed in the Executive Board. Therefore, I look forward to having an exchange of views on the remaining questions raised in the various papers following a more complete assessment of the issues by the staff.

Mr. Song made the following statement:

During the discussion on March 3, 1987 on the compensatory financing facility, almost all Executive Directors stressed the importance and usefulness of the facility. This consensus is highlighted in the present staff paper.

The aim of this discussion should be to restore the facility's main characteristics, so that it can be used in a timely and appropriate way by all members facing balance of payments problems due to reversible export shortfalls. Restoring the vitality of the facility is in the best interest of all developing and industrial countries, particularly in view of the stagnation of world trade in recent years. Therefore, it is important not only to avoid any steps that will tighten the conditionality under the facility, but also to take steps to ease the conditionality in practice. Any modification of the provisions governing the use of the facility should be conducive to improving the facility's functioning.

The size of the lower compensatory financing tranche, namely, 50 percent of quota, need not be changed. A country experiencing an export shortfall has sufficient grounds for using this tranche as long as the country is willing to make, or has made, reasonable efforts to overcome its payments difficulties. In this respect, the test of cooperation should be interpreted in a flexible and fairly broad way.

The cooperation requirement for the upper credit tranche, namely, access between 50 percent and 83 percent of quota, should be seen as being met by one of the following conditions: the existence of a satisfactory balance of payments position apart from the effects of the export shortfall; the approval in principle of a stand-by or extended arrangement; the approval of an arrangement under the structural adjustment facility, or the existence of policies that would qualify a member country to undertake such an arrangement. It would be appropriate to eliminate the three-year rule from the cereal decision or to establish a separate cereal facility.

It is well known that the Group of Twenty-Four has proposed that the cost to low-income countries of using the Fund's general resources should be reduced through the establishment of an interest subsidy facility. The question of concessional use of the compensatory financing facility can be included by the Executive Board in its consideration of that proposed interest subsidy facility.

As to contingent use of Fund resources, it should be a supplement to the compensatory financing facility and not as a substitute for that facility.

Mr. de Groote made the following statement:

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

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

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

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

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

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

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

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

To summarize, the enhanced compensatory financing facility could be worked out with the following access scheme:

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

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

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

As to the more operational issues discussed in the staff paper, I can support the proposed introduction, into the formula for calculating shortfalls, of a ceiling on export projections in order to contain the amounts of compensation associated with rapid export growth. As to overcompensation in the case of successive compensatory financing facility purchases, I agree with the staff that we should consider deducting any overcompensation produced by the first purchase from the amount to be compensated by the second compensatory financing facility purchase. And as to commodities the fluctuations of which would entitle a member to use both segments of the external shock facility, I do not see any reason for excluding oil any more than any other commodity. Gold could also motivate access to the facility, since compensation for its fluctuations cannot be regarded as an intervention in its price, prohibited by

Article V, Section 12(a). As to the income level of countries that would be entitled to access to the renovated facility, I do not recognize any useful reason for preventing high-income countries, such as Australia, from calling once again on the facility if all conditions are present entitling them to do so.

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

Mr. Rye made the following statement:

My comments are preliminary. My authorities will wish to give further consideration to the compensatory financing facility and to Secretary Baker's proposal for a new external contingency facility.

My Australian authorities continue to have reservations about the general need for a special facility like the compensatory financing facility, but that is well known and can perhaps be taken as read. I personally have no difficulty in accepting that on many occasions the facility has, in Mr. Finaish's words, played a constructive role.

However, I wish to emphasize that my Australian authorities are not in favor of creating an extra facility. They could accept a modification of the terms of the compensatory financing facility or its replacement by a new facility, but they could not support the retention of the compensatory financing facility as well as the creation of a new external contingency facility.

As I understand it, Secretary Baker's proposal for the creation of a new facility is based on the view that the external environment facing adjusting countries has become more difficult and unpredictable. Increasingly, adjustment programs can and do go off track for reasons other than the short-term declines in export receipts that are the reason why the compensatory financing facility was originally proposed. I have some sympathy for those who take this perspective. The proposal being developed by the United States does seem to offer the prospect of creating a more flexible and responsive facility than the compensatory financing facility. At the same time, I share some of the concerns that were expressed by Mr. Goos. Undoubtedly, short-term fluctuations in external conditions can create difficulties, but the task is to distinguish such short-term problems from long-term changes to which policy adjustment must take place. In this connection, one cannot escape the exercise of judgment, and I therefore agree with Mr. Goos that there needs to be less automaticity, not more.

Another concern about the U.S. proposal is that it would seem to move the Fund further toward becoming a body that is concerned primarily with addressing the debt crisis. Some movement in this direction is no doubt inevitable, but it can go too far. The external contingency facility would, it seems, be concentrated essentially on the highly indebted countries. Like others, I am not enthusiastic about the idea that a replacement for the compensatory financing facility would not be available, even in the form of lower-tranche drawings, to members that do not have a financial arrangement with the Fund.

One could of course raise many questions about the operational modalities of an external contingency facility, but others have already done that, and I have little to add, other than to say that I share some of the doubts that were expressed about the inclusion of interest rates in the coverage of the new facility. Like Mr. Enoch, I would like to see the question of symmetry addressed in detail; Mr. de Groote's comments on this matter were of particular interest. In sum, my authorities see merit in the concept behind the external contingency facility. Mr. Dallara's statement represents a step toward elaborating the proposal that was outlined by Secretary Baker, but there seems to be a fair way to go in fleshing out this idea before it could be regarded as a workable proposal, and in the process of doing so some questions of principle should be given further consideration.

Like Mr. Enoch, I have been wondering why there is a need to create a special facility when there may be other ways to respond adequately to external events such as interest rate rises and significant increases in imported prices. In this context, I am not referring to the growth contingency proposal that was raised by the Group of Twenty-Four, about which I have serious reservations, but rather to the use in selected cases of contingency elements in stand-by arrangements, including, perhaps, provisions that would respond to the exogenous events--or some of them--referred to by Mr. Dallara. Of course, the Mexican precedent exists, but the pros and cons of extending that need to be considered carefully, and I expect that the staff will wish to consider this when it prepares its next paper on the subject.

As for the compensatory financing facility itself, a number of the calls for change relate to the perceived operational weaknesses of the existing facility. In this connection, of course, there are widely diverse views. Current and potential recipients of compensatory financing consider that the facility has become overly restrictive and has thus lost its quick-disbursing character. Other Directors have raised concerns about the increasing arrears associated with the compensatory financing facility, and there have been many questions raised about the formula for calculating the export shortfall. In addition, there are serious issues surrounding the tendency for overcompensation that has been observed over the previous several years.

One particular concern is whether the front-loaded nature of compensatory financing facility disbursements contributes to effective adjustment. In this connection, I note that of the cases of linked stand-by arrangements and compensatory financing purchases since January 1985, 32 percent of the total disbursements have been made by the compensatory financing facility, and in only 3 of 13 such cases has the compensatory financing facility provided substantially less than half the agreed total amount.

I will now comment on the main proposals that have been made in the staff paper to respond both to the perceived weaknesses of the compensatory financing facility and to suggestions for improving the facility.

The staff proposal to introduce a new tranche and a phasing approach seems to represent a reasonable compromise between the conflicting views presented by Executive Directors during the previous discussion of the facility, in March 1987. As to the scope of the facility, I agree with the staff's conclusion that the facility should not be limited to primary commodities, and that the import content of exports should not be taken into account in the export shortfall calculations. Any changes in these directions would cause considerable administrative problems.

The staff paper reveals a substantial problem with respect to overcompensation. The analysis supports the case for some modification of the existing formula. I could go along with the approach that seems to be favored by the staff, namely, to include some limits on projected exports. I certainly would not favor the proposed extrapolation technique, which would eliminate the exercise of judgment in calculating export shortfalls. Calculations of export shortfalls should continue to be in nominal terms.

The fact that drawings under the cereal decision have not been made since May 1985--and in only a very limited way in the two years before--adds weight to the reservations that I have about the need for that decision. I prefer to abandon the decision and to concentrate efforts on improving the compensatory financing facility and stand-by arrangements more generally.

I appreciate the concerns that led Mrs. Ploix's authorities to propose a concessional window for the compensatory financing facility for the low-income countries. However, given that the enhancement of the structural adjustment facility is in process, and that there are clear limits on the financial assistance available to subsidize concessional lending, I am inclined to agree with Mr. Dallara that the pursuit of this proposal is neither necessary nor feasible at this time.

Mr. Feldman made the following statement:

Secretary Baker's proposal to create an external contingency facility was initially greeted with optimism by countries facing unexpected balance of payments difficulties, as the underlying idea seemed to be that the resources made available through the compensatory financing facility could be expanded in quantity and quality precisely to assist countries experiencing various exogenous shocks. Access to the new facility would be triggered by unforeseen external developments outside the control of member countries, such as a shortfall in export earnings derived from slower than expected export market growth or lower than expected world export prices, higher sustained interest rates, above the initially assumed level, or additional financing needs arising from natural disasters.

I strongly support the idea of broadening the coverage of the existing compensatory financing facility, as suggested by Mr. Dallara. My authorities have emphasized on several occasions the need to create a special facility that would provide financial resources to indebted countries facing high and unstable international interest rates, thereby avoiding the economic overadjustment that would otherwise be necessary to cope with the macroeconomic imbalances of the industrial countries.

Unfortunately, the staff presentation implies a significant departure from the spirit embodied in the present design of the compensatory financing facility, which, as Mrs. Ploix correctly reminded us, has been implemented specifically to assist member countries with short-term shortfalls due to circumstances beyond their control. The departure from the current situation includes a significant tightening of the conditionality and a weakening in the automaticity of the facility. The proposals imply that access will undoubtedly be linked to some Fund arrangements, preferably a stand-by arrangement or an extended arrangement, and phasing will be strengthened to make drawings under the compensatory financing facility more dependent on the country meeting performance criteria. These proposals provide for either the same availability of resources--83 percent of quota--combined with more conditionality, or a modest increase in the resources available through the facility--from 83 percent to 100 percent--and broader coverage of possible sources of exogenous shocks, coupled with a significant tightening of conditionality. The message seems to be that the amount of resources that countries experiencing external difficulties which are beyond their control may have will remain approximately the same, but its availability will be dependent upon the implementation of an adjustment program. The new scheme can be interpreted as a dilution of compensatory financing by Fund arrangements, especially stand-by arrangements. In other words, access to the compensatory financing facility--at least its upper tranches--will become compensation for fulfilling the targets and limits under a stand-by or extended arrangement. I continue to oppose this objective; as Mr. Nimatallah has stated, this proposal is inappropriate, unfair, and discriminatory, because members that do not need an arrangement with the Fund would automatically be excluded, and there would be no room for a purchase by a member with a conventional export shortfall. I would add to Mr. Nimatallah's correct assessment that even for countries having an arrangement with the Fund, subordinating drawings under the compensatory financing facility to the fulfillment of performance criteria will introduce an additional degree of uncertainty that will negatively affect the countries' capability to cover its financing gap and will therefore become a new strain on the debt situation.

My authorities favor an enlargement of the present compensatory financing facility, both qualitatively and quantitatively. The facility should be enlarged to include financial compensation for high and unstable international interest rates, and it is in this sense that they are supportive of Mr. Dallara's proposal. If modification of the present compensatory financing facility is thought to involve many technical difficulties, I am inclined to favor preserving the facility as it is, and to complement it with an interest facility. My basic position remains the same as the one in the G-24 report on the role of the Fund in adjustment with growth.

Basically, the G-24 report proposes that: (i) the facility should finance export shortfalls as quickly as possible; (ii) the facility should be free of conditionality; (iii) coverage under the compensatory financing facility should be extended to all external sources of disturbances in the balance of payments that are beyond the control of the members concerned; (iv) the access limits under the facility should be increased; (v) in the absence of adequate quotas, the best way to increase access would be to use directly the size of the shortfall, rather than quotas, as the basis for determining access; (vi) the period of repayment should be enlarged; and (vii) repurchases should be adjusted in line with the country's capacity to repay.

A detailed discussion on the technical features of the facility should be postponed at this stage. Such a discussion should be scheduled after reaching an agreement on the guidelines for the facility.

I favor the inclusion of contingency clauses into Fund-supported adjustment programs. The incorporation of contingency mechanisms into programs should be dealt with on a case-by-case basis.

I fully support Mrs. Ploix on the availability of the compensatory financing facility to the poorest countries. As she has pointed out, many eligible low-income countries cannot afford the terms of the compensatory financing facility because they can no longer borrow at market interest rates. In facing this situation, the Fund should examine the possibility of increasing the access of these countries to the compensatory financing facility by allowing them to use the facility under concessional conditions in the form of increased maturities and lower interest rates.

Mr. Ovi made the following statement:

As a matter of principle, the Nordic countries have long been skeptical of financial support schemes related directly to specific items of the balance of payments. However, I recognize that the implementation of the present compensatory financing facility has been fairly satisfactory, and that the facility has proved useful to many member countries. Future compensatory financing should also focus on offsetting only temporary shortfalls. Furthermore, the operational modalities of such financing should be as clearly distinct as possible from those of ordinary Fund financing arrangements.

It is clear from the staff paper that the magnitude of overdue obligations relating to compensatory financing facility repurchases has increased substantially. This development partly reflects serious structural problems in many debtor countries, which underscores the need for some degree of conditionality on compensatory financing. At the same time, the need for timely and adequate financing justifies less conditionality on drawings in the lower tranches. In other words, I favor maintaining a compensatory financing facility that is structurally similar to the present facility. Therefore, I also support the staff proposal to introduce three tranches under a revised compensatory financing scheme. A revision of the compensatory financing facility along these lines could ensure both timely access with low conditionality and the provisions of upper tranche financing combined with adjustment programs.

I also agree that structural adjustment facility lending, as well as approval in principle of a stand-by arrangement in the upper credit tranches, may form the basis for access to the second and third tranches of the revised compensatory financing facility.

Although I am somewhat skeptical of the idea of phasing disbursements under the compensatory financing facility, I recognize the difficulties inherent in determining the underlying causes of a given export revenue shortfall. In addition, phasing of disbursements might reduce the problem of overcompensation. Therefore, I support the phasing procedure that is outlined in the staff paper.

As to the method of calculating the trend, the present judgmental procedure seems satisfactory; it is clearly better than any more mechanical method. Obviously, however, the actual access to the facility should be restrained somewhat. In particular, I have difficulty in accepting the practice of providing access to the compensatory financing facility in cases involving a continued negative trend in export revenues, instead of only when there is a temporary shortfall. In such cases, an ordinary credit tranche arrangement, emphasizing structural adjustment, would be more appropriate. On the other hand, it is true that only a few purchases have been permitted in such cases.

A more serious problem is the possibility of a purchase under the compensatory financing facility in cases in which countries are experiencing significant export growth. The fact that a large portion of purchases under the facility has been provided to member countries with persistent, strong growth in export revenues is a cause for serious concern, and the staff proposal to introduce limits on projected export growth is therefore constructive. In addition, I support the staff proposal that both export trends and possible projection limits should continue to be calculated in nominal terms.

The present procedures for early repurchases due to overcompensation are too weak and do not treat similar cases equally. Therefore, I support the staff's proposal that previous overcompensation be subtracted from future purchases under the compensatory financing facility. Such offsetting should be provided in cases in which there is no overlap between the time periods for which the shortfall is calculated. Nevertheless, the best solution would be for all overcompensation to be subject to early repurchase.

I have serious doubts about the French proposal on a concessional compensatory financing facility. The purpose of the compensatory financing facility should, to the greatest extent possible, be to compensate temporary export shortfalls. Moreover, given the current cumbersome process for reaching agreement on the enhancement of the structural adjustment facility, concessional support through the compensatory financing facility seems unrealistic.

As to the cereal facility, continuation in its present form is acceptable.

I will now make preliminary comments on the U.S. proposal for an external contingency facility. I welcome Mr. Dallara's opening statement, which provides useful information on the outline of a new facility. Still, a substantial number of questions raised at this meeting remain unanswered. Therefore, at this stage, I can only give my authorities' initial reactions to the proposal.

The major advantage of the U.S. proposal is that the financing requirements of a member country would be seen in their totality. A serious defect of the proposal is that the new facility could not be used to compensate for export revenue shortfalls in cases in which a stand-by or structural adjustment arrangement is not appropriate or, indeed, is unnecessary. The implementation of the proposal might consolidate even further the present dominance of the developing countries as the sole borrowers from the Fund. Moreover, a flexible interpretation of the staff's three-tranche proposal could, to a large extent, meet the concern underlying the U.S. proposal.

Furthermore, compensation for sustained changes in exogenous variables appears to be in direct contradiction to the basic principle behind the compensatory financing facility of financing only temporary shortfalls. Indeed, Mr. Dallara could usefully outline more fully the reasoning behind the proposed fundamental departure from the present scheme. In addition, at the operational level, as Mr. Nimatallah noted, the U.S. proposal gives rise to numerous problems. At the same time, it is true that interest rates on external debt are in most cases clearly beyond the control of a single debtor country; no policy measures at the country level can be expected to affect the interest rate level in world financial markets. Although I am skeptical about the proposed interest rate compensation, I look forward to further discussion of this issue before I take a more definite position on it. The continuing discussion of the compensatory financing facility should include empirical studies, based on historical data, of the implications of the various proposals. Such studies might include possible combinations of the two proposals without being as specific as Mr. de Groote suggests.

Although I am skeptical about the general use of automatic contingency mechanisms, one such example might be a revision of the compensatory financing facility based on total access of 100 percent of quota, with drawings beyond 83 percent of quota being used only for contingency support, in other words, in addition to compensatory financing.

Another possible combination might apply to lower-tranche drawings: in cases of natural disaster or in cases in which purely exogenous factors of an erratic nature affect an economy, disbursements could be automatic, followed by a review of the need for further domestic adjustment. At the same time, in cases involving serious doubts about the need for additional adjustment, a straightforward review of the countries' situation could take place before any release of Fund resources.

Mr. Sengupta made the following statement:

In its latest paper on the compensatory financing facility, the staff has concentrated on the concerns of some, but not most, Directors that were expressed during the discussion in March 1987. Indeed, the staff suggestions, especially on conditionality and phasing, have overlooked the majority view of Directors. Noting that conditionality under the compensatory financing facility was embodied in the test of cooperation, and that the interpretation of cooperation had been clarified in 1983, the Chairman summed up the discussion at that March 1987 meeting by saying that most Executive 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. Most Directors also said that present procedures for determining the trend of export earnings were appropriate, and that access to the facility should be determined on the basis of deviations from a trend, irrespective of the trend itself.

In the light of these conclusions, the staff's proposals to reduce the lower tranche under the facility to 33 percent of quota and to have effective access above 83 percent of quota on approval of an arrangement surely do not address the concerns of the majority of Executive Directors. The staff was expected to suggest a mechanism to liberalize the existing lower tranche of the compensatory financing facility of 50 percent of quota and to recommend ways in which to improve the monitoring of the test of cooperation to facilitate the use of up to 83 percent of quota, consistent with the spirit of the March 1987 Executive Board discussion and the 1983 guidelines. The staff has argued that, since existing practice governing the implementation of the facility has resulted in a "loss of operational flexibility" with "the conditions separating purchases in the lower and upper compensatory financing tranches becoming increasingly blurred, use of the lower tranche alone has diminished significantly." Instead of suggesting that this practice should be reversed, the staff has proposed that the lower tranche of the facility should be reduced to 33 percent and that conditionality on the remaining access should be increased. There is no logic to this approach. If 50 percent of the present access under the lower tranche is in practice being held up by the effort to enforce conditionality, why will a limit of 33 percent improve matters? Indeed, it is not surprising that Mr. Dallara wishes to reduce the first tranche limit further, to 25 percent, on practically the same grounds--or the absence of any ground--as in the staff proposal. I strongly oppose the suggestion. There is no reason to reduce the lower tranche of 50 percent of quota. That tranche should be made available, as the staff has suggested, through greater flexibility in the implementation of the guidelines, thereby providing wider use of the lower tranche without the need to await any formal arrangement with the Fund.

The staff has not failed to recognize the logic of the compensatory financing facility; it has failed to follow through on the full implications of the logic. Drawings under the facility are meant to compensate temporary shortfalls in export earnings from medium-term trends, so that a country can withstand the adverse effects of the shortfall without being forced to adopt policies that have a disrupting effect on the structure of production and on the pattern of trade. A shortfall can occur whether or not a country has any underlying balance of payments problems. The staff admits that if the underlying balance of payments position is basically sound, maximum access under the compensatory financing facility should be assured, on the assumption that policy changes are not required. The logic is the same if the temporary shortfalls are superimposed on longer-term payments difficulties; countries should adopt appropriate policies to meet these payments problems, and for that purpose they could request Fund assistance under an arrangement if they considered such assistance necessary. But whatever policies the countries adopt to meet these difficulties, they should not be affected or changed because of the existence of temporary shortfalls. It is for this reason that the staff itself notes on page 3 that "the

1983 guidelines on cooperation were designed to differentiate between payments imbalances attributable solely to temporary shortfalls and thus not requiring policy changes, and imbalances attributable to longer-term causes and consequently requiring policy adjustments." Following this reasoning, a country facing export shortfalls superimposed on some balance of payments problems should only have to be willing to cooperate with the Fund in adopting the right kinds of policies in the spirit of the 1983 decision. I see no reason to recommend any further tightening of conditionality or any phasing of purchases as suggested by the staff. Once the test of cooperation is met, it is necessary to provide all the compensation to overcome the problems created by the shortfalls. It is also important that such financing should be disbursed quickly. Promoting purchases under the lower tranche of the compensatory financing facility to avoid lumpiness of disbursements has no logical connection to the extent of the export shortfall or to the need for compensation.

The staff has worked out in Annex II of the supplementary paper the role of phased purchases in stabilizing foreign exchange earnings. The simulations show that for a large proportion of the countries concerned--54 countries of the 79 examined--phasing of purchases over four quarters would have led to an increase in instability compared to an absence of phasing. This conclusion becomes stronger when purchases are phased over eight quarters. These are important findings, and they give credence to the view that the availability of substantial compensation close to the time of the shortfall reduces fluctuations in foreign exchange earnings of developing countries.

For these reasons, phasing should not be attempted, and the minimum that should be done is to leave the tranches under the compensatory financing facility as they are. Since I do not agree to phasing, there can be no question of assessing export shortfalls at the time purchases are made. I continue to believe that compensation related to the upper tranche under the compensatory financing facility should not be linked to either the negotiation or the approval of an arrangement. In fact, there is no evidence to prove that compensatory financing has been a disincentive to the adjustment efforts of countries that have made use of such financing.

The staff has observed that overdue obligations of members have risen since the early 1980s. However, there is no reason to believe that the increasing arrears to the Fund are due to full disbursements under the compensatory financing facility. As the staff notes, the bulk of overdue obligations is attributable to only three countries that have both used the compensatory financing facility and have undertaken stand-by or extended arrangements. Indeed, in the absence of separate data on the arrears of those members that use only the compensatory financing facility--and do not have stand-by or extended arrangements--it cannot be proved that the arrears are due to any characteristics of the present compensatory financing facility. On the contrary, it can be argued that, if countries have accumulated arrears on stand-by and extended arrangements for whatever reasons, they would also, more likely than not, also be in arrears in respect of the compensatory financing facility. Much more analysis and data are also needed to show that any country has fallen into arrears on purchases under the compensatory financing facility because of the nature and payment characteristics of that facility. Hence, it cannot be concluded that these countries would not have fallen into arrears if the nature of the compensatory financing facility had been changed or if the drawings under the facility had been linked to a stand-by or extended arrangement.

The current formula for calculating shortfalls is adequate and functions well. The studies in Annex III of the supplementary paper do not provide any strong reason for changing the formula. The application of a deductible would aggravate undercompensation. Upper limits on projected exports would, even if appropriate with reference to the expected rate of inflation over the medium term, effectively reduce the amounts that would be available under the current formula. Introducing a ceiling on export growth and placing more fetters on drawings under the compensatory financing facility may actually hamper adjustment efforts.

I recognize that it is logical to make an adjustment for overcompensation in the case of successive purchases, but an adjustment for undercompensation could also be made. However, such adjustments would complicate the administration of the compensatory financing facility and introduce an element of uncertainty for borrowers. In any event, the amounts involved seem to be very small. Therefore, the present framework could well be allowed to continue.

I can accept the idea of creating a separate cereal facility, in which event there could be a separate limit for that facility as distinct from the current limit.

Assistance under the compensatory financing facility should be provided on concessional terms to all member countries that are eligible to use the structural adjustment facility, but it should not be conditional upon the agreement by borrowing members to a policy framework paper. Eligibility is the more appropriate criterion for such conditionality, which seems to be consistent with Mrs. Ploix's proposal.

As for the proposal by the U.S. Secretary of the Treasury about the institution of an external contingency facility, I regret that this has been proposed as a substitute for the compensatory financing facility. There are many ideas in the

U.S. proposal for a new facility which are positive and consistent with the contingency mechanisms that are proposed in the recent G-24 report. In its next paper, the staff should carefully examine all the proposals relating to contingency mechanisms within a Fund-supported adjustment program. However, these contingency mechanisms are separate from the compensatory financing facility, which is to provide, as Mrs. Ploix has noted, "financial assistance to compensate for past shortfalls experienced by Fund members that have not necessarily undertaken a Fund-supported adjustment program." Mrs. Ploix has also rightly pointed out that "the compensatory financing facility compensates for the adverse consequences of an existing situation, while contingencies can be considered as insurance for the future." Indeed, as is discussed in great detail in the G-24 report--and these arguments can fully incorporate the reasons given by Mr. Dallara for supporting the U.S. proposal--and as Mrs. Ploix has noted, the contingency mechanisms are expected to provide additional resources in the course of a Fund-supported program if foreign exchange earnings fall below the level projected in the program. In every sense of the term, these proposals are complementary to the compensatory financing facility. While I urge the staff to continue examining these proposals, none of my authorities can support any proposal that is meant to substitute for the compensatory financing facility.

I will refrain from discussing the details of the U.S proposal until the staff has examined all aspects of that proposal as well as the G-24 proposal. The staff has also posed a set of questions on external contingencies. The implications of these questions are far reaching, and there has been too little time in which to receive the views of our authorities. I hope that we will return to these questions when we discuss the staff paper on the external contingency facility. However, I wish to point out that the G-24 report has discussed practically all the questions raised by the staff and includes a number of the suggestions made by Mr. Enoch at the present meeting. However, there is one point, which was clearly stated by Mr. Abadallah, which should be faced squarely: if a contingency mechanism is to provide genuine protection for the adjustment efforts of a member country from the adverse consequences of exogenous developments on the country's balance of payments flows, the contingency mechanism must provide for adequate compensation by making additional resources available. The argument that if resources are not available, compensation should be only partial--a similar point on interest compensation was made by Mr. Enoch--fails to take into account the very rationale for the scheme. Moreover, such resources cannot be provided unless the Fund's resources are expanded. Therefore, it is only natural to expect that those who promote such contingency mechanisms would also support an increase in quotas.

Mrs. Ploix said that she wished to reiterate that her authorities were prepared to contribute to the provision of concessional financing under the compensatory financing facility.

Mr. Massé made the following statement:

> Two distinct situations can be delineated, which require different responses by the compensatory financing facility. For countries with payments difficulties that are limited only to temporary export shortfalls, my authorities do not envisage any change in the essential characteristics of the facility. However, in cases in which temporary shortfalls are superimposed on longer-term payments difficulties, the response of the compensatory financing facility should be different and should involve an appropriate blend of financing and adjustment.
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> The underlying objective of the compensatory financing facility in the second, more difficult of these two situations should be to assist members in adopting effective adjustment measures to secure viability over the medium term. Imbalances that are attributable to longer-term causes will require policy adjustment, and assistance under the compensatory financing facility in these cases will need to give greater weight to this consideration, not only to strengthen the member's economy, but also to provide adequate protection for the revolving nature of the Fund's resources.
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> A number of the modifications suggested by the staff go in the right direction when measured against these criteria. My authorities are willing to consider trying to increase the flexibility of the compensatory financing facility to make it more accessible as long as a country experiencing a shortfall is making reasonable efforts to overcome its payments difficulties. At the same time, a reduction in the size of the lower tranche of the compensatory financing facility seems reasonable. In addition, I can support phasing of compensatory financing disbursements, based on the existence of appropriate policies, or on the approval of a program supported by a stand-by arrangement or possibly by a structural adjustment arrangement, and subsequently on conformity with performance under the adjustment program along the lines suggested in the staff paper. In addition, any purchase under the compensatory financing facility should be assessed in relation to the shortfall prevailing at the time of each purchase.
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> As to the formula used in calculating shortfalls, the suggestion that a ceiling should be introduced on export projections for the postshortfall years appears to be reasonable, although it does involve the complication of determining an appropriate ceiling in light of prospective inflation developments. In this connection, it would be appropriate to conduct periodic reviews of this upper limit.

Calculations or shortfalls in real terms would not, on balance, be useful, for the reasons that are outlined in the staff paper. Similarly, limiting calculations to primary products would be inappropriate, and attempting to adjust export data for variations in the cost of the import content of exports would not be useful, given the likely difficulties in so doing.

My authorities would be willing to support the staff's proposals on overcompensation. As to the cereal decision, my Canadian authorities are not convinced that removal of the three-year rule would be appropriate. Removing the limit would be tantamount to establishing a separate facility, and, as the staff has noted, separate facilities compensating for fluctuations in various components of the balance of payments tend to provide less overall stabilization than compensation for fluctuations in the sum of these components.

As to the question of responsibility for the export shortfall, the benefits of limiting compensation to that portion of the shortfall that is determined to be beyond the member's control probably do not outweigh the complications that this would introduce. Nevertheless, on previous occasions, I have expressed concern about the extent to which a member's policies may have contributed to export shortfalls, and I encourage the staff to continue to investigate this issue. In this connection, I support the proposal to pay more explicit attention to the possible effects of exchange rate overvaluation in assessing individual requests for compensatory financing.

While my authorities support the overall goal of assisting the poorest member countries, they feel that the provision of assistance on concessional terms under the compensatory financing facility to countries qualifying for assistance under the structural adjustment facility is not the most appropriate response to the situation of these countries. My authorities agree with the view expressed at earlier Executive Board discussions that protectionist agricultural policies are an important cause of weak commodity markets. In addition, it seems clear that the benefits of an interest subsidy plan for the compensatory financing facility pales when compared with the loss of revenues arising from these policies. More generally, enhancement of the structural adjustment facility seems to be a more appropriate response by the Fund, and I see little prospect that member countries would be willing to provide additional resources for a concessional compensatory financing facility.

With respect to the proposals to establish an external contingency facility, my authorities view this as a concept that should be supported and further developed. The proposal for a new facility has a number of attractive features; as a contingency facility that could be activated during the implementation of

Fund-supported programs, it would be a forward-looking mechanism that could help maintain the viability of programs and ease crisis management in the event of unforeseen adverse external developments. In addition, the proposed facility would respond to net changes in balance of payments financing needs caused by a relatively broad range of factors beyond a country's control. And since additional funds would be made available within the context of a Fund-supported program, procedures would be in place for monitoring policies and performance. Therefore, the proposed external contingency facility warrants further study by the staff, in particular its potential impact, operational characeristics, and related issues. In this connection, the staff's opening statement on this matter seems to be an excellent starting point. However, my authorities have a number of questions, many of which have been raised by the staff and other Executive Directors. Like others, they have reservations about the inclusion of interest rates in the coverage of the new facility, the degree of compensation, and the associated financing requirement and the effects on the Fund's financial and liquidity position. In addition, I am concerned about distributional aspects of such a scheme, as the Fund would perhaps be perceived as altering its role in the debt strategy in a way that minimizes the role of the banks in the strategy and possibly bails them out. My authorities are also concerned about considerations of moral hazard.

I recognize that the compensatory financing facility has on occasion played a useful role in providing a substantial amount of assistance reasonably rapidly to members facing temporary shortfalls for reasons that are largely beyond their control, and in supplementing amounts available under other arrangements. The external contingency facility alone may have some drawbacks in these cases, hence, it might be appropriate to examine the usefulness of a facility that combines the features of the compensatory financing facility, as amended in the light of today's discussion and the proposed external contingency facility.

Mr. Kyriazidis made the following statement:

I will comment only on the compensatory financing facility. I am not in a position to express views on the external contingency ideas that have been put forward. The two subjects are distinct. The treatment of broader contingencies under Fund-supported adjustment programs should be discussed on its own merits on the basis of a structured proposal supported by appropriate staff analysis and after our authorities have been given sufficient time to study the matter and to formulate concrete views.

The compensatory financing facility has performed satisfactorily in the more than 20 years it has been used by providing essential financial support in a timely and flexible manner to countries experiencing temporary export shortfalls. The temporary and exogenous character of the disturbances that the compensatory financing facility is designed to compensate justify its autonomy from program financing, and, provided that the temporary character of the facility is safeguarded, this autonomy should be preserved if the Fund is to maintain its ability to respond in an appropriate, timely, and flexible manner to members' needs. Moreover, the method of calculation has been sufficiently straightforward to ensure transparency in the utilization of the resources under the compensatory financing facility. For all these reasons, the pitfalls in the use of the compensatory financing facility, particularly the somewhat frequent cases of overcompensation and the conceptual difficulties in applying the formula whenever the export trend is negative, are relatively minor compared to the advantages of the facility. Only relatively small changes are therefore necessary to improve the facility.

The inappropriate access policy and the relatively high conditionality in the lower credit tranche seem to be the root causes of the apparent lack of balance between financing under stand-by arrangements and under the compensatory financing facility. The decreasing use of the facility in the lower tranche and the disproportionately large drawings under the facility in comparison to the corresponding drawings under stand-by arrangements--in four cases, compensatory financing facility drawings exceeded drawings under associated stand-by arrangements--are at odds with the respective functions of the compensatory financing facility and standard program financing. Either member countries consider the conditions of Fund financing excessively burdensome given the current degree of conditionality for the lower tranche, or they prefer to reach broader arrangements with the Fund that provide larger amounts of financial help in a single set of negotiations. In either case, we are facing a somewhat abnormal use of the facility, as the flexibility and speed of the financial assistance by the Fund are being substantially hampered.

The flexibility and speed of drawings under the lower tranche of the compensatory financing facility need to be increased. To this end, it could be appropriate to reduce somewhat the conditionality on the lower tranche of the facility, through a flexible, although certainly not loose, application of the cooperation criterion, and to make it correspondingly more effective in the upper tranche. In this context, access under the lower tranche could be lowered to 40 percent of quota if this would help to increase the speed and flexibility of use of the facility without creating additional risks for the Fund's resources.

As for the upper tranche, more effective conditionality is indeed necessary, particularly when the temporary nature of the disturbances and of the corresponding use of Fund resources appears to be open to question--for example, in the case of a continuous negative trend in exports after the shortfall, or when the shortfall appears not to have been produced by circumstances completely beyond the control of the member. I do not believe, however, that the most effective way of achieving this goal would be to make compensatory financing conditional upon formal approval of stand-by or extended arrangements. Adequate enhanced surveillance arrangements, which are more in line with the nature of the facility, would be more appropriate and effective, or, in some cases, monitoring under a structural adjustment arrangement.

The introduction of phasing would be contrary to the spirit of the facility. As a shortfall has already occurred when compensatory financing is requested, the financing by the Fund should provide relief for the exogenous event as soon as possible, provided that all the preconditions are met. It is incorrect to justify phasing by pointing to the frequency of large compensatory financing facility drawings simultaneously with drawings under a stand-by or structural adjustment arrangement. In fact, these cases apparently call for an adjustment of access policy under these facilities, or simply ensuring the nonsimultaneity of disbursements wherever appropriate. Moreover, phasing is not justified whenever, as in the case of "normal" use of the compensatory financing facility, there are no performance criteria to observe. The compensatory financing facility should maintain the backward-looking character of its financing for countries with payments problems, the solution to which has to be evaluated ex ante.

The current coverage should be maintained, including services, at the discretion of the borrowing member, and I would not in principle favor the introduction of a deductible amount.

As for export trends, I am concerned about the use of the formula in the--rather limited--cases of a negative trend of export receipts after the shortfall. In such cases, as the capacity of the member to repay the Fund comes into question, stricter application of the conditionality requirement should be envisaged.

As for a positive export trend, I do not believe that any ceiling on the calculation of the shortfall would be appropriate in principle. However, as the number of cases of overcompensation is still high, I could consider the introduction of a limit of 20 percent on export growth as proposed by the staff.

Mr. Posthumus made the following statement:

The review of the compensatory financing facility that the staff made shows that the facility has no major or unacceptable shortcomings. The compensatory financing facility should not be a vehicle for contingency clauses. Thus, the best solution would be to decide to leave the compensatory financing facility as it is, without any changes or amendments.

I recognize that there has been criticism of the management of the facility, on the one hand, and that concern has been voiced about risks for the adjustment process on the other. The staff has tried to look into both issues, and their proposal takes those factors into account.

If a majority can be found for the staff proposals, then I am prepared to join in the support for these proposals as a line of defense against possible further efforts to abolish the compensatory financing facility. However, my first and preferred option is to leave the compensatory financing facility as it is. The staff proposals relate only to countries that experience temporary shortfalls in their exports which are superimposed on longer-term payments problems. For all the other countries, as I understand it, there would be no changes in the guidelines. As regards the question which conditions should be fulfilled to draw in the second tranche, I think that the guideline should be that policies might be supported by a stand-by arrangement. As "in principle" approval of an arrangement is not approval, and as there are usually good reasons to wait with the final approval, I do not think that this is sufficient in general.

As regards the three-year rule in the cereal decision, I would support a deletion of this rule. As this leads to almost the same result, the alternative of having a separate cereal facility with an access limit combined with that of the compensatory financing facility seems also acceptable. Although I do not like increasing the number of facilities, after all, a cereal facility already exists more or less.

The discussion about contingency facilities threatens to become separated from the basic approach of the Fund, which is to assist in an orderly adjustment process by providing temporary financing. Economic and other circumstances change, gradually or suddenly. Adjustment is always necessary, and adjustment policies are therefore also always necessary; in discussing new mechanisms we should keep this in mind. I understand a contingency facility to be a facility for drawing upon the Fund if certain well-defined contingencies arise, thus providing a certain automaticity and financing certainty. One could, of course, make the drawing dependent on certain policy conditions, but this undermines the arguments for the special facilities.

I cannot really understand why the United States proposes to replace the compensatory financing facility by another facility, partly on the basis of doubts about the present association of the compensatory financing with effective economic measures and partly on the basis of doubts regarding the present safeguarding of Fund resources, while at the same time proposing a new facility with even more contingency facility elements in it.

And in the text of Mr. Dallara's statement the purpose of the external contingency facility really is to provide additional financing in support of Fund-approved stand-by and other arrangements. Thus, the existing program may be safeguarded, but the additional financing apparently does not require additional adjustment. However, a sudden increase of import prices, for example, requires adjustment, even if there would be additional Fund financing. The staff writes on page 38 that more persistent adverse developments are likely to require redesigning the adjustment program. Are sustained higher interest rates more persistent? Such adjustment is necessary as well because these additional drawings will have to be repaid.

I may misunderstand the intention to some extent. I hope so. But the statement is not fully clear in this respect, and in fact it creates the impression that the external contingency facility is much more helpful in promoting adjustment and reform programs than the compensatory financing facility, while, in fact, according to the U.S. proposal, the external contingency facility needs the same new limitations as the compensatory financing facility.

There are a number of other issues, which I will not dwell upon. One is the basic difference between the compensatory financing facility and contingency facilities, as mentioned by Mrs. Ploix. It is a pity that the Group of Twenty-Four has also mixed these two elements in their recent report, if I may be allowed this mild criticism against one of my authorities. Other questions relate to the interest rate facility, on which Mr. Goos and Mr. Nimatallah made a number of remarks which I support. The problem of interest rates and foreign debts is a part of the debt strategy, which means that debtors and creditors should solve it, case by case. Furthermore, I agree with Mr. Rye that the external contingency facility seems directed at a limited group of countries only.

The issue of contingencies, of course, is a very important one, and the U.S. proposal tries to approach the issue in a comprehensive way. It should be discussed further, and we should also consider it in the framework of stand-by arrangements. However, with Mr. Nimatalah and Mr. Goos, I hesitate to introduce more specific variables.

Mr. Kabbaj made the following statement:

The staff paper tries to examine a number of issues that were raised and concerns that were expressed by Executive Directors during the previous discussion on the experience with the compensatory financing facility. However, it is my understanding that the staff's recommended modifications to the existing guidelines on access to the facility have not taken into account all the issues that were raised by all Executive Directors. It appears that the concerns that were expressed by some Directors, particularly about members' overdue financial obligations to the Fund, the large amount of outstanding use of Fund resources under the compensatory financing facility in relation to an accompanying stand-by arrangement, members' capacity for repayments, and the revolving nature of the Fund's resources, have been the dominant factors in the staff's recommended modifications. The original intention behind, and the nature of, this facility have not been fully taken into consideration.

I welcome this preliminary consideration of the U.S. proposal for strengthening the Fund's role in the debt strategy, which was presented at the 1987 Annual Meetings, and Mr. Dallara's opening statement, which provides further background information. The staff's opening statement on possible broader treatment of external contingencies in Fund-supported adjustment programs raised important and delicate issues and questions for further consideration by the Executive Board. However, at this juncture, the U.S. proposal to create a new external contingency facility, while welcome, should only be discussed in the context of additional Fund financing; the proposed facility should not replace the compensatory financing facility. I also agree that as the compensatory financing facility is important and useful, compensating past shortfalls should remain an essential activity of the Fund and the basic features of the facility should remain unchanged. However, I continue to have an open mind on further consideration of the U.S. proposal as well as of other proposals aimed at improving the effectiveness of the Fund in addressing the problems of its members. Any reduction in access limits, any additional conditionality, and any phasing of disbursements under the compensatory financing facility would run counter to the very emergency nature of this facility. The recent G-24 report on the role of the Fund in adjustment with growth fully covers the facility and stresses that by its very nature, in providing financing for member countries with export shortfalls in the quickest possible time, the facility should be free of conditionality, and the size of the shortfall, rather than the member's quota, should be the basis on which access is determined. The Group of Twenty-Four also calls for the expansion of coverage under the compensatory financing facility to all external sources of disturbances in the balance of payments that are beyond the control of the member's concern. In addition, the report notes the need to extend the repurchase period, which is based on the length of the business cycles of the 1960s, a basis that is no longer applicable.

The modifications suggested by the staff apparently would increase the conditionality on compensatory financing. I wonder whether the proposals to reduce the size of the lower tranche, reduce access available on approval of a stand-by arrangement, and hold in reserve a certain level of access would, as the staff claims, retain "the essential characteristics of the facility and its effectiveness." Therefore, I oppose these proposed modifications.

The actual implementation of the compensatory financing facility by the staff has resulted in sharply lower use of the facility, especially the lower tranche. Outstanding use of the compensatory financing facility declined by about 40 percent between end-1984 and 1987, while the use of credit tranche arrangements declined by 5.5 percent.

This trend is worrying, particularly as the period under review witnessed a sharp decline in commodity prices and a general worsening of economic and financial conditions of developing countries. It is no secret that this outcome is the result of the tightening of effective conditionality and sometimes of the insistence on the inclusion of a stand-by arrangement that discouraged many members from using the compensatory financing facility.

I favor the full implementation of the guidelines that the Executive Board laboriously crafted in 1983, including the characteristics attached to the lower tranche of 50 percent of quota. These guidelines explicitly state that the existence of an arrangement is not a necessary condition for the use of the compensatory financing facility. Therefore, drawings under the facility should be treated separately from purchases under other arrangements that are designed solely to address members' balance of payments problems arising from structural imbalances.

I strongly believe that access under the facility should be determined by the magnitude of the export shortfalls in order to provide adequate financing to help countries implement their programs in an orderly fashion. This access would prevent countries resorting to undue restrictions on current international payments, including imports necessary for growth-oriented adjustment programs. Members' overdue financial obligations to the Fund, which are concentrated in a small number of countries, and other related issues should not be overemphasized and should not be determining factors in limiting members' actual access.

As to phasing, a drawing under the compensatory financing facility should take place as soon as the requirements are met and the request is approved. In this connection, the argument made by some Executive Directors concerning the possible weakening of adjustment efforts under stand-by or extended arrangements by member countries that have immediate and relatively large access to the resources of the compensatory financing facility is not convincing. Indeed, based on available data, members using the facility have, on average, not allowed their adjustment efforts to weaken relative to the efforts of those members that did not have recourse to the facility. As the staff has stated, in some cases, disbursement at an early stage has in fact reinforced the incentive to adjust and has increased the ability of members to take prior actions.

Despite the further improvement in the world food situation, the cereal decision should continue to serve its accommodative role in providing balance of payments assistance to member countries facing increases in the cost of their imports. Further flexibility in the provisions of the decision--for example, the establishment of a separate facility or the reconsideration of the three-year rule--would strengthen the usefulness of this important decision.

While I strongly support Mrs. Ploix's proposal to give less developed countries access to the compensatory financing facility on concessional terms, all developed countries should provide the estimated amounts needed for the operation of both the subsidy on the rate of charge and the lengthening of the repurchase period.

Mr. Dallara noted that a fundamental question that had been raised by a number of speakers was whether the facility that had been proposed by Secretary Baker was conceptually distinct from or related to the compensatory financing facility. Both the present facility and the new facility were clearly designed to address shortfalls in export earnings caused by exogenous circumstances in a manner that would avoid undermining the efforts of the countries concerned to achieve their economic objectives. It was, of course, true that the compensatory financing facility was ex post in its approach, while the proposed facility would be more forward looking, but there were nevertheless some conceptual relationships between the two. In that connection, Mr. de Groote's comments had usefully shown how the present and the proposed facilities went in the same direction, even though each approached the problem of export shortfalls from different perspectives. The external contingency facility proposed by Secretary Baker was a much broader approach than the compensatory financing facility, but it certainly encompassed the objectives of the existing compensatory financing facility.

Inherent in the ex post versus ex ante approach was the question of timeliness, and he was struck by the emphasis that Mr. Abdallah had placed on that question, Mr. Dallara continued. In that connection, the main issue was how to gauge timeliness. Comparing disbursements under an external contingency facility, which would be made over the course of a program period, with the disbursements under the compensatory financing facility, which were made at the outset of a program period, it was perhaps natural to think that the financing under the proposed facility might be less timely. However, if the question was whether or not the Fund was in a position to respond in a timely manner to adverse exogenous developments soon after they occurred, then the answer was clearly in favor of the U.S. proposal: the average lag between the occurrence of a shortfall and a disbursement under the compensatory financing facility was about 11 months, while the lag between an adverse exogenous development and the occurrence of a net financing need under the U.S. proposal would be in the range of 3-5 months. Accordingly, the U.S. proposal would clearly provide for an improvement in the Fund's ability to respond in a timely manner. There might, understandably, be some concern about the timeliness of assistance as a new approach was phased in, but the U.S. proposal took that problem into account by including certain transitional features.

There had been considerable discussion on conditionality, Mr. Dallara recalled, and the present occasion was not the appropriate one on which to conduct a full-scale examination of that matter. As Mr. Sengupta's comments suggested, the Executive Directors who were concerned about conditionality were not opposed to conditionality per se, but thought that the issue at hand was the appropriate conditionality for the financing concerned. That question arose in the context of access to any facility. Viewing even part of the existing compensatory financing facility or a new facility as warranting only minimal conditionality would run a serious risk with respect to the Executive Board's responsibilities under the Articles.

As some Executive Directors had said, there was no persuasive evidence of the existence of a link between disbursements under the compensatory financing facility and the problem of overdue financial obligations, Mr. Dallara commented. However, there was clearly persuasive evidence that the Executive Board had failed in its responsibility to safeguard the use of the Fund's resources. The Executive Board had been unable to deal effectively with the arrears problem in an ex post fashion. That failure was evident during the recent discussion on Sudan's arrears, when the Executive Board had agreed not to hold the next review of Sudan's arrears for six months, even though Sudan continued to have more arrears than any other member country and the authorities were making aggressive efforts to deal with the problem. The only logical approach to the arrears problem was an ex ante one. To that end, the Executive Board must look at the broad range of Fund policies, not exclusively those governing the compensatory financing facility. At the same time, the compensatory financing facility certainly should be taken into account at an early stage of any investigation of how Fund policies might need to be strengthened in order to deal with the arrears problem.

Another issue was the comparison between the short-run and long-run costs and benefits of possible financing schemes, Mr. Dallara said. Some Executive Directors were understandably concerned about a strengthening of conditionality under either the compensatory financing facility or an external contingency facility because they felt that the strengthened conditionality would have a negative effect over time on member countries that used the Fund's resources. However, in his view, whatever flexibility might be lost under such a change would be more than offset by the potential soundness of the policies of the countries concerned. For example, his authorities' approach to the indicators exercise was based on their view that greater discipline in policy formulation and implementation was needed by all member countries; the same approaches seemed applicable to possible compensatory financing mechanisms.

He was not opposed to the possibility of limited use of the external contingency facility without a stand-by, extended, or structural adjustment arrangement in selected cases in which member countries had payments problems owing to temporary circumstances beyond their control, but in other respects had a satisfactory payments situation, Mr. Dallara continued. That possibility was clearly worth considering further, although the circumstances in which such a possibility would be appropriate would have to be carefully circumscribed.

A number of Executive Directors had understandably raised the issue of moral hazard, Mr. Dallara noted. The moral hazard effect of the use of a new facility or the existing compensatory financing facility would be a function of the extent to which compensation would be provided for factors that were within or beyond the control of the member country concerned. The potential moral hazard that a member country using the Fund's resources might feel less need for adjustment would depend on the extent to which compensation under the external contingency facility or the compensatory financing facility covered developments which were clearly exogenous. The financing would clearly be provided in response to circumstances that were truly beyond the control of the member country. Also, as he had noted in his opening statement, at the time of a review of a program under the external contingency facility, agreement could be reached on any additional policy measures that might be needed to preserve the program's viability. As a result, there would be no cases in which additional financing would be provided but no additional adjustment would be made by the country receiving the resources.

More thought should be given to possible ways of building symmetry into adjustments in the amounts of financing provided under the external contingency financing facility as economic circumstances changed during the course of a program, Mr. Dallara said. His authorities had already considered the possibility that the reserve target under a program could be adjusted upward in response to net exogenous positive developments in the balance of payments. At the same time, caution was required in dealing with the problem of symmetry; going very far to deal with that problem would not be practical.

It had been suggested that the U.S. proposal would further strengthen the Fund's orientation toward responding to the debt crisis, rather than to member countries' overall balance of payments needs, Mr. Dallara remarked. That outcome was certainly not his authorities' intention. It was of course true that the external contingency facility would provide some, carefully gauged compensation for interest rate developments. At the same time, his authorities had also clearly indicated their willingness to see import price developments, natural disasters, and the effects on export markets of protectionist policies of trading partners be taken into account. While the approach might respond particularly to aspects of the debt crisis, that was inevitable, given the realities of the payments problems of the 1980s.

The U.S. proposal was not intended in any way to exclude or discriminate against any member country or group of members, Mr. Dallara stated. Each request for assistance must be evaluated on a case-by-case basis and on its own merits in the context of the provisions of the new facility.

Given his authorities' basic views on the role of the Fund and on its limited resource base, Mr. Dallara said, his authorities would reflect on the comments and concerns expressed at the Board meeting. He hoped that the innovations suggested by the United States in the form of the proposed facility, modest as some might view them to be, would not be lost in an effort to preserve approaches that might no longer be valid.

Mr. Nimatallah said that most of the points that Mr. Dallara had made were sensible but only in the context of a combination of the U.S. proposal with the existing compensatory financing facility. It was still not clear to him why Mr. Dallara insisted on replacing the compensatory financing facility. There was an element of complementarity between the U.S. proposal and the existing facility.

He hoped that during the ongoing review of the compensatory financing facility member countries would be able to continue to use the facility, Mr. Nimatallah commented. As he understood it, the staff had discouraged Gabon from using the facility on the ground that the facility was being reviewed. There should be no delays in reviewing requests for compensatory financing while the facility was being reviewed by the Executive Board.

Mrs. Ploix said that she agreed with Mr. Nimatallah that the proposed external contingency facility and the existing compensatory financing facility were not mutually exclusive. Most speakers had clearly stated that the existing and proposed facilities addressed problems at different stages in member countries' relations with the Fund and at different stages in the countries' adjustment programs. The two facilities could be complementary.

The Executive Directors agreed to continue their discussion on November 18, 1987.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/155 (11/16/87) and EBM/87/156 (11/17/87).

3. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND GUIDANCE

The Executive Board approves the recommendation by the Committee on Liaison with the CONTRACTING PARTIES to the GATT with regard to the guidance statements for the Fund representative attending the GATT consultations with Brazil and Korea in the week beginning November 23, 1987, as set forth in EBD/87/278, Supplement 1 (11/13/87).

Decision No. 8730-(87/156), adopted
November 17, 1987

4. SUDAN - RELEASE OF INFORMATION

The Executive Board approves the release of the staff report on the formulation and implementation of the Sudanese Government's Program of Action (EBS/87/232, 11/11/87) to participants in the Consultative Group meeting to be held in Paris on December 2, 1987, as set forth in EBD/87/295 (11/13/87).

Adopted November 16, 1987

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/247 (11/13/87) is approved.

APPROVED: July 12, 1988

LEO VAN HOUTVEN
Secretary

Table. Compensatory Financing Facility Review Paper (EBS/87/165):
Summary of Executive Directors' Comments at EBM/87/37

EBS/87/165				Position Taken by Executive Directors (EBM/87/37)			
				In agreement		Opposed	
Page	Paragraph Number	General Topic	Covered in MD's Summing Up	Number	Voting power	Number	Voting power
1	2	Welcome link of CFF with upper tranche stand-by arrangements	Yes	7	44.8	12	39.0
1	2	Policies needed to ensure better safeguard for Fund resources	Yes	7	46.8		
1	2	Revolving character of Fund resources overemphasized to detriment of timely use of CFF	Yes	11	34.5		
2	5	Cooperation guidelines do not safeguard Fund resources, particularly where debt service capacity already strained	Yes	6	41.3		
2	6	Phased access appropriate in some circumstances to reinforce adjustment	Yes	7	44.8	11	32.2
3	1	To ensure stabilizing role, CF dispursement should be timely, and not phased.	Yes	12	39.1		
3	1	In favor of allowing CF purchase where stand-by approved in principle only	Yes	5	17.6		
3	1	Access limits inadequate	Yes	7	19.9	2	24.9
3	1	Suggestion to reduce lower tranche and its conditionality		1	4.3		
3	1	Need for greater use of CFF in today's environment	Yes	6	19.7		
16	1	Certain export profiles not in spirit of CFF, but shortfall compensible under current formula	Yes	6	40.5	6	21.0
16	2	Suggestion to limit compensation when there was positive export growth from preshortfall years to shortfall years and rapid post-shortfall growth was forecast		3	28.5		
16	3	Troubled by projection errors		7	29.7	3	11.8
16	4	Compensation for declining trend appropriate when caused by protectionist policies		2	4.8		
26	2	Generalized early repurchase for overcompensation not practical	Yes	5	14.5	4	16.9
26	2	No objection to adjusting for overcompensation in successive purchases		3	12.3		
32	2	Favor a deduction for that part of a shortfall deemed to be within the member's control		3	12.6	5	16.4
32	2	In assessing "beyond the control" current procedures adequate	Yes	9	33.9		
32	4	Concern over not accounting for import content of exports		1	6.6		
33	4	Study Ploix proposal	Yes	7	26.4	2	10.1
37	1	Against use of CFF for contingency purposes		11	37.1	3	26.0