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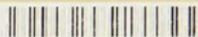
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Friedman UNCTAD Files - Geneva Meeting /  
IMF Compensatory Financing

Feb. 1967

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Irving Friedman UNCTAD Files: Geneva Meeting on Supplementary Finance February  
1967 - IMF compensatory financing

INTERNATIONAL BANK FOR  
RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT  
ASSOCIATION

INTERNATIONAL FINANCE  
CORPORATION

This is alright

N. A. Serrano

- 2/2

Mr. Friedman



# Office Memorandum

*Dr. Sarma*

TO : Mr. J. J. Polak

FROM : R. R. Rhombert *RRR*

SUBJECT : Draft Note on Effect of the Compensatory Financing Facility  
on the Cost of the Supplementary Financing Scheme

DATE: February 1, 1967

I attach a first draft for a reply in response to a request by the Intergovernmental Group on Supplementary Financing to provide an assessment of the effects of recent changes in the Fund's compensatory financing facility on the annual cost of the Supplementary Financing Scheme.

Before his departure, Mr. Fleming left a draft of the first section of this note, and after receipt of the requisite data from the IBRD the remaining portion of this note was drafted. Mr. Fleming had expressed a hope that it would be possible to forward this note to Mr. Sidney Dell in time to be used at the forthcoming meeting of the Intergovernmental Group which Mr. Fleming will be attending.

Attachment

cc: Mr. Fleming  
Mr. Nicoletopoulos  
Mr. Finch  
Mr. Maccone  
Mr. Sarma

Effects of Recent Changes in the Fund's Compensatory Financing Facility on the Annual Cost of the Supplementary Financing Scheme

Prepared by the Staff

February , 1967

The estimates contained in the present note have been prepared in response to a request put forward at the first meeting of the Intergovernmental Group on Supplementary Financing to provide an assessment of the effects of recent changes in the Fund's compensatory financing facility on the annual cost of the Supplementary Financing Scheme.

The question to which this note attempts to provide an answer was formulated on the assumption that the nature of the Fund's compensatory financing facility would not be affected by the coming into existence of a Supplementary Financing Scheme. It seems necessary to preface this note with the warning that this assumption cannot in fact be taken for granted.

The principal changes made in the Fund's compensatory financing facility in its recent revision are as follows:

1. The over-all limit on compensatory financing drawings outstanding was extended from 25 per cent of quota to 50 per cent of quota, subject however to a maximum annual increase in such drawings outstanding of 25 per cent of quota.
2. The method of estimating the trend value from which export shortfalls are calculated was changed so as to give a greater weight to the qualitative estimate (market-analysis forecasts) and less to the statistical formula, which gives weights of 50 per cent to the exports of the shortfall year and 25 per cent to the exports of each of the two preceding years; the qualitative estimate itself, however, is now subject to certain limits set out on page 8 of the report Compensatory Financing of Export Fluctuations: A Second Report by the International Monetary Fund.

3. While compensatory drawings continue to be repayable in the fourth and fifth years following the drawing, the Fund recommends that 50 per cent of any export excess occurring in the first four years after a compensatory drawing should be devoted to its repayment.

The facility contains, in both its original and its revised form, a number of qualitative elements, such as that members of the Fund cannot use the facility unless they have a balance of payments need to do so, that any shortfall compensated has to be largely attributable to circumstances beyond the control of the member, that compensation will occur only if the member is prepared to cooperate with the Fund in an effort to find appropriate solutions for its balance of payments difficulties, and that compensatory drawings will only take place if the member chooses to ask for them. In particular, it was assumed that:

- (a) all members having a shortfall will seek a compensatory drawing and will be eligible for compensation;
- (b) compensation will not be reduced to avoid double compensation arising from any drawing under the Fund's regular tranche policy within a 12-month period prior to the date of the compensatory drawing in question;
- (c) the limit on the increase in outstanding drawings by 25 per cent of quota in any 12-month period, which may be waived in the case of shortfalls resulting from disasters and major emergencies, will hold in all cases;
- (d) all members will comply with the recommendation on repayment out of excess exports rather than postpone repurchases until the fourth and fifth year of the drawing.

One of the most important of the arbitrary assumptions made relates to the manner in which account is taken of the role of qualitative estimates in the determination of the norm with respect to which shortfalls are calculated. In calculating the effects of Fund compensatory drawings under the original facility, the Bank staff had worked on the assumption that the trend value in question would be based exclusively on the statistical

formula giving weights of 50 per cent to exports in the current year and 25 per cent to the exports of each of the two preceding years. Under the new facility, which lays greater emphasis on qualitative market appraisal, this assumption would seem to be unsuitable. It has been assumed, instead, that the trend value would lie halfway between the norm calculated in accordance with the statistical formula just mentioned and the five-year moving average of exports centered on the shortfall year, subject to the limits stated in the Fund report on page 8. In other words, it has been assumed that the trend value would be based partly on a correct anticipation of exports in the two years following the shortfall year and partly on the formula based on existing statistical data.

The estimate by the Bank staff of the average annual cost of the Supplementary Financing Scheme was made by averaging the results of computations for two samples of developing countries, both adjusted to a global basis. One sample consists of 14 countries for the period 1957-63 and the other of 18 countries for the period 1959-63. It was concluded that the combined effect of the Fund's old compensatory facility and the application of the overages of the Scheme to repay Scheme lendings was to reduce the average annual cost of the Scheme by about \$400 million.

In arriving at this estimate, the Bank staff had assumed that Fund drawings under the compensatory facility in years of Scheme shortfalls reduce the cost of the Scheme, but that repayment of these drawings neither increases the cost of the Scheme in years in which there are Scheme shortfalls nor reduces the overages available for repayment to the Scheme in years in which there are Scheme overages. Table 1 compares cost savings calculated on this basis (Basis A) resulting from compensatory drawings under the old and the new Fund facility. The average annual cost reduction resulting from Fund drawings would have been \$90 million if the old Fund facility had been in existence during the sample years and \$148 million if the new Fund facility had been in existence during this period. The net saving to the

Table 1. Hypothetical Reduction in Average Annual Cost of the Supplementary Financing Scheme Resulting from the Fund's Compensatory Financing Facility and Scheme Overages

(In millions of U.S. dollars)

	Old Fund Facility (1)	New Fund Facility (2)	Difference (2) - (1) (3)
<u>Cost reduction through Fund facility</u>			
Basis A (drawings only)	90	148	58
Basis B (drawings and repayments)	70	86	16
<u>Cost reduction through Fund facility and Scheme overages</u>			
Basis A (drawings only)	399	457	58
Basis B (drawings and repayments)	379	395	16

Scheme resulting from the revision of the Fund facility would, therefore, have been \$58 million. This saving would increase the average annual cost reduction resulting from the use of the Fund facility and of Scheme overages from \$399 million on the basis of the old Fund facility to \$457 million on the basis of the new Fund facility.

Since the original computations made by the Bank staff were reported in the Bank's study Supplementary Financial Measures, it has been suggested that a realistic assessment of the possible reduction of the cost of the Scheme through use of the Fund's compensatory financing facility should take account not only of compensatory drawings from the Fund but also of the associated repayments to the Fund. The results shown under Basis B in Table 1 are computed on the assumption that repayments of compensatory drawings that would have occurred in years of Scheme shortfalls increase the cost of the

Scheme (in years of Scheme shortfalls) or reduce the overages available for repayment to the Scheme (in years of Scheme overages). Fund drawings that would have occurred in years when there was no Scheme shortfall, and the associated repayments, are left out of account, since such drawings would not have reduced the cost of the Scheme. On this assumption, the cost reduction through the old Fund facility is \$70 million and that achieved through the new Fund facility is \$86 million. The additional cost reduction resulting from the change in the Fund facility is \$16 million.

On Basis B the reduction of the cost of the Scheme resulting from use of the Fund's compensatory facility and the application of Scheme overages, taken together, is \$379 million with the old Fund facility and \$395 million under new Fund facility.

The computations reported on Basis B would appear to give more realistic estimates of the cost reduction available through the compensatory facility of the Fund than do those reported on Basis A. As Table 1 shows, it turns out by coincidence that the effect on the cost of the Scheme of the expansion of the Fund's facility described earlier in this note is almost exactly offset by the effect of having taken account of repayments of compensatory drawings. The best estimate of the reduction in average annual cost of the Supplementary Financing Scheme resulting from use of the new Fund facility and the application of Scheme overages is, therefore, still approximately \$400 million, i.e., equal to the estimate reported in Supplementary Financial Measures.

It should be noted that this estimate is based on the assumption that member's access to the Fund's compensatory facility was intact at the beginning of the sample period, 1957 or 1959. If it had been assumed instead that the Fund's facility had been in existence for some years preceding the beginning of the sample periods, some of the countries included in the samples would have had compensatory drawings outstanding in 1957 or 1959, and their further access to compensatory drawings would have been reduced. On this assumption, the cost saving to the Scheme resulting from the compensatory facility would have been less than that reported in Table 1. This consideration

is relevant because, if the Supplementary Financing Scheme came into effect sometime in the future, the Fund's compensatory facility will in fact have been in existence for some time and some of the countries eligible for supplementary financial assistance would<sup>then</sup> be likely to have outstanding compensatory drawings. It is difficult, however, to make an appropriate allowance for this fact in the computations reported here for three reasons: First, since the date at which the Supplementary Financing Scheme may come into effect is not known, it is not possible to say for how many years the new Fund facility will then have been in existence; the computations would have been very complicated if it had to be assumed that for some past years the old Fund facility had been in existence and for the remaining years preceding the hypothetical introduction of the Scheme in 1957 or 1959 the new Fund facility had been in existence. Second, even though the Fund's facility has now been in existence for over three years, only one of the countries included in the sample used by the Bank staff for these computations has in fact made a compensatory drawing; it is not clear therefore that all of the sample countries that could have drawn should be assumed to have outstanding drawings at the time of the possible introduction of the Supplementary Financing Scheme. Third, in the Fund's computations of hypothetical drawings the outstanding drawings of primary producing countries are very high at the beginning of 1959 (in contrast to the amounts outstanding in the beginning of 1957) because of the large drawings made under these hypothetical computations in 1958, which was a peak shortfall year under the Fund's definition of shortfall; it is uncertain what should be appropriately assumed about the incidence of shortfalls in the years just preceding the introduction of the Supplementary Financing Scheme at an uncertain future date. For these reasons, it is thought advisable not to give a quantitative estimate of the reduction in the cost savings through the Fund's facility on the assumption that the Fund's compensatory financing scheme had been in existence before the beginning of the sample periods chosen for the Bank study. It must be anticipated, however, that as a result of this factor the cost saving afforded by the Fund's compensatory facility would be somewhat lower than that estimated in this note.

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

DATE: January 20, 1967

FROM: N. A. Sarma

*Sarma*SUBJECT: Supplementary Finance: Effect of Changes in Compensatory Facility

On the basis of past data for certain countries received from Mr. Fleming, Mr. Gassner has worked out the impact of Fund's CFF on the Scheme's cost, on alternative assumptions regarding use of overages. We have discussed this with Mr. Macone. We would like to have a word with you before we give any of these estimates to Mr. Fleming.

## OFFICE MEMORANDUM

TO: Mr. J. Marcus Fleming

DATE: January 11, 1967

FROM: N. A. Sarma

SUBJECT: Compensatory Financing Facility of the Fund: Proposals for Supplementary  
Financial Measures

Attached hereto is a brief note, for discussion, about which  
I had mentioned to you.

For info, please.

I have just sent this to Mr. Fleming.

N. A. Sarma  
- 1/4

Mr. Friedman

COMPENSATORY FINANCING FACILITY OF THE FUND:  
PROPOSALS FOR SUPPLEMENTARY FINANCIAL MEASURES

1. The Compensatory Financing Facility of the Fund is designed to compensate for temporary shortfalls in export receipts, particularly for primary producing countries. Drawings under this facility can be made up to a limit of 50% of a member's quota, provided that net drawings do not normally exceed 25% of quota in a twelve-month period. Like other Fund drawings, repayments are to be made within five years. Thus, under the Compensatory Financing Facility, as in other Fund operations, the revolving nature of Fund resources is assured. Drawings under the Compensatory Financing Facility are virtually automatic. In addition, for purposes of this Facility, the Fund is prepared to waive the requirement that total outstanding drawings may not exceed Fund holdings of a member's currency beyond 200% of quota.

2. The assistance that a member country obtains from the Fund under this Facility is of short-term duration, like the assistance obtained through regular drawings. It also helps to meet temporary and reversible balance of payments deficits, and fully accords with the use of all Fund resources.

3. The Supplementary Finance Scheme is designed to help avoid the disruption of well-conceived development programs which have commanded international support for their financing, when this disruption could potentially be caused by a lack of foreign exchange due to an unexpected export shortfall. Thus, supplementary finance is viewed as part of basic

development finance, though this particular assistance becomes available when an unexpected shortfall in exports occurs. The terms suggested for supplementary financial assistance are consequently similar to those appropriate for the financing of long-term investments. A basic feature of the Scheme is a "Policy Package", that is, an agreement between the agency administering the Scheme and a member country, about the development program to be undertaken by the country and a set of basic development policies which are objectively regarded as appropriate by the international community.

4. A matter of special importance in this Policy Package is the set of policies which a country intends to pursue in connection with its exports. Another element of the Policy Package that has to be a part of the initial understanding is the set of monetary and financial policies of the developing country, as these would affect the development program itself, the mobilization of domestic resources for the program, and the balance of payments. In reaching an understanding with a member country, the Agency could avail itself of the experience and advice of the International Monetary Fund and the World Bank on matters falling within their respective fields of responsibilities.

5. The Fund's Compensatory Financing Facility and the proposed supplementary financial measures deal with related aspects of a basic problem faced by LDC's - that is, the volatility and uncertainty of their exports. As such, the two facilities would supplement each other. The Compensatory Financing Facility is designed to deal with instability of exports - the year to year fluctuations in export receipts. The Supple-

mentary Finance Scheme is not an equilibrating device but is concerned with unexpected and unfavorable changes in exports from reasonable expectations. This is reflected in the methodology of export projections. The Compensatory Financing Facility tries to estimate a trend value, based on past experience, centered on the current shortfall year, and projections for two future years. Supplementary Financing Scheme tries to estimate future export eventualities over a planning period on which a developing country can rely for making its development plans.

6. The main difference between the two is in the purpose; the Fund Facility seeks to assist a country in meeting a temporary balance of payments deficit, and the assistance provided is of short duration. The Supplementary Finance Scheme, on the other hand, is intended to help a beneficiary country to maintain the growth process by making good the loss of foreign exchange from an unexpected export shortfall, and the assistance to a country under this scheme becomes part of general development finance, and long term.

*Smith - Mrs. Santos*

## OFFICE MEMORANDUM

TO: ~~Mr. Irving S. Friedman~~

DATE: January 19, 1967

FROM: N. A. Sarma

*Sarma*SUBJECT: Compensatory Financing Facility: Proposals for Supplementary Financial Measures

Herewith a comment from Mr. Marcus Fleming on the note I had sent to him earlier.

*What next?*

*Herein, preliminary draft, please, for your immediate use.  
(Previous pp also are below)  
Mr. Friedman  
Sarma, 1/24*

1. Our viewpoint is that the two facilities deal with related aspects of a basic problem faced by LDC's - that is, the volatility and uncertainty of their exports, and that the two facilities would supplement each other. As for the policy package, insofar as the role of the Fund is concerned, our approach continues to be as stated in Fund document SM/66/95, and quoted by Mr. Fleming. However, so long as the possibility exists of another agency, outside the Fund and the Bank, administering the Scheme, we can only say, as I did in my note: "In reaching an understanding with a member country, the agency could avail itself of the experience and advice of the International Monetary Fund and the World Bank on matters falling within their respective fields of responsibilities."

2. Mr. Fleming takes the view (contrary to ours) that the two are competitive, rather than complementary, and that it would be extremely difficult if not impossible to negotiate the relevant policy package provisions. As I understand his position, Mr. Fleming sees little possibility of Bank-Fund understanding on this matter.

3. If Mr. Fleming should take this position at the forthcoming Intergovernmental Group meeting, we would have to state that in our view the two facilities have their respective, useful, functions to the benefit of LDC's, that it is feasible as well as necessary to proceed with setting up the Supplementary Finance Scheme if the purpose of the UNCTAD resolution is to be served. In other words, the Bank Study concurs with the UNCTAD view that there is a real need for supplementary financing: this is the substance of the matter on which the Fund has so far not taken a view.

4. Does the recent enlargement of the Fund facility affect the position? It would seem that the Fund facility may be expected to provide to meet export shortfalls covered under the Supplementary Finance Scheme about \$75 million a year more than before the revision of the Fund facility. Essentially, the need for Supplementary Finance Scheme remains.



# Office Memorandum

*origin of default is  
development program -  
dys - SFS -  
yhat - MF -  
DATE: January 18, 1967*

TO : Mr. Sarma  
FROM : J. Marcus Fleming *JMF*  
SUBJECT : Compensatory Financing Facility:  
Proposals for Supplementary Financial Measures

Thank you for your note of January 11. I am sorry that I have only recently been able to see it, and that I shall be leaving again for London almost immediately, so that I have to comment rather hastily and on a purely personal basis.

My feeling is that while the supplementary financing scheme and the compensatory financing facility have to some extent different purposes, these purposes are not in such different fields that they can be regarded as complementary rather than competitive. The Fund, in compensating short- to medium-term fluctuations, is in fact trying to enable countries to maintain their economic activity including their economic development on a more or less even keel. The supplementary financing scheme also has its short-term compensatory aspect in the offsetting of shortfalls and overages within the planning period. The difference is that its object is to enable a country to fulfil an investment plan based on what at the beginning of the planning period were reasonable expectations. In other words, whereas the Fund scheme is aiming at continuous adjustment of everything including development, the supplementary financing scheme is conceived in terms of discontinuous revision of plans. Quite apart from the differences of objective is the technical difficulty of including reasonable and workable provisions regarding balance of payments policies in a policy package which is negotiated far in advance of the situation to which these policies relate. Incidentally, I notice that the phrase you use about the initial agreement with member countries, namely that the Agency "could avail itself of the experience and advice of the International Monetary Fund" falls quite a bit short of what had been our understanding of the Bank staff's position and was quoted on page 9 of Fund document SM/66/95 to the effect that: "It is understood that the Bank staff, being aware that quantitative precision in such matters could not be achieved over a five-year period, had envisaged, in making their proposals, that the initial policy package might include undertakings on the part of the country concerned to follow such recommendations as the Fund might make in subsequent years in consultation with that country with respect to exchange policies and internal financial policies, provided that these were compatible with the objective of maintaining the development program as originally agreed." I personally have always felt that it would be extremely difficult, if not impossible, to negotiate such provisions in a policy package, and I think that your own more cautious language is perhaps a recognition of this.

*① ?  
not really*

*not really  
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*(A)  
kill on  
part*

*① Further activity Bank try to maintain a good development program (1) amount  
4 items  
② money off  
5 items  
③ plan - project  
two good  
④ policy package -*

Mr. J. Marcus Fleming

January 11, 1967

N. A. Sarma

Compensatory Financing Facility of the Fund: Proposals for Supplementary  
Financial Measures

Attached hereto is a brief note, for discussion, about which  
I had mentioned to you.

COMPENSATORY FINANCING FACILITY OF THE FUND:

PROPOSALS FOR SUPPLEMENTARY FINANCIAL MEASURES

1. The Compensatory Financing Facility of the Fund is designed to compensate for temporary shortfalls in export receipts, particularly for primary producing countries. Drawings under this facility can be made up to a limit of 50% of a member's quota, provided that net drawings do not normally exceed 25% of quota in a twelve-month period. Like other Fund drawings, repayments are to be made within five years. Thus, under The Compensatory Financing Facility, as in other Fund operations, the revolving nature of Fund resources is assured. Drawings under the Compensatory Financing Facility are virtually automatic. In addition, for purposes of this Facility, the Fund is prepared to waive the requirement that total outstanding drawings may not exceed Fund holdings of a member's currency beyond 200% of quota.

2. The assistance that a member country obtains from the Fund under this Facility is of short-term duration, like the assistance obtained through regular drawings. It also helps to meet temporary and reversible balance of payments deficits, and fully accords with the use of all Fund resources.

3. The Supplementary Finance Scheme is designed to help avoid the disruption of well-conceived development programs which have commanded international support for their financing, when this disruption could potentially be caused by a lack of foreign exchange due to an unexpected export shortfall. Thus, supplementary finance is viewed as part of basic

development finance, though this particular assistance becomes available when an unexpected shortfall in exports occurs. The terms suggested for supplementary financial assistance are consequently similar to those appropriate for the financing of long-term investments. A basic feature of the Scheme is a "Policy Package", that is, an agreement between the agency administering the Scheme and a member country, about the development program to be undertaken by the country and a set of basic development policies which are objectively regarded as appropriate by the international community.

4. A matter of special importance in this Policy Package is the set of policies which a country intends to pursue in connection with its exports. Another element of the Policy Package that has to be a part of the initial understanding is the set of monetary and financial policies of the developing country, as these would affect the development program itself, the mobilization of domestic resources for the program, and the balance of payments. In reaching an understanding with a member country, the Agency could avail itself of the experience and advice of the International Monetary Fund and the World Bank on matters falling within their respective fields of responsibilities.

5. The Fund's Compensatory Financing Facility and the proposed supplementary financial measures deal with related aspects of a basic problem faced by LDC's - that is, the volatility and uncertainty of their exports. As such, the two facilities would supplement each other. The Compensatory Financing Facility is designed to deal with instability of exports - the year to year fluctuations in export receipts. The Supple-

mentary Finance Scheme is not an equilibrating device but is concerned with unexpected and unfavorable changes in exports from reasonable expectations. This is reflected in the methodology of export projections. The Compensatory Financing Facility tries to estimate a trend value, based on past experience, centered on the current shortfall year, and projections for two future years. Supplementary Financing Scheme tries to estimate future export eventualities over a planning period on which a developing country can rely for making its development plans.

6. The main difference between the two is in the purpose; the Fund Facility seeks to assist a country in meeting a temporary balance of payments deficit, and the assistance provided is of short duration. The Supplementary Finance Scheme, on the other hand, is intended to help a beneficiary country to maintain the growth process by making good the loss of foreign exchange from an unexpected export shortfall, and the assistance to a country under this scheme becomes part of general development finance, and long term.

SFS/7nd

## OFFICE MEMORANDUM

TO: Files

DATE: November 21, 1966

FROM: Bimal Jalan *BJ*SUBJECT: Lunch with Mr. Southard, et. al.

1. Messrs. Friedman, Kamarck, Frank and Jalan had lunch with Messrs. Southard, Fleming, Finch and Nicoletopoulous to talk over some of the issues pertaining to the Scheme on Supplementary Finance.

2. The central issue was whether the Fund considered the Scheme an acceptable one or not - what was the attitude of the Fund towards the Scheme and what role the Fund envisaged itself playing in the further discussions on the Scheme? Mr. Southard said that the Fund found itself in a difficult "intellectual-political" position. The proposed Scheme impinged on matters which were of considerable concern to the Fund; but the Fund had a number of conceptual difficulties with the Scheme as formulated by the Bank Staff. For example, the idea of underwriting "trade balances" on the basis of export projections was not very attractive to the Fund. The Scheme was only a partial one since it looked only at the export picture - the Fund in making judgments about the need for assistance to a country considered the entire balance of payments position. The Fund felt that there were a number of ways, which already existed, in which assistance could be provided to countries experiencing export shortfalls. There was the IMF assistance as also bilateral emergency assistance. The Supplementary Finance Scheme, moreover, does not seem to have a very high priority if one considers the multitude of problems that yet remain to be tackled e.g., food and agricultural problem. Mr. Southard felt that a Scheme for Supplementary Finance, given all the other competing claims, did not have much chance of coming into existence in the near future.

3. With these considerations in the background, the Fund found it very difficult to decide what its attitude to the Scheme ought to be - it was still groping for answers to many of these questions. It did not want to "rock the boat", but it could not take an active role in proposing suitable modifications of the Scheme because then the Board would have to be involved in a very intimate way in discussing the Scheme which was being handled outside the Fund. So, for the moment the Fund would wait and see how discussion evolved in the UNCTAD. It would, of course, cooperate with the UNCTAD to the extent possible, for example, by providing any technical material that they might ask for Mr. Southard, however, did not think it will be possible to write a joint paper with the Bank on Bank-Fund collaboration. It was difficult to indicate precisely the amount of funds that could be available to meet shortfalls from the Fund facility if and when the Scheme came into existence, since it could not be assumed that in that event the Fund facility would remain unaltered. Mr. Fleming was, however, trying to put some data together which might help to arrive at some sort of an estimate.

4. Mr. Frank suggested that, in taking a view on the Scheme, it was important to have in mind the origins of this proposal. The Bank was not the originator of this idea, it worked out a feasible Scheme to solve a problem that the countries of the world - covering almost the entire membership of the Fund and the Bank - wanted tackled. So the question of priorities between different claims should not really be a consideration, this is something that the countries have come out in favor of doing, and the Bank has suggested a way of doing it consistent with long-term developmental ends. Mr. Southard said that, granting that UNCTAD wanted something to be done along these lines, he would have been happier if the Bank staff had built on the existing international machinery rather than proposing an entirely new Scheme; for example, the Bank staff could have proposed a means by which short-term drawings on the Fund could be refinanced if export shortfall proved to be irreversible.

5. Mr. Friedman explained why it was found difficult to build on the existing Fund facility. The Fund facility provided virtually automatic finance to meet the payments difficulties caused by an export shortfall; the Bank thought of supplementary finance as a part of development finance and, therefore, conditional on satisfactory performance. As long as a country was performing well according to agreed policies and programs, it should receive supplementary assistance whenever its development was threatened by unexpected declines in exports. There was no such conditionality, nor the assurance of a continuation of an agreed development program, in the Fund assistance. So far as long-term projections are concerned the Bank has to make these anyway in its normal course of activity, irrespective of the Supplementary Finance Scheme. An export projection is an integral part of a development program, and the Bank cannot escape from the responsibility of making its own projections when it is called upon to judge a country's plans and policies. If a development program is to be protected from disruption, assistance has to be related to the export projection on which the program is based.

6. Mr. Southard suggested that we should meet again and explore some of these questions further, possibly before Christmas.

## OFFICE MEMORANDUM

TO: Mr. Sarma

DATE: September 26, 1966

FROM: Irving S. Friedman

SUBJECT: IMF Compensatory Finance

Could you make a summary of the Fund's report, together with any comments which you think might be worth passing on to Mr. Woods.

Thanks.

ISF  
September 29, 1966

This was done in a brief note which you forwarded to Mr. Woods on September 13.

This published report is virtually the same as the Fund's paper of June 13, except for the section on Repurchase of Compensatory Drawings. It is now decided to maintain the repurchase system of 3 - 5 years. This also is covered in our earlier note.

Mr. Friedman

N. A. Sarma 9/29

Fund's Compensatory Financing Facility, and  
Supplementary Financial Measures

1. Fluctuations in export earnings have been a main cause of balance of payments difficulties, especially for primary exporting countries. Fund financing has been available to countries to meet temporary payments difficulties, but in the early 1960's a number of countries believed that Fund assistance was inadequate from the viewpoint of compensatory finance for export fluctuations. Accordingly, after considerable discussion of the subject, in February 1963, the Fund adopted its Compensatory Financing Facility. It was also decided to consider sympathetically the case for special quota increases - apart from a general increase - for primary exporting countries with relatively small quotas. A number of such quota increases have taken place.
  
2. The Compensatory Financing Facility, as it has been implemented so far, has the following features: a) temporary shortfalls in export receipts may be met by a member by Fund drawings, subject to the established policies on repurchase, including the outside limit of 3 - 5 years; b) the drawings outstanding under this provision are limited normally to 25 per cent of quota, but the Fund is prepared to waive the limit on Fund holdings of 200 per cent of quota where waiver is needed to permit compensatory drawings or to the extent such drawings are outstanding; c) the facility is available if the Fund is satisfied that the shortfall is of a short term character, largely due to circumstances beyond the control of the member, and that the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its payments difficulties.
  
3. So far, only three countries have had recourse to this facility - Brazil, U.A.R., and Sudan. This limited use is attributable to the fact

that in the years since the facility was introduced the export trade of developing countries has maintained an upward trend, mainly as a result of the rise in prices of several primary commodity exports, and generally in line with world trade trends.

4. Taking into account the experience so far with the Fund compensatory facility, limited as it is, and the suggestions made from several quarters for its revision and enlargement, in particular the proposals made in a recommendation of UNCTAD, the Fund is now proposing certain changes.

Hereafter, drawings under this facility may amount to 50 per cent of a member's quota provided that (i) except in the case of shortfalls resulting from disasters or major emergencies, such drawings will not be increased by a net amount of more than 25 per cent of the member's quota in any twelve-month period, and (ii) requests for drawings which would increase these drawings outstanding beyond 25 per cent of the member's quota will be met only if the Fund is satisfied that the member has been cooperating with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties. The other features of the facility remain essentially the same as before.

5. The Fund compensatory facility starts by defining the 'normal' level of exports in any year as the average exports for a five-year period, including the current year, the two previous years and the following two years. This is known as the 'moving average' and corresponds to the idea of the underlying medium-term trend in exports. The shortfall in any year is then taken as the extent to which actual exports fall short of this 'normal' level. This norm cannot be determined exactly for any current year. Therefore, the Fund estimates this by an average of the actual exports of the past two years, each with a weight of one-quarter and the exports of the

current year for which the shortfall is being calculated, with a weight of one-half. The effect of giving such a large weight to the exports of a shortfall year is to reduce the 'norm' itself and hence to reduce the amount of shortfall for which compensatory finance is available. The Fund itself has found that this estimate has not worked so well in recent years and therefore it proposes to combine this with a qualitative estimate of exports of next two years in determining the 'norm' from which the shortfall is to be calculated. It is precisely because the trend or norm is a moving average for five years centered on the current, shortfall, year as the middle year that a rough balancing of shortfalls and surpluses of actual exports with respect to trend results over a reasonable period of time. In the Fund report on "Compensatory Financing of Export Fluctuations" it had been stated: "The least inaccurate estimate of the normal level in any given year is likely to be one that attributes a great weight to the exports of the year itself." This has been the method applied so far; essentially it is intended now also to persist with the same method. The recommendation of UNCTAD that greater weight be given to the actual experience of the three preceding years is rejected.

6. Revised on the above lines, it is to be expected that drawings under the compensatory facility will be larger hereafter. There would be variations from year to year and the amounts in peak years may be considerable. It is understood from the Fund staff that their calculations indicate that the annual average of compensatory drawings are likely to be \$150 mn., on the basis of 1951-64 data.

7. In the Bank study, a range of estimates is given, derived from different samples of countries and on the basis of data available for varying time periods. After taking into account overages (excess exports of a country that could be set off against its export shortfalls in other years), and assuming that about \$150 mn. a year is made available under the Fund compensatory financing facility, the net magnitude of export shortfalls is likely to average over \$ one billion a year. In the Bank study itself, the resources required for the Agency are placed much lower, at \$300-\$400 mn. a year, for an initial experimental period of 5 years, on several considerations. This requirement takes full account of the Fund facility; in this sense it is residual. If the Supplementary Finance Agency were to undertake refinancing of outstanding drawings under Fund facility, the Agency might well need larger resources in the future than during the first five years of operation.

8. The rather large differences in estimates under the two schemes arise mainly from the different purposes for which the estimates are made and the different methodology adopted. The supplementary finance scheme<sup>1/</sup> is designed to avoid disruption of a country's development program; accordingly, export prospects are considered in the context of a development plan, and take account not only of various objective factors, domestic and external, but also the impact of new policy measures. The supplementary finance scheme tries to estimate future export receipts over a planning period on which a developing country can rely in formulating and implementing its development plan. On the other hand, the Fund facility is designed to help countries to bring their export availabilities (export receipts plus

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9. Various alternative systems of repurchases have been considered for the Fund facility, and it is decided to retain the existing system of repurchase within a 3-5 year period, but with the recommendation to members that one half of any export excess that may occur in the first three years after the drawing should be devoted to repurchase. Earlier suggestions which would in effect have lengthened the repayment period were not accepted by the Board. Thus, the revolving nature of Fund resources is fully assured. On the other hand, with some exceptions, the approach of the supplementary finance scheme is that assistance should be extended on about the same terms at which a country is obtaining development finance more generally. This, again, arises from the purpose of the scheme to help to maintain the growth process of a member country.

10. Thus, both in respect to scale of assistance, as well as terms thereof, there are important differences between the Fund facility, even when enlarged, and the supplementary finance scheme. The two deal with related aspects of a basic problem faced by LDC's - i.e. the volatility and uncertainty of their exports arising from the structure and commodity concentration of their export trade, and affecting their economic development. As such, as now envisaged, the two facilities would seem to supplement each other.

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12. These matters are not urgent in the sense that no Bank decision is of course required, but Governors and others might be speaking to you about these matters.

*(Original  
to Mr. Wood - 9/15/66)*

Fund's Compensatory Financing Facility, and  
Supplementary Financial Measures

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2. The Compensatory Financing Facility, as it has been implemented so far, has the following features: a) temporary shortfalls in export receipts may be met by a member by Fund drawings, subject to the established policies on repurchase, including the outside limit of 3 - 5 years; b) the drawings outstanding under this provision are limited normally to 25 per cent of quota, but the Fund is prepared to waive the limit on Fund holdings of 200 per cent of quota where waiver is needed to permit compensatory drawings or to the extent such drawings are outstanding; c) the facility is available if the Fund is satisfied that the shortfall is of a short term character, largely due to circumstances beyond the control of the member, and that the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its payments difficulties.
  
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## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

DATE: September 13, 1966

FROM: Paulo H. Pereira Lira *PHL*SUBJECT: IMF Criticism of the Bank Study on Supplementary Finance

Please find attached the draft on the IMF paper on Supplementary Finance prepared by Professor Frank and myself.

P. Pereira Lira  
I. Frank  
September 12, 1966

#### IMF CRITICISM OF THE BANK STUDY ON SUPPLEMENTARY FINANCE

The Fund Staff paper on "Supplementary Financing and the Fund" (SM/66/95) was submitted to the IMF Executive Directors for information on August 4, 1966. It is strongly critical of the Scheme outlined in the Bank Staff Study in response to the UNCTAD Resolution.

Two main points are central to the Fund's criticism:

1. the Scheme would tend to undercut the influence of the Fund by requiring the Agency to deal with balance of payments problems and policies which are the jurisdiction of the Fund;

2. even if there were no jurisdictional problem (the policy package being entrusted entirely to the Fund as far as balance of payments policies are concerned), the Scheme would not be workable.

#### Elaboration of the Fund's Criticism

1. Jurisdiction The Scheme would undermine the influence of the IMF with respect to balance of payments policies because a) its criteria differ from those of the Fund and are not easily reconcilable with the latter's; and b) the Agency would be the new residual lender in international finance, displacing the Fund from this position.

The differences in criteria relate to the amount of foreign exchange availabilities from exports to which a country should adjust and the timing of the adjustment measures. The Fund believes, in relation to its operations in general and the Compensatory Financing Facility in

particular, that countries should be encouraged to adjust to the medium-term trend of their exports (subject to yearly revisions) and not to export availabilities on the scale originally envisaged when the development program was set up (as would be the case with the Supplementary Finance Scheme). Moreover, according to the Fund, a country should adjust its claims on resources, whether for investment or for consumption, to unexpected trends in outside forces affecting the balance of payments as soon as these trends can be recognised and distinguished from temporary fluctuations. In its view, the Scheme gives inadequate weight to the danger of adhering to a development plan which, in the light of export developments, has been shown to be not sustainable over the long run.

As to the question of residual financing, the Fund considers that its role as residual lender has been decisive in enabling it to influence countries' policies with respect to balance of payments equilibration. The introduction in the international financial field of a new residual lender would reduce the Fund's effectiveness.

2. Workability The second line of criticism is that the Bank Scheme is unworkable even if there were no jurisdictional problem, the Fund being in charge of the Agency's balance of payments policy prescriptions. The Fund cannot see how it could commit itself to quantitative precision regarding the financial and exchange policies required to implement balance of payments projections over a five-year period; nor could it make advance prescriptions as to the appropriate method of adjustment in the face of the thousand and one events that

might tend to falsify the projection. Such policy guidance as a basis for a guarantee of foreign exchange availabilities can only be made - according to the Fund's practice - for periods of one, or at the most two, years ahead.

#### Comment on the Fund's Criticisms

1. The essence of the Fund's opposition to the Bank Scheme can be attributed to its failure to take into account one fundamental change in existing international economic relations which would come about if the Scheme were in operation. The ultimate meaning of the Supplementary Finance Scheme is that the donor countries would underwrite a five-year export projection of a less developed country, if it were part of an acceptable development program and if the country adhered to certain policies agreed upon in advance. All policy formulations, including balance of payments adjustment policies, would have to take this new circumstance into account.

2. There is no doubt that adjustment policies would differ depending on whether an exchange constraint existed as a result of an unexpected shortfall in export proceeds. What the Scheme intends to do is precisely to remove this exchange constraint, thus allowing other adjustment patterns consistent with the maintenance of the scale of an agreed long-term development program. If both the Agency and the Fund started from this same benchmark, there would not seem to be any reason for irreconcilable policy prescriptions.

3. The Fund's concern as to the timing of the adjustment measures results from a misunderstanding of the Bank Study's attitude in this respect. There is no doubt that countries should adjust their sectoral investments to new prospects in their export markets as soon as there is an indication of permanent change. As stated above, however, this adjustment would proceed under circumstances in which the export income over the period is guaranteed by the international community. The guarantee would be revised only in exceptional circumstances where a fundamental change of such magnitude had occurred that a reduction in scale or recasting of the development program as a whole had to take place.

4. The Fund's preoccupation with its role as a residual lender is understandable. In examining this question, it is useful to distinguish two functions performed by the Fund: as a lender of international resources and as an adviser to countries. In the Supplementary Finance Scheme, the Fund is expected to act as the international agency which provides advice as to a country's monetary, fiscal and balance-of-payments policies in the context of its development program. The IMF's role would be analogous to that which it is already supposed to play in consultative groups. In these circumstances its advice is bound to be different from that which it gives when an actual Fund drawing is contemplated since, in the latter case, the policy package associated with the drawing is influenced by the constraint that IMF loans must have a revolving character, repayable at most in five years.

5. Apart from its function as policy adviser, the Fund would also play a role as a lender of resources under the Supplementary Finance Scheme. Under the Scheme, a country experiencing an export shortfall would be expected to apply for assistance in the first instance from the Fund. But the Scheme would stand ready to refinance such IMF loans so that the revolving nature of the Fund's operation would be preserved. The important difference in relation to other Fund drawings, however, would be that the policy package associated with this operation would be drawn having in mind that the country now had a guaranteed export income. The fact that different policy packages would be associated with particular uses of Fund resources is not something new but a mere application of the current IMF practice according to which policy requirements vary in relation to the tranche level in which a country requests a drawing.

6. Attention should also be called to the fact that the Supplementary Finance Scheme deals with only one type of unexpected balance of payments pressure -- that associated with shortfalls in export proceeds. There are other types of pressures, such as those occurring on the import side and in relation to capital movements, for which the Fund would be the only provider of assistance.

7. There is no doubt that the Scheme, by increasing the provision of one particular type of long-term assistance, may contribute to reduce the potential use of Fund resources. This is true, however, of all increases in development finance (and particularly of program aid)

to the extent that they help countries to avoid balance of payments crises. At the same time, by decreasing the frequency of crises situations, the Scheme creates conditions in which the Fund's role is enhanced as an adviser on monetary, fiscal, and exchange policies appropriate to long-term development.

8. The Fund's charge of impracticality of the Scheme seems to be based on a misconception. The guarantee of the export projection for the five-years is not unconditional, but subject to periodic reviews in which the Agency satisfies itself that the country is acting in accordance with the policy directions established in the initial understanding. The Study was also explicit in stating that even this basic understanding may be subject to change if circumstances warranted.

9. Finally, and on a more general level, the Fund may think it not advisable to provide a five-year guarantee of export proceeds when the same is not done for other items of the balance of payments. This seems to be the upshot of the remark in the Fund's paper to the effect that the Scheme would provide too much financial support to a development program under one type of contingency (export shortfall) compared to what is given in others. But this criticism applies not to the Bank Staff Scheme but to the original UNCTAD Resolution. When initially dealing with the problem, we convinced ourselves that unexpected export shortfalls were an important cause of disruption of development programs. At the same time we recognised that there were other causes of potential disruption which remained unattended. Even so it seems to us that if the donor countries were willing to take care of one particular type of shortfall, this insurance could substantially improve the basic conditions under which the development efforts of the developing countries take place.

Sept. 13/66

Fund's Compensatory Financing Facility, and  
Supplementary Financial Measures

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*Fund's Compensatory Financing*

Mr. George D. Woods

September 13, 1966

Irving S. Friedman

Fund's Compensatory Financing Scheme and Bank's Supplementary Financial Measures.

In view of the Fund's very recent decision on compensatory financing I thought you might find useful the attached memorandum comparing the Fund's version and the proposed Supplementary Financial Measures.

Attachment

INSERT A PAGE 5

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## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman DATE: September 12, 1966

FROM: Paulo H. Pereira Lira *PHL*

SUBJECT: Supplementary Finance Scheme - Meeting of September 6, 1966

Messrs. Friedman, Frank, Hulley, Macone, Sacchetti, Sarma, Sundrum and Pereira Lira were present.

Mr. Friedman informed that the UNCTAD Board had set October 10th as the date for the first meeting of the Intergovernmental Group of Experts on Supplementary Finance, in Geneva. He said it was time now to decide which papers being prepared by the Bank group should be made available to the Intergovernmental Group of Experts. The proper channel to do this was the Secretary-General of UNCTAD. These papers were not meant to introduce changes in the Scheme, but to supply additional information and fill in gaps in relation to the broad outline which had been presented in the Bank Staff Study. They did not have to be sent all at the same time and could be submitted with the indication that they represented the current thinking of the Bank Staff on the different matters discussed and not necessarily a final position on them.

Mr. Friedman indicated that he would like to have at least one, and preferably two, of the people who were working on Supplementary Finance attending meetings which might be held by other bodies to discuss the subject.

In relation to the papers which were already available, Mr. Friedman mentioned it would be useful to start with the discussion of the \$300 to \$400 million a year figure, as the financing requirement for the Agency. He felt that a more specific explanation of this financing was in order, before bringing into discussion the question of rationing. He was not prepared to accept now this idea, which would really have deep implications for the Scheme. A Scheme with rationing was really a very different one than the one that had been originally proposed.

Mr. Friedman advanced then the way in which he felt the \$300 to \$400 million figure could be arrived at:

	\$ billion
A. total shortfalls (as estimated by simulation exercise)	1.6
B. <u>minus</u> :	
a) improvement in LDC's performance, including better export performance (one fifth of 1.6 billion)	.3
b) improvement in forecasting techniques	.2
c) shortfalls in countries which were not eligible to participate in Scheme	.2
C. shortfalls which had to be taken care of (A-B)	.9
D. <u>minus</u> : (procedures to take care of shortfalls, outside the Agency)	
a) IMF financing	.1
b) U.S. and other countries financing	.15
c) use of overages	.1
d) internal adjustment process by LDC countries ("belt tightening" of consumption and use of reserves - 1% of export earnings of LDC's)	.2
E. shortfalls to be financed by the Agency (C-D)	.35

Mr. Friedman observed that he was trying to estimate only how much was needed to start running the Scheme. If the Agency was going to undertake refinancing of loans received from other sources to take care of the shortfalls more funds would be needed. He had omitted from his considerations also the adjustment for the scale of operations, which had to be subsequently introduced to take into account the factor of growth in exports, when compared to the period of the simulation exercise. As to the treatment of oil countries, he saw no basis for excluding them, even though it might be more difficult to make the export forecasts for them. It would be necessary to talk to the oil companies, as had been recently done in the case of Algeria. He felt that including them in the estimate of total shortfalls would not contribute to reduce this magnitude. But the oil countries could be expected to make a larger use of reserves to meet the shortfalls, thereby reducing the claims on the Agency.

Mr. Friedman felt that in preparing the paper on the financing requirements of the Agency, there would be some elements for which we cannot get precise estimates. In dealing with this, we should try to get at least some rough estimates, rather than being completely pessimistic. The paper should examine also the question of the biases which existed in the Bank's techniques of forecasting. More specifically, he wanted the following items to be taken care of: by Mr. Macone - memo on the estimate of the basic \$1.6 billion and on the relationships of overages and IMF Compensatory Financing; Professor Frank - investigation with the American authorities on how much financing for export shortfalls could be contemplated, even if the Supplementary Finance Scheme was in operation; Mr. Sarma - to consider what would be the reasonable figure which would be attributed to the IMF and, subsequently, ask the IMF directly what would be their suggestion considering the expanded Compensatory Facility.

cc: Professor Frank,  
Messrs. Hulley,  
Jalan,  
Macone,  
Sacchetti,  
Sarma,  
Sundrum.

## OFFICE MEMORANDUM

TO: Mr. Irving Friedman

FROM: Ugo Sacchetti *U.S.*

SUBJECT: SUPPLEMENTARY FINANCING AND THE FUND (SM/66/95)

DATE: September 7, 1966

My comments on the above document follow.

I take for granted that the description of the Supplementary Financing Scheme, contained in pages 1-7 is, on the whole, accurate. Therefore, I confine myself to the last section under the subtitle: Interrelations with the Activities of the Fund.

It seems to me that the document touches upon three main issues:

- a) The possibility of disparities between the advice given to member countries under the Scheme and the advice given by the Fund in the face of a balance of payments disequilibrium.
- b) The possibility of disparities as between the policy packages (their nature and content) prescribed under the Scheme and by the Fund, respectively for the use of their resources.
- c) The internal consistency of the proposed arrangements under the Scheme.

I have left aside the question as to which agency has the primary responsibility in balance of payments matters. The document explicitly claims an "exclusive" for the Fund (beginning of page 8 and of page 11); ignoring, apparently, Article I(iii) of the Bank charter, which affirms that one of the purposes of the Bank is "the maintenance of equilibrium in balances of payments by encouraging international investment for the development of productive resources...." Read in conjunction with Article I(v) and (vi) of the Fund Agreement this, if anything, suggests some sort of condominium; and the experience has shown that the coexistence is not difficult provided that one agency looks after the restoration of balance in the short run; and the other concerns itself with longer-run balance achieved with the help of international capital movements. The reference made above to the Bank charter does not imply that the Bank will be the administrator of the Scheme; it rather implies that the purpose quoted above would probably be included, in its essence, if not in its form, in the charter of the Agency.

1. The possibility that a country receives disparate advice from two international organizations is not as scandalous as it is presented: it

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happens all the time under the present multiplicity of international and regional institutions. (See Fund Consultations papers and OECD Annual Review documents). Not that one should be proud of this state of affairs; on the contrary I would say that disparity of advice resulting merely from the multiplicity of agencies is obviously regrettable and to the extent possible should be avoided. However, to the extent that disparity in advice is the result of different considerations reflecting either the different purposes of the agencies giving the advice or the nature of the financial assistance that they are in the position to give, such a disparity is unavoidable.

2. The more important issue raised by the document in question relates, however, to the possibility of disparities in the requirements set out by the Fund and under the Scheme, respectively, for the use of the resources of the two agencies. In a way it is surprising that this is raised as an objectionable feature in a Fund document since disparities in requirements are a distinct possibility under the Fund policies for the use of Fund resources. In fact this has been the main objection raised within the staff of the Fund against the semi-automaticity of the Compensatory Financing Scheme. It was pointed out that if a country in the credit tranches requested a stand-by arrangement in connection with e.g., a balance of payments deficit caused by a decline in exports, it would be required to undertake certain commitments. If, however, the country found these commitments too onerous, it could apply for the use of the Fund resources under the Compensatory Financing Scheme, in which case the requirements are much more lenient. (This happened in the case of Brazil in 1963). Likewise, a country which is not prepared to undertake certain commitments required by the Fund tranches policies, to obtain a stand-by arrangement, could wait sometime until the discharging of repurchase obligations (which presumably is under way) brings it to a tranche level that makes it possible for it to obtain the same arrangement under more lenient requirements, even though its policies assumedly have not changed.

To apply these considerations to the relationships between the Fund and the Agency, one could visualize cases where the Agency could be bothered by the changing requirements of the Fund. Suppose, for example, that in the case of one country, the Fund and the Agency set out, at one point in time, the same requirements for the respective operations, the Fund operation being a stand-by arrangement. Suppose further that at the time of the next annual review under the Scheme the country's policies have deteriorated to the point where it no longer qualifies under the Fund tranches policies for a stand-by arrangement, but exports having fallen below the trend, the country can obtain Fund resources under the Compensatory financing policy. For the latter purpose, however, the Fund requirements would be minimal, which could be in conflict with the Agency's requirements, which presumably would remain unchanged. Thus, in this case, it would be the "versatility" of the Fund policies that could be a factor of disturbance in the Agency's operations.

All that the above paragraphs say is that well run financial agencies condition the use of their resources to requirements that are

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consistent with the purposes of the resources themselves; and if the purposes are different, the requirements are bound to be different. Disparities are bound to appear not only between agencies but also within each agency (as shown above for the Fund) and this applies to the Bank Group as well.

In my opinion, what lies behind this issue is the fact that, to the extent that the Bank moves - under the Supplementary Financing Scheme or otherwise - into program financing, there would be an obvious and inevitable coexistence in this field; and the only thought which comes to my mind in this connection is that the coexistence should be peaceful, through contacts, collaboration and common services to the maximum possible extent.

3. The matter of possible internal inconsistencies is raised, I believe, in the first full paragraph of page 10. I am not sure I understand the issue correctly, but I believe the reconciliation problem would be reduced or eliminated if in proposition (a) in the text the word "conditional" were added before the word "assurance"; and if, with regard to proposition (b), the operational feature were borne in mind that the Agency's packages are subject to annual reviews.

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman DATE: September 6, 1966

FROM: N.A. Sarma *N.A. Sarma*

SUBJECT: Fund's Compensatory Financing, and Supplementary Financial Measures.

Attached hereto is a brief comment, indicating why there would still be need for Supplementary Financing Scheme, even with proposed enlargement of the Fund's Facility.

Attachment: Note on Fund Compensatory Financing and Supplementary Financial Measures.

cc: Messrs. Isaiah Frank  
John Hulley  
Macone  
Sundrum  
Pereira Lira

Fund Compensatory Financing Facility and  
Supplementary Financial Measures

1. The Fund facility is designed to compensate for temporary shortfalls in export receipts; i.e. deviations from a medium-term trend in export receipts. It is proposed to enlarge this facility to 50 per cent of a member's quota from the present 25 per cent limit. Drawings under this facility beyond 25 per cent will, however, be allowed only if the Fund is satisfied that the member has been cooperating with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties. The Fund will waive the limit on Fund holdings of 200 per cent of quota where waiver is needed to permit compensatory drawings or to the extent such drawings are outstanding.
  
2. Revised on the above lines, annual average of compensatory drawings are likely to be \$350-\$400 mn., on the basis of 1951-64 data. In the Bank study, a range of estimates is given, derived from different samples of countries and on the basis of data available for varying time periods. After taking into account overages (excess exports of a country that could be set off against its export shortfalls in other years), and assuming that about \$400 mn. a year is made available under the Fund Compensatory Financing Facility, the net magnitude of export shortfalls is likely to average about \$ one billion a year. In the Bank study itself, the resources required for the Agency are placed much lower, at \$300-\$400 mn. a year, for an initial experimental period of 5 years, on several considerations. This requirement takes full account of Fund Facility and, therefore, is residual.
  
3. The above is mainly due to the different purposes for which the estimates are made and the different methodology adopted. The SFF is designed to avoid disruption of a country's development program; accordingly, export prospects are considered in the context of a development plan, and take account not only of various objective factors, domestic and external, but also the impact of new policy measures. The SFF tries to estimate future export eventualities over a planning period on which a developing country can rely in formulating and implementing its development plan. On the other hand, the Fund facility is designed to help countries to bring their export availabilities closer to the presumed trend level, rather than to provide them with a financial buffer against reductions as compared with their previous standards, or to make good shortfalls from export levels projected for a plan period ahead. Broadly the Fund method is to estimate a five-year moving average, centred on the current year (i.e. the shortfall year), the preceding two years, and the two years following. It is intended to give greater weight in future than in the past to 'qualitative' as against 'statistical' estimate, but the main feature of the methodology is the substantial weight given to the shortfall year in the determination of the norm. This has the effect of reducing the extent of shortfall and drawing entitlement as compared to a formula which does not take into account the shortfall year itself in estimating trend value. It is precisely because the trend or norm is a moving average for five years centred on the current, shortfall, year as the middle year that a rough balancing of shortfalls and surpluses of actual exports with respect to trend results over a reasonable period of time.

4. Various alternative systems of repurchases are being considered for the Fund facility. The chief feature remains, i.e. repurchases within five years, with the proviso that a member may offset repurchases (wholly or in part?) against actual export receipts for determining the amount of any new compensatory drawings. Thus, the revolving nature of Fund resources is assured. It is estimated that about two-third of all compensatory drawings would be repaid within three years, and over four-fifths within five years; little remains outstanding beyond eight years. On the other hand, while eventually the SFF also may become a revolving fund, for a considerable number of years the obligations of members to the Agency will continually rise. There may also be a few instances where relatively short repayment terms are appropriate. But, by and large, the approach of SFF is that assistance should be extended on about the same terms at which a country is obtaining development finance more generally. This, again, arises from the purpose of the scheme to help to maintain the growth process of a member country.

5. Thus, both in respect to scale of assistance, as well as terms thereof, there are important differences between the Fund facility, even when enlarged, and the SFF. The two deal with related aspects of a basic problem faced by LDC's - i.e. the volatility and uncertainty of their exports arising from the structure and commodity concentration of their export trade, and affecting their economic development. As such, as now envisaged, the two facilities would seem to supplement each other.

6. Fund staff paper: "Supplementary Financing and the Fund":

- (a) The paper purports to confine itself to the Bank proposals, without taking a position on the UNCTAD resolution itself; states that the Scheme raises serious difficulties for the Fund; and considers the Scheme not feasible operationally.
- (b) In recent discussions between Fund and Bank staff, the refinancing role of the Agency with respect to Fund's Compensatory Financing is recognized explicitly. It is also clarified that the initial policy package might include undertakings on the part of the country concerned to follow such recommendations as the Fund might make in subsequent years in consultation with that country with respect to exchange policies and internal financial policies, provided that these were compatible with the objective of maintaining the development program as originally agreed. Even so, the Fund paper remains highly critical of the proposals.
- (c) The scheme proposed by Bank staff is only an outline and it is quite possible that it may be modified during further discussions with Fund staff, in the intergovernmental group set up by Trade and Development Board of UNCTAD, and in the course of deliberations by individual governments. The nature and content of policy package, and the degree of its operational feasibility, would have to be

carefully gone over, and there would be scope for further elaboration and precision. But, above all, the Bank study concurs with the UNCTAD view that there is a felt need for which supplementary financial measures are a feasible solution. This is the substance of the matter. The criticisms in the Fund staff paper of the Bank's scheme apply equally to the UNCTAD resolution though the paper does not directly take a view on the resolution itself.

- (d) The apprehension may be in part jurisdictional. A joint subsidiary of the Fund and Bank may be envisaged and the possibility explored of dovetailing the proposed Supplementary Financing Scheme with enlarged Compensatory Financing and other operations of the Fund.

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

FROM: N.A. Sarma *N. A. Sarma*

SUBJECT: Supplementary Financial Measures.

DATE: September 2, 1966

Attached hereto is a brief note on the subject, for discussion at the meeting on September 6, as desired. (This is prepared in consultation with Messrs. Pereira Lira and Sundrum).

Attachment: Note on Supplementary Financial Measures.

cc: Messrs. Isaiah Frank  
John Hulley  
Macone  
Sundrum  
Pereira Lira

- 1) For UNCTAD - want to explain our scheme (no matter what at this time) - or fill in gaps -
- 2) For academics - any new views -
- 3) what are practical difficulties presently faced?
- 4) to what use IMF staff think SFS not capital ex. reserves sufficient for other operations of IMF -

## Supplementary Financial Measures

The first meeting of the intergovernmental expert group of UNCTAD on the subject, scheduled to begin September 12, is likely to be postponed by a few weeks. Meanwhile, certain issues have been pointed up during discussions in the DAC Working Party on UNCTAD matters, in the Fund staff study of Bank proposals, and in our review of certain aspects of the Scheme.

1. DAC Working Party meeting, July 7, 1966, to discuss Supplementary Finance:
  - a) French opposition, to the point of readiness to kill the Scheme, based on their preference for organization of markets, e.g. commodity agreements.
  - b) A general preoccupation with the estimates of financial requirements; how \$300-\$400 mn. a year is derived.
2. Fund staff paper: "Supplementary Financing and the Fund":
  - a) The paper purports to confine itself to the Bank proposals, without taking a position on the UNCTAD resolution itself; states that the Scheme raises serious difficulties for the Fund; and considers the Scheme not feasible operationally.
  - b) In recent discussions between Fund and Bank staff, the refinancing role of the Agency with respect to Fund's Compensatory Financing is recognized explicitly. It is also clarified that the initial policy package might include undertakings on the part of the country concerned to follow such recommendations as the Fund might make in subsequent years in consultation with that country with respect to exchange policies and internal financial policies, provided that these were compatible with the objective of maintaining the development program as originally agreed. Even so, the Fund paper remains highly critical of the proposals.
  - c) The scheme proposed by Bank staff is only an outline and it is quite possible that it may be modified during further discussions with Fund staff, in the intergovernmental group set up by Trade and Development Board of UNCTAD, and in the course of deliberations by individual governments. The nature and content of policy package, and the degree of its operational feasibility, would have to be carefully gone over, and there would be scope for further elaboration and precision. But, above all, the Bank study concurs with the UNCTAD view that there is a felt need for which supplementary financial measures are a feasible solution. This is the substance of the matter. The criticisms in the Fund staff paper of the Bank's scheme apply equally to the UNCTAD resolution though the paper does not directly take a view on the resolution itself.

- d) The apprehension may be in part jurisdictional. A joint subsidiary of the Fund and Bank may be envisaged and the possibility explored of dovetailing the proposed Supplementary Financing Scheme with enlarged Compensatory Financing and other operations of the Fund.
- e) Given the total opposition of France to the Scheme, the concern expressed by Belgium, Germany and some others on certain aspects and by the Secretary-General of UNCTAD on certain other aspects, and the objections that may be raised by the LDC's with respect to the content and detail of the policy package, the Fund paper as it now stands can only weaken any constructive approach to the basic idea; in the result one of the few useful initiatives that emerged from the first UNCTAD may get lost in controversy.

3. Our discussions:

- a) If the Supplementary Financing Scheme should refinance short-term borrowing from other agencies, such as the Fund's Compensatory Financing Facility for meeting export shortfalls, then the financial requirements for the Scheme have to be reconsidered.
- b) Use of foreign exchange reserves, to the extent possible, would have been taken as a means of financing the development program of a country, at the time the development program was discussed and agreed upon between the country and the Agency. Given the reserves position of most LDC's, especially non-oil exporters, and their desire to use excess reserves, if any, for financing development programs, the use of such reserves for meeting export shortfalls is for further consideration.
- c) The possibility of including use of other sources of finance as part of the initial understanding between the Agency and the country under the Scheme, having in mind promptness and certainty of such assistance by the Agency, is the chief merit of the Scheme.
- d) Reexamination of the estimate of \$300-\$400 mn. a year as the resources required for the Agency for an initial experimental period of five years.
- e) If the donor countries do not contribute the required amount, the Agency cannot undertake to meet a substantial part of the shortfall. If only a part of the shortfall can be met, say, about 50 per cent, a disruption of the development program cannot be avoided; what are the implications of this for the Scheme?

*perhaps not?  
not clear?*

*A must*

*not a real  
question - unless  
can make above more economical*

*(magnitude - duration) -  
I've still say \$ 1.6 billion per year  
(-) more - new make  
(+) less - new rights or priority, savings?*

*Mr. Friedman*

Isaiah Frank

August 19, 1966

COMMODITY AGREEMENTS AND SUPPLEMENTARY FINANCE

Exporters of primary products face two problems which have become matters of major concern to the international community: the short-run instability of export receipts; and the tendency of export receipts to grow too slowly over the long-run to support the development goals of poor countries. International action to mitigate each of these problems can be approached in two ways: through commodity arrangements designed to affect the prices of primary exports, and through financial mechanisms designed to offset shortfalls in export earnings. Supplementary finance falls into the latter category and is intended to prevent the disruption of development programs arising from any type of unanticipated export shortfall (short-term or long-term) beyond the control of the country concerned and beyond its ability to offset from other sources of finance.

The distinctive feature of supplementary finance is that it comes into play as a result of the failure of export earnings to come up to expectations as expressed at the beginning of a plan period. To the extent that commodity agreements succeed in stabilizing the export earnings of developing countries, the scope for supplementary finance would be reduced since greater stability would usually imply greater predictability as well, at least within the time-perspective of a development plan. By the same token, to the extent that countries have access to supplementary finance, the need for commodity stabilization agreements may be reduced since countries would be protected from the

disruptive consequences on their development of unanticipated swings in export earnings. The two approaches therefore complement each other and are in no way mutually inconsistent.

In recent thinking, the pure short-term stabilization purpose of commodity agreements has been subordinated to the potentiality for using international price-control mechanisms as a device for improving the export earnings of developing countries over the long-run. Whereas in former years the objective of commodity agreements, in theory if not in practice, was to stabilize prices around a long-term trend determined by market forces, the more recent thinking has been to combine the stabilization function with a conscious effort to affect the price trend itself. One of the purposes of the International Coffee Agreement, for example, is to prevent coffee prices from declining below the level of 1962. For any commodity for which demand is price-inelastic, higher prices over the long-run would mean greater foreign exchange earnings for exporters. This approach is essentially what the French mean when they refer to the "organization of markets" as a means of improving the position of developing countries.

Just as pure stabilization agreements may be viewed as complementary to supplementary finance, <sup>broader</sup> market-organization schemes, such as proposed by the French, may be viewed as complementary to ordinary long-term development assistance. Both market-organization and financial aid are designed to transfer additional resources to developing countries, the former by requiring importers (principally the rich countries) to pay more for the commodities they buy from poor countries, the latter

by capital transfers from the governments of the rich countries to the governments of the poor countries.

There is good reason to believe that future attempts to establish commodity agreements will be guided by the French notion that such agreements should combine for particular commodities both the price-raising and the stabilization objectives. In considering this "market organization" approach as an alternative to financial mechanisms, three questions arise: (1) Is it desirable to bring about resource transfers to poor countries through commodity agreements? (2) Is this a feasible approach? (3) To what extent is it likely that such agreements would reduce the need for supplementary finance?

Desirability of "market organization"

The question of the desirability of "market organization" as a means of transferring resources to poor countries breaks down into three parts: (1) who bears the burden; (2) who receives the benefits; and (3) what are the risks of such an approach.

As for the first question, the burden is clearly borne by the countries required to pay higher prices for their imports of primary products. For some commodities (e.g., coffee and cocoa) the vast bulk of the exports come from poor countries and go to rich countries. But for others (e.g., rice) poor countries are themselves the major importers as well as exporters and the effect of an agreement would be to redistribute income among less developed countries. But even if the arrangement were limited to the former type of commodities, the question arises as to how the burden is distributed within the importing country.

Price-raising schemes, however administered, are essentially mechanisms for taxing consumers in the importing countries. But unlike direct taxes, which provide the bulk of government revenue in advanced countries, the incidence of price-raising schemes falls most heavily on the lower-income groups.

As for the beneficiaries of such schemes, insofar as they are individual producers in developing countries, the recipients may deserve such assistance neither on the basis of need nor contribution to development. The added income to producers might even encourage increases in output and accentuate the problem of surpluses. By various tax devices, however, the resource transfers might be siphoned away from individual producers and channeled to the governments of exporting countries which could use the funds for diversification or other development projects. But there would be no guarantee that the distribution of this aid among countries would accord with internationally accepted principles since it would accrue automatically to countries on the basis of their volume of exports of the supported commodity. Since such transfers are highly concessionary forms of financial assistance, one might well inquire as to whether the same performance criteria and tests of need now applied by IDA to its concessionary loans should not be applied to resource transfers through the organization of markets.

Experience with domestic price-support schemes suggests certain risks inherent in the use of this technique for transferring income to primary producers. Such schemes can work over the long-run only where effective means exist to control national production and marketings.

The surpluses that have plagued U.S. agricultural price-support programs over the years bear testimony to the difficulty of achieving effective controls even in a single country with a well-functioning administrative apparatus. The risk of breakdown is always present in an international scheme as governments of developing countries find it difficult to finance the holding of surplus stocks, as new or more efficient producers seek larger quotas, and as efforts to circumvent the controls through smuggling or other devices increase in scale.

Despite the risks and inequities of international price-raising agreements for individual commodities, they can add to the total of resources transferred to developing countries. In the face of a growing need in developing countries, the volume of bilateral aid has remained virtually unchanged at about \$6 billion per year throughout the five-year period 1961-65. The difficulties of bringing about a substantial increase in aid through the conventional national budgetary processes is such that one should not rule out other feasible techniques even though they may be subject to certain serious deficiencies.

#### Feasibility of "market organization"

Assuming it is desirable to resort to "market organization" for transferring resources to poor countries, how feasible is this approach? Apart from difficulties of an administrative or negotiating character, can the price-raising device be applied to most of the primary products now exported by developing countries? If a ten percent price increase could be obtained on, say, two-thirds of the present volume of primary

exports from less-developed to developed countries, the former would receive approximately \$1.5 billion of additional resources, an amount equal to one-fourth the present volume of bilateral economic aid.

In actuality, however, the applicability of the "market organization" technique is sharply limited by a set of rather rigid conditions. As already suggested, the locus of production is an important consideration. Unless the commodity is produced almost exclusively in developing countries, it is doubtful that this technique can be successfully applied. If advanced countries are major exporters, importers are not likely to agree to international price-raising arrangements. But even where production in advanced countries is for home consumption, the effect of higher world market prices may well be to increase the volume of domestic output in the advanced countries at the expense of exports from developing countries. Price-raising schemes would therefore seem to be feasible only with respect to those relatively few commodities such as coffee, bananas, etc. for which developing countries effectively control supplies in import markets. As a recent U.N. report points out, 3/4 of the primary commodities exported by the developing countries are subject to competition from similar items produced in the industrial countries. (1)

Another limitation is competition from substitutes, including synthetics. Especially for industrial raw materials, higher prices

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(1) If petroleum is excluded, the figure is 2/3. 't Hooft-Welvaars, M.J. "The Organization of International Markets for Primary Commodities," U.N. Conference on Trade and Development, Proceedings, Vol. III, United Nations, New York, 1964, p. 483. Among the main products are cotton, copper, fats and oils, sugar, meat, iron ore.

make substitutes more attractive (aluminum for copper, synthetic fibre for cotton, plastic for jute, one vegetable oil for another, etc.). Although export earnings may increase for a few years, they may be adversely affected over a more extended period because of the stimulation of substitution. The demand for many primary products appears to be characterized by low short-run price-elasticities but by high elasticities in the long-run.

When the various constraints are taken into account, it would seem that price-raising schemes would have to be limited to the following commodities: coffee, tea, cocoa, bananas and tin. Based on 1964 data, exports of these commodities from the developing countries amounted to 12.40 percent of their total exports, including petroleum, or 16.96 percent if petroleum is excluded. If coffee and tin are excluded from the figures (since agreements already exist for these commodities) the remaining products account for only 4.25 percent of developing countries' exports, including petroleum, or 5.82 percent excluding petroleum.<sup>(1)</sup>

Apart from the economic restraints, there are severe practical limitations to negotiating agreements even with respect to "eligible" commodities. Producer and consumer interests have to be reconciled, but these coincide only in regard to the reduction of price fluctuations, not in relation to setting the price target itself. Because the Coffee Agreement seeks to keep the price above what it would be in the absence

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(1) United Nations Conference on Trade and Development, Trade and Development Board, Permanent Sub-committee on Commodities. "International Organization of Commodity Trade - Examination of Criteria for the Selection of a List of Commodities of Interest to the Developing Countries," TD/B/C.1/PSC/8, May 20, 1966, Appendix A.

of the Agreement, it encountered serious opposition in the United States and it took several years of hard bargaining and persuasion for Congress to adopt the necessary implementing legislation. Even supporters of regular aid appropriations objected to this method of transferring resources. But conflicts of interests exist not simply between consumer and producer, but as among producing countries as well. These conflicts may relate to the interests of small vs. large producers, new vs. established producers, or to producers of different grades and varieties of the product.

Among the main points of contention in negotiating agreements are the questions of price, size of total quota, allocation of the quota among producing countries, the method of adjustment to changing circumstances of total quotas and country allocations, policies with respect to the maintenance and financing of stocks, the mechanism of enforcement, etc. Recent unsuccessful attempts to negotiate a cocoa agreement illustrate the difficulty of resolving these as well as other problems. Although there is a good basis for believing that a cocoa agreement will in the end be achieved, obstacles have been such as to leave few grounds for optimism that agreements can be negotiated for many commodities lower down in the scale of "eligibility."

Are commodity agreements a substitute for supplementary finance?

The answer to this question is partly implicit in what has already been said about the narrowness of the range of commodities in which agreements combining price raising and stabilization objectives are possible. Yet there is little interest today in pure stabilization agreements predicated on an acceptance of whatever underlying price trends are determined by market forces and directed purely to evening out fluctuations about such trends. As Gerda Blau stated in a recent FAO report,<sup>(1)</sup> "The fact that the conclusion of price stabilizing commodity agreements has proved so difficult in practice appears to indicate that neither exporters nor importers were really prepared to pay a substantial premium for this kind of insurance."

Today the main concern of developing countries is with the trend of prices and earnings rather than with short-term fluctuations. Provided the trend is satisfactory, purely short-term declines can be met through access to ordinary sources of liquidity, including regular and compensatory drawings from the IMF. By definition, such fluctuations in earnings will reverse themselves within a year or two. It is the more persistent adverse movements of exports that are the main concern of developing countries. As explained above, however, these can, as a practical matter, be dealt with through commodity agreements only in a handful of cases. Supplementary finance is directed precisely to such adverse movements occurring within the time-span of a development plan.

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(1) International Commodity Arrangements and Policies, FAO Commodity Policy Studies 16, Special Studies Program No. 1, Rome 1964, p. 142.

Even if more commodity agreements could somehow be negotiated than now seem feasible, there would still be a case for supplementary finance to offset shortfalls of export earnings for those countries that do not benefit from such agreements.

But the need for supplementary finance is not necessarily limited to countries whose exports do <sup>not</sup> benefit from commodity agreements. Such agreements are intended to stabilize, shore up or raise the price of primary commodities. They cannot insure against the other element of risk, namely adverse movements in volume. If consumption in the main importing countries declines and remains depressed for more than a year or two, it is unlikely that a commodity agreement can succeed in maintaining the earnings of the primary product exporters. Buffer stock operations and export quotas could help maintain prices and moderate the decline in earnings, but if the adverse movement in demand were persistent, some other mechanism would have to be brought into play. Supplementary finance can, therefore, serve as a useful complement in offsetting export shortfalls even for commodities benefiting from international agreements. Insofar as commodity agreements do, however, help to sustain the earnings of exporters, the cost of maintaining a supplementary finance scheme would of course be less.

It has been alleged that a basic difference between the organization of markets through international commodity agreements on the one hand and supplementary finance on the other is that the commodity approach deals with the fundamental causes of adverse trends whereas

supplementary finance deals merely with their symptoms. According to this view, commodity agreements can come to grips with the underlying disequilibrium between supply and demand of which price is merely a symptom, whereas supplementary finance can simply provide compensation for the effects of the disequilibrium after the event.

Unfortunately, this view rests on an idealization of the functioning of commodity agreements and on a misconception of the basic elements of supplementary finance. When one examines the history of commodity agreements, one is left with scant basis for optimism that they can in fact cope effectively with the underlying forces of demand and supply which determine price over the long-run. Total demand is dependent on the demand schedules of thousands of consumers which cannot be readily influenced. While it is true that demand is affected by measures to increase access to markets, such measures have not been integral parts of commodity agreements and are today being pursued independently of efforts at market organization. As for the supply side, the feasibility of effective control measures has not thus far been borne out by experience. Even the Coffee Agreement, which has had a fair record of price stabilization, has had little success in bringing production and consumption into equilibrium. The Agreement establishes no real production controls and leaves exporting countries entirely on their own in adjusting production to demand. Overproduction has continued and much of the attention of national policy-makers in the coffee-producing countries has been directed to the financing and storage of surplus

stocks rather than to the basic problem of controlling production. Perhaps it will be possible in the future to build a real stimulus to production control and diversification into commodity agreements, but this is still mostly a hope.

On the other hand, supplementary finance is not simply a device to provide symptomatic treatment for the results of the disequilibrium underlying adverse export movements. The essence of the supplementary finance proposal is that funds would be provided to offset shortfalls in export earnings only from realistic projections and on the condition of prior agreement between the administering agency and the country with respect to development objectives and the policies designed to realize them. Basic to the whole conception of supplementary finance is the inclusion in a development program of measures to shift resources out of export commodities where market prospects are poor to other, more remunerative fields. Unless a country lived up to its commitments in this respect, access to supplementary finance would be denied.

Our conclusion is that there is no one method of dealing with the commodity export problems of the developing countries. As stated at the outset, commodity agreements and supplementary finance are not mutually exclusive alternatives; in fact, they can complement each other. But the scope for commodity agreements directed to the

problem of adverse trends is limited in terms of the products to which they are applicable, and the countries that would benefit. Even where they are feasible, moreover, commodity agreements cannot insure against adverse movements in export earnings as opposed simply

to price. For all these reasons, supplementary finance has an essential role to play in preventing the disruption of development programs as a result of export shortfalls.

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman  
FROM: N.A. Sarma *Sarma*  
SUBJECT: Supplementary Financing and the Fund

DATE: August 17, 1966

1. On August 2 Mr. Isaiah Frank and myself met Messrs. Fleming and Finch in Mr. Fleming's office, for further consideration of their paper on Supplementary Financing.

2. Mr. Fleming was categorical that their paper was concerned only with the Bank proposals and, at this stage, they were not taking a view of the UNCTAD resolution itself. By refusing, however, to include a statement in the paper to the effect that they were not taking a position on the UNCTAD resolution, they left the paper open to the interpretation that the Bank's proposals raised serious difficulties for the Fund but that the resolution itself was acceptable.

3. Consequent to the discussions earlier held in your office and our further talk on August 2, a few changes have been made in the paper; the paper, however, remains substantially the same as before. Attached hereto is the final version. The few changes from the earlier draft are sidelined. The main addition is at pp. 9-10 and reads as follows:

"It is understood that the Bank staff, being aware that quantitative precision in such matters could not be achieved over a five-year period, had envisaged, in making their proposals, that the initial policy package might include undertakings on the part of the country concerned to follow such recommendations as the Fund might make in subsequent years in consultation with that country with respect to exchange policies and internal financial policies, provided that these were compatible with the objective of maintaining the development program as originally agreed."

4. The meeting was set up by Mr. Fleming for 3 pm on August 2. Throughout he was abrupt, and wanted to discuss only the two or three changes in the text proposed by him. More than once he referred to the fact that he had another meeting to attend at 4 pm.

5. We suggested that it would be useful if they clarified in their memorandum that we were consulted on certain points in the Bank study of a factual and descriptive nature, and not regarding interpretation or analysis. We also stated that we would be available for any further discussion that they might like to have.

Attachment: "Supplementary Financing and the Fund", SM/66/95

cc: Mr. Isaiah Frank.

SM/66/95

August 4, 1966

To: Members of the Executive Board  
From: The Secretary  
Subject: Supplementary Financing and the Fund

Attached for the information of the Executive Directors is a memorandum prepared by the staff concerning Supplementary Financing and the Fund.

Att: (1)

Other Distribution:  
Department Heads  
Division Chiefs

INTERNATIONAL MONETARY FUND

Supplementary Financing and the Fund

Prepared by the Research and Statistics Department  
in Consultation with the Exchange and Trade Relations  
Department, the Area Departments, and the Legal Department

August 4, 1966

Introduction

The staff report (SM/66/55) on the meeting of the UNTAD Committee on Invisibles and Financing Related to Trade held in April of this year pointed out that the proposals made in the IBRD staff study on Supplementary Financing Measures, which had been discussed in the UNTAD Committee on Invisibles and are to be examined by a group of government experts set up by that Committee, "have profound implications not only for the Fund's compensatory financing facility but for the general financial operations and other activities of the Fund."<sup>1/</sup>

The present paper is designed to explore briefly some of these implications. It is not designed to review the over-all merits of the proposals. Any exploration of their implications for the Fund, however, necessarily involves touching on a wide range of problems. Attention to these problems should in no way be allowed to obscure the difficulties faced by the developing countries at this time, and, in particular, should in no way detract from the recognition of their need for increased amounts and easier terms of assistance.

UNCTAD Resolution on Supplementary Financial Measures

The Study by the Bank staff took its start from Recommendation A-IV-18, which, having been originally proposed by the United Kingdom and Sweden, was adopted by the United Nations Conference on Trade and Development in June 1964. A copy of this Recommendation is attached at Annex I.

As will be seen, the Recommendation invited the Bank to study the feasibility of a scheme under which the IDA, using additional resources, would provide longer-term assistance to developing countries in the form

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<sup>1/</sup> SM/66/55, page 2.

of non-reimbursable transfers or of contingent loans on concessional terms to the extent necessary to avoid disruption of development programs on occasions when:

- (a) export proceeds (including, where appropriate, invisibles) had fallen below "reasonable expectations," and
- (b) there had been actual or attempted recourse to the IMF's compensatory facility but this had, for some reason, proved inadequate.

Illustrative reasons for possible inadequacy of the Fund's facility under (b) above are cited in the Recommendation. They are:

- (i) that following a compensatory drawing in one year exports might fall below reasonable expectations in subsequent years;
- (ii) that when drawings had to be repaid, exports might not have recovered sufficiently for this to be possible without disruption of development;
- (iii) that there might be a significant shortfall in exports which the IMF judged to be not of a short-term nature and which it, therefore, refused to finance.

These illustrations, especially (i) and (iii), appear to assume that the Fund employs a definition of export shortfall similar to that suggested in the Recommendation, but might be unable to provide adequate finance because the shortfalls, so defined, were expected to, or did in fact, go on too long. In reality, however, as will become clearer below, the Fund's concept of shortfall from medium-term trend as at present defined is substantially different from that of "shortfall from reasonable expectations" however interpreted, and very different from the latter concept as interpreted in the Study.

#### The Bank Staff Scheme

Executive Directors have received copies of the printed version of the Study, *Supplementary Financial Measures*, produced by the Bank staff in response to the foregoing Recommendation. Such of the features of the scheme proposed in that study as appear most relevant to the operations of the Fund are set forth below. Page references are to the printed document, henceforth referred to as the "Study."

#### A. Purpose

In harmony with the UNCTAD Recommendation A-IV-18, the objective to which the Study addresses itself is that of "preventing the disruption of sound development programs or policies by unexpected shortfalls in export earnings which are of a nature or duration which cannot adequately be dealt with by short-term balance of payments support," or, more precisely,

that of providing developing countries "with a ready source of long-term assistance to enable them to maintain internationally approved development programs in the face of unforeseen adverse export movements that are beyond their control and beyond their ability to offset from reserves or to finance on a short-term repayable basis." (p. 2) The emphasis on "programs" is important. While "development" is a continuous and continuously adjusted process, "development programs," partly for reasons of publicity and legislative convenience, are made at discrete intervals covering a number of years at a time, and their frequent adjustment is difficult.

B. Administration

The scheme is to be administered by an (unspecified) international agency (hereinafter referred to as the "Agency"), working in close cooperation with the IBRD and the IMF.

C. Nature of Export Shortfalls to be Financed

The scheme is one for the prompt, partial and conditional financing of the export shortfalls of the developing countries. The first question is how these shortfalls are defined. The UNCTAD Recommendation had defined them as "shortfalls from reasonable expectations." This implied that the shortfall would be measured not, as in the Fund scheme, from some currently estimated export trend but from some expected level of actual exports. The Recommendation left it vague how far prior to the time of the shortfall the expectation was to have been formed, and to whom it was to appear "reasonable." The interpretation adopted in the Study is that export projections covering a four or five year period should be made simultaneously with and as part of a development program which, with its associated policies, would be agreed between the country and the Agency. This implies that the export projections from which the shortfalls are measured would be such as had appeared reasonable at a point of time preceding the shortfall by anything from a few months to more than five years. By contrast, the compensatory financing shortfall of the Fund is measured from a trend value consisting of the average exports over a five-year period centered on the shortfall year, as estimated after the end of that shortfall year. The estimation of the Fund shortfall thus involves forecasting exports less than two years ahead, and the influence on the trend estimate of such forecast data is reduced by the inclusion in the trend of figures for past exports.

An important feature of the Supplementary Financing Scheme is its cumulative aspect. Strictly speaking, what is to be financed (to the extent appropriate) is not the shortfall for any particular year but the net cumulative shortfall for the projection period as a whole. Before any assistance was provided with respect to a shortfall for any particular year, an allowance for any "overages" or excesses of actual over projected exports that might have occurred earlier in the projection period would be subtracted from the shortfall, and any overages occurring later would entail repayments of assistance provided earlier. Overages would not, however, be carried over from one projection period to another.

On the assumption that projected exports would probably follow a less uneven course within the projection period than would actual exports, this arrangement would lead to some smoothing out of current export availabilities (export receipts plus financing) within that period provided that shortfalls accrued throughout the period or in its early years; it would, however, have little or no effect of this kind if overages occurred throughout the period or in its early years.

Moreover, if export availabilities are made to approximate projected exports--whether by financing of shortfalls or repayment of overages--in the last years of one projection period, they may change abruptly between then and the first years of the next projection period.

D. Degree of Compensation of Shortfalls

It is not envisaged that the scheme would compensate export shortfalls, even on the cumulative basis described above, in full. In the first place, as discussed below, there would be some sort of prior agreement between Agency and country as to "how much of a shortfall in expected earnings could be experienced without disrupting the development program." (p. 7) Secondly, "It would be expected that as far as possible a part or even all of the shortfall would be offset by use of the country's own reserves or by drawings on the IMF. To the extent that export shortfalls, as defined under the Scheme, were to overlap shortfalls under the IMF compensatory financing facility, the IMF should, if possible, be the source of help. Furthermore, the member might well be in a position to combine drawings under the compensatory financing facility with drawings under the ordinary tranche policy of the Fund." (p. 7) "In addition, the Agency would take into account the possibilities of using other sources--for example, the emergency foreign trade loans of the U.S. Export-Import Bank, the program loans and the Food for Peace Program of the U.S. Agency for International Development, the World Food Program, etc.--for offsetting shortfalls," (p. 8)

It will be seen that the Scheme is intended to provide only residual financing of shortfalls as defined in the proposal. "After other sources of finance had been taken into account, the Agency would provide the remaining amount needed to prevent disruption of the development program, according to the prior agreement with the country." (p. 8) Given the need to explore all other sources of finance, the scheme could not indicate what proportion of net shortfalls countries would be expected normally to leave uncompensated or to meet out of their own resources or out of national or international financial assistance that would have been available to them in any case. On p. 64 of the Study, it is estimated that total gross shortfalls for all developing countries over the 1959-63 period may have amounted to \$1.6 billion per annum, which is equivalent, net of overages, to \$1.4 billion per annum. However, it is suggested (p. 13) that the net financial requirement for an initial experimental period of 5 years might be \$300-\$400 million per annum. Part of this difference is accounted for by the assumption that the projections on which the shortfalls

are based would improve, and that some developing countries would be unable to qualify under the Scheme; however, the allowance for non-financing of shortfalls or their financing with existing resources is presumably substantial.

E. Nature of Performance Criteria

It is an important characteristic of the arrangements for Supplementary Financing put forward in the Study that they attempt to combine conditionality in the provision of assistance with some degree of assurance to the recipient that assistance will in fact be forthcoming. This object is to be accomplished by providing that assistance from the Agency will be conditional on the member's implementation of "an agreement on development policies" to be concluded with the Agency in advance of the occurrence of the shortfall. "A member would qualify for assistance under the Scheme as long as its agreement with the Agency on development policies was being carried out. In case a member were not living up to agreed policies, it would be informed by the Agency that it would no longer be entitled under the Scheme to assistance in case of subsequent export shortfalls." (p. 12)

The scope of this prior agreement is exceedingly wide. It is intended to cover:

- (i) the country's export expectations,
- (ii) projections of all the other principal elements in its balance of payments including imports, reserve use, and external financing,
- (iii) its development program, with particular reference to the public sector.

On all these issues the agreement would cover not only projections but the policies required to implement them. This is explicit with respect to exports and development planning and is strongly suggested (see p. 9) for balance of payments matters also, at least as regards "major criteria and policies."

The agreement would also cover:

- (iv) a judgment on how much of a (hypothetical) shortfall in expected earnings could be experienced without disrupting the development program, and
- (v) the feasible adjustments to unexpected shortfalls without disrupting the agreed development program, including use of available resources and other sources of external credit." (p. 8)

It appears to be envisaged that all of these topics would be dealt with, to some extent, in an initial agreement between the country and the Agency at (or before) the beginning of each projection (planning) period, though it is difficult to see how policies on (ii), (iv) and (v), applicable to the period as a whole, could be established at that time in other than vague terms. Since, however, it is accepted that "Economic policies require revisions in response to changing circumstances and no agreement on specific issues can remain valid for the duration of a five-year plan," it is envisaged that "the policy package would not be frozen at the time of the initial consultation" and it is proposed that consultations should take place at appropriate intervals (probably annually) between the member and the Agency, "each having the right to initiate discussions looking to a new agreement on appropriate policies and each remaining bound by an outstanding agreement if no such discussion is underway. The financing plan and balance of payments projection agreed on at the start of the period would also have to be reviewed at these times." (p. 10) This formulation leaves it unclear whether the obligations incurred in consideration of the initial agreement, including the obligation to compensate shortfalls from the initial projection, remain effective only until one of the parties has asked for a new agreement, or until discussions to this end have got underway, or, finally, until a new agreement has been reached. The wording on p. 12, however, ("A member would qualify for assistance under the Scheme as long as its agreement with the Agency on development policies was being carried out") would support the lastmentioned interpretation. Moreover, from what is said on pages 42 and 52 of the Study, it would appear that revisions in export expectations would be of somewhat infrequent occurrence.<sup>1/</sup> On the other hand, it is envisaged that the adjustment measures (point (v) above) would be adapted from time to time, and the point is made that "a rolling plan, that is, a plan revised every two or three years but each time for a period of four or five years ahead--may be the most effective type of planning in the right circumstances." (p. 43)

Finally, it is proposed that there would be consultations at the time of the shortfall "only ... to ensure that other available sources of financing were being used and that feasible adjustment measures not endangering the development program were being taken." (p. 10)

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<sup>1/</sup> e.g., "... the duration of export projections depends on the duration of the plan or program of which they are an integral part, which, in turn, depends on a large variety of factors including structural changes in export demand." (p. 42) "Adverse export movements reduce the capacity to import and depress incomes with the consequent depression of savings or government revenues, but generally do not invalidate the planned pattern of resource allocation." "... it is generally not possible to judge whether a particular export shortfall is a temporary event or the beginning of a new trend. (See pages 40-41.) So long as there is such uncertainty, it will be more sensible to adhere to the carefully prepared development program than to undertake quick alterations." (p. 52)

F. Terms of (Residual) Financing

As is stated on p. 59 of the Study, "Under the Scheme, the Agency should base the terms of its finance--the rate of interest as well as maturities--on the over-all financial and economic position of the member. The Agency should take account of factors similar to those considered by the existing international financing agencies." Greater precision is given to this statement by the following sentence from p. 60 of the Study: "By and large, it may prove reasonable to extend assistance under the Scheme on about the same terms at which the country is obtaining development finance for other purposes."

G. Relationship to Certain Points in the UNCTAD Recommendation

The Study emphasizes, and gives a particular interpretation to, certain key features of the UNCTAD Recommendation while giving lesser weight to other features. The features emphasized include the gearing of assistance to (a) shortfalls in exports from "reasonable expectations," and (b) the avoidance of "disruption of development programs." The special interpretation given to these concepts consists in the use made of discrete projection or planning periods, each covering a term of years, though the Recommendation might not have precluded a scheme based on a more continuous process of projection and policy formation.

The elements in the UNCTAD Recommendation given less weight are those which envisage (i) the use of the scheme to finance shortfalls too persistent for the Fund to handle under its compensatory financing facility, and (ii) the refinancing of Fund assistance which falls due for repayment when exports are unsatisfactory. The notion under (i) is largely inapplicable, as a result of the difference in the definition of "shortfall" presently used in Fund practice and in the Study respectively, though on the Study's own definition of shortfall some account of the element of "persistence" is taken through the provision for using "overages" to offset shortfalls within a given projection period.

Interrelation with the Activities of the Fund

From the description given above it would seem that many problems may arise in reconciling the supplementary financing scheme as set forth in the Study, with the functions of the Fund in the balance of payments sphere, and with the principles on which the Fund has, until now, exercised these functions. These problems relate to the Fund's activity as a whole, including its regulatory and consultative functions as well as its financing functions.

The Agency, as already explained, is to make agreements with, and apply conditions to, countries desirous of qualifying for supplementary financing assistance on such matters as basic export policies and balance of payments policies in general, and, in the event of unexpected export developments, the measures of balance of payments adjustment to be adopted and the use to be made of the country's reserves and borrowing potential.

All these are matters which fall within the purview of the Fund, and are, indeed, at the center of its concern. Unless the Agency and the Fund in dealing with such questions were able to achieve a reconciliation in their criteria and policies, undesirable consequences could easily arise. For example, in the absence of such reconciliation, a member, in dealing with a given export shortfall, might well receive disparate advice from the two international organizations. To the extent that Fund resources were used to finance part of the shortfall, a part being financed by the resources of the Agency, the member might even be faced with two different sets of conditions for financing. Moreover, since the Agency would provide the residual financing, the country would know that any decline in Fund financing due to failure to adhere to Fund terms could be made good by the Agency, provided the Agency's terms were adhered to.

Again, it has to be borne in mind that the supplementary financing proposal is intended to cover only disequilibria arising from shortfalls in exports, including current invisibles, while the Fund's financial assistance covers disequilibria arising from any and all elements in the balance of payments. This would lead to the anomalous situation that whereas in the event of unexpected declines in exports the Agency, being the residual lender, would often be in a position to secure the adoption of its prescriptions regarding the appropriate adjustment policies, in the event of unexpected changes in other elements, e.g., declines in capital inflows or in import-competing production, the Fund, which in that case would be the residual lender, might be in a position to secure the adoption of its--possibly rather different--prescriptions for adjustment.

The Study shows an awareness of the problem of reconciliation referred to above by providing that, in preparing the policy package, "full collaboration would be required with existing international agencies including the IBRD and the IMF." (p. 10) "As a consequence," it is believed, "the financing plan would normally be consistent with the financial policy targets and criteria agreed upon between the country and the international financing agencies."

The extent to which this expectation would be realized so far as the Fund is concerned clearly depends on the precise relationship that would be established between the Fund and the Agency, and on the extent to which the Fund's views as to appropriate adjustment policies would be accepted by the Agency. At the very least, there would be need for a very high degree of coordination between the prescriptions of the Agency--or of the Bank--with respect to appropriate development policies and the prescriptions of the Fund with respect to appropriate balance of payments adjustment policies.

Consideration of certain of the features of the proposed scheme--its emphasis on periodic planning, its procedures for arriving at the policy package, and to a lesser extent its provisions as to the terms of lending--imply an attitude towards the balance of payments adjustment process which differs to some extent from that so far adopted by the Fund. No implication is intended that the Fund's attitude is necessarily right and that of the scheme necessarily wrong, but merely that the marriage of minds described above may not be easily arrived at.

In the first place, while the injunction laid upon the Fund in Article 1 of its Articles of Agreement to "shorten the duration and lessen the degree of disequilibria in the international balances of payments of members" is to be read together with the acknowledgement, in the same Article, of "the development of the productive resources of all members" as a primary objective of policy, it has been the Fund's practice to urge its members to begin the process of adjusting their claims on resources, whether for investment or for consumption, to unexpected trends in outside forces affecting the balance of payments, as soon as these trends can be recognized and distinguished from temporary fluctuations. The Fund's facility for the compensatory financing of export fluctuations is a particular example of this general policy expressed, because of its semi-automatic nature, in a more formal manner than usual. The aim of this facility is to keep export availabilities (i.e., export receipts plus compensatory drawings minus repurchases) as close as possible to the medium-term trend of export receipts, as currently estimated. The scheme presented in the Study, on the other hand, aims at providing countries with export availabilities that are related to levels largely determined one to five years in advance, and though there is provision for annual consultations in which the country could be urged to hew to some more realistic line, it is not clear that a country reluctant to adopt this advice could be faulted or denied its right to export availabilities on the scale originally envisaged so long as the country was following the policies agreed upon. Again, while the Fund lays emphasis on smoothness and continuity of adjustment, the Study lays greater emphasis on fulfilment of predetermined programs. Perhaps the Fund approach could be criticized for taking too little account of the time lag required for the adjustment of development programs to emergent realities, and that of the Study for laying too much emphasis on long-term forecasts in the balance of payments field and too little emphasis on the dangers of persistence in adhering to a development plan which export developments have shown not to be permanently sustainable.

The longer the time given to adjust to adverse changes in the balance of payments the more substantial must be the financial assistance provided for meeting such adverse trends. While all causes of disequilibria will affect the ability of a country to sustain its development program, there is a clear possibility, under the Supplementary Financing Scheme, especially if the Fund and the Agency operate under different criteria of adjustment, that too much financial support will be given to development programs in one contingency (export shortfalls) compared with what is given in others.

Differences of approach between the Fund and the Agency as to the policy aims to be negotiated with member countries are likely to involve differences in character of the negotiations themselves. Even if the policy package, which is the central feature of the Supplementary Financing Scheme, were entrusted entirely to the Fund, so far as balance of payments policies are concerned, it is difficult to see how the Fund could commit itself to quantitative precision regarding the financial and exchange policies required to implement balance of payments projections over a five year period, or could make advance prescriptions as to the appropriate method of adjustment in the face of any of the thousand and one events that might tend to falsify the projections. It is understood that the Bank staff, being aware that quantitative precision in such matters could not be achieved over a five-

year period, had envisaged, in making their proposals, that the initial policy package might include undertakings on the part of the country concerned to follow such recommendations as the Fund might make in subsequent years in consultation with that country with respect to exchange policies and internal financial policies, provided that these were compatible with the objective of maintaining the development program as originally agreed.

Quite apart from the problems, already discussed, of reconciling the objective of flexible balance of payments adjustment with the implementation of a predetermined development program, however, countries on their side might well hesitate to commit themselves in advance to adopting whatever methods of adjustment the Fund might later recommend to deal with unforeseen balance of payments difficulties.

So far as balance of payments policies are concerned, therefore, it is not easy to see how the two principal features of the scheme, (a) advance assurance for the countries concerned regarding prospective export availabilities, and (b) assurance for the Agency (and for the countries providing the funds) that suitable policies will be adopted by countries drawing upon the resources of the Scheme, are to be reconciled. It is no accident that, in the Fund's current practice, both advance assurance of financing--by way of standby arrangements--and agreements as to balance of payments policies to be pursued as a condition of such assistance are confined to periods of one, or at most two, years ahead.

It has been a principle of Fund operation not only that Fund resources should be confined to the financing of temporary deficits but also that drawings should be repaid in the medium term, i.e., the deficit should be not only temporary but also reversible. An essential feature of the Supplementary Financing Scheme is that assistance provided to developing countries should be provided on a more or less long-term basis. Clearly there is a much better case for saying that countries should aim to eliminate their deficits in a relatively short period of years than that they should aim thereafter at producing an (equally temporary) surplus in order to permit early repayment. While the Fund does not provide long-term balance of payments financing, it does not follow that balance of payments financing should never have a long repayment period. For example, the conception contained in the UNCTAD Recommendation that compensatory financing that cannot be repaid to the Fund in the short run out of export surpluses might be refinanced on a long-term basis is one that deserves serious consideration.

It should be clear, however, that this conception could not be extended to the proposition that all Fund drawings by developing countries should be repayable, if at all, only over a very long period without bringing into question the rationale of the membership of these countries in the Fund. This rationale, as well as the proposition that the developing countries have an important need for reserves, is founded in the belief that these countries are not only in need of long-term capital but are also subject to reversible fluctuations which they can properly meet by short-term credit and short-run fluctuations in their reserves. Many of the developing countries have built up their reserves over time, with short-term fluctuations, and have either never used the Fund or used the Fund as it was intended to be used, for periods of a few years only.

Given the various discrepancies between the principles of balance of payments adjustment that have traditionally been applied by the Fund and those explicit and implicit in the supplementary financing scheme, a system under which the proposed new Agency would urge the member to finance as large a part as possible of any shortfall--as defined in the Scheme--and would itself provide residual financing also calls for a certain amount of examination. It is the residual financing which is in a sense decisive for the policy to be followed by a country, and it is for this reason that the Fund, as the international agency bearing primary responsibility in the sphere of balance of payments equilibration, has normally itself played the role of residual financier.

Where shortfalls in terms of the Fund's compensatory financing scheme happened to coincide in time, though not in magnitude, with shortfalls under the supplementary financing proposal, it might no doubt be possible for a country to draw under the terms of the Fund's facility and then draw further amounts under the supplementary financing scheme. Even in this case, however, the compensatory financing scheme would have missed part of its intention--that of encouraging countries to adjust to the medium-term trend of their exports--and would be serving a purpose other than its own. Still greater difficulties would obviously arise if the Fund were asked to allow an ordinary drawing, in the credit tranches, to help finance a shortfall under the supplementary financing scheme, in the knowledge that the residual financing provided under the scheme would enable the country to disregard the policy conditions of the drawing.

In conclusion, it may perhaps be instructive to summarize some of the observations made above by asking the question in what essential respects the supplementary financing scheme would differ from the Fund. Both the scheme and the Fund are intended to give countries protection from temporary difficulties in order to enable them to pursue their policy objectives with a minimum of unnecessary disturbance.

1. Perhaps the most striking difference between the supplementary financing scheme and the Fund is that the scheme concentrates on one kind of disturbance--export shortfalls--whereas the Fund's resources are available to members to meet temporary disequilibria arising from disturbances in any or all of the items in the balance of payments, including irregularities in the supply of capital or in the need for imports. The latter may often be due to inappropriate financial policies. The Fund will, in that event, reach understandings with the countries concerned as to the policy measures necessary to overcome these payments difficulties but will, assuming these understandings are satisfactory, assist the country in maintaining a reasonable level of imports until the payments difficulties have been overcome. The Fund's compensatory financing facility is only a minor part of the Fund's total assistance to countries within this general framework.

2. The supplementary financing scheme is based on different criteria of balance of payments adjustment than those applied by the Fund. Many of the difficulties described in this paper would disappear if the criteria of balance of payments adjustment applied by the Fund and the supplementary financing agency were brought into harmony. To the extent that modifications to this end are made in the Fund's own policies, however, they should extend across the whole field of Fund operations. It would be illogical for the Fund to facilitate the maintenance of development programs in the event of unexpected export declines to any greater extent than it is prepared to facilitate their maintenance in the event of other unexpected adversities in the balance of payments.

3. Supplementary financing, primarily because it is based on different criteria of adjustment, is likely to be much larger in scale than the Fund. Net Fund drawings by less developed countries have averaged \$120 million a year over the last 10 years for payments difficulties of any kind. Supplementary financing, which addresses itself only to payments difficulties arising from export shortfalls, is expected to amount, on a residual basis, to \$300 to \$400 million a year.

4. Fund drawings are repayable within a 5-year period, although members can make new drawings when their situation and their policies justify such drawings under Fund criteria. Supplementary financing drawings would be repayable on terms similar to those applicable to development finance.

United Nations Conference on Trade and Development  
Final Act and Report

Annex A.IV.18

Supplementary Financial Measures

A

*The Conference,*

*Recognizing* that adverse movements in the export proceeds of developing countries can be disruptive of development, and noting that the International Monetary Fund (IMF) can make available balance-of-payments support to help meet the short-term effects of shortfalls in export proceeds,

*Recommends* that the International Bank for Reconstruction and Development be invited to study the feasibility of a scheme with the objective set forth in Section I below and based on the principles set forth in section II below, and, if appropriate, to work out such a scheme.

I. Objective

1. The new scheme should aim to deal with problems arising from adverse movements in export proceeds which prove to be of a nature or duration which cannot adequately be dealt with by short-term balance-of-payments support. Its purpose should be to provide longer term assistance to developing countries which would help them to avoid disruption of their development programmes.

II. Principles

2. The scheme should be provided with resources by contributions from participating countries, shared between them on an equitable basis.

3. Developing countries only should be eligible for assistance from the scheme; such assistance should be on concessional and flexible terms.

4. The scheme should normally be applicable after a developing country had had recourse to the International Monetary Fund, under its compensatory financing facility, and it had been possible to make a full assessment of the nature, duration and implications of any adverse movement in the export proceeds of the developing country concerned.

5. An adverse movement for the purposes of the scheme should be regarded as a shortfall from reasonable expectations (see Note 1 below) of the level of export proceeds (including, in appropriate cases, invisible exports).

6. A *prima facie* case for assistance from the scheme should be established by reference to shortfalls from reasonable expectations and to their nature and duration (see Note 2).

7. Once a *prima facie* case has been established there should be an examination, under the International Development Association, of all relevant economic circumstances (see Note 3) in order to assess how far assistance from the scheme would be required and justified in order to help avoid disruption of development programmes. Subject to these points, assistance could cover a substantial proportion of a shortfall from reasonable expectations.

8. Resources for the scheme, which would be administered under the International Development Association, should be in the form of additional commitments, prescribed in advance, for contributions to the Association; all major Part I member countries of the Association should contribute.

#### NOTES

Note 1. To the extent that these could be prescribed in advance they could be taken account of by developing countries for planning purposes.

Note 2. The following are offered as illustrative circumstances which might constitute a *prima facie* case for assistance from the scheme to a developing country:

- (i) If, following an IMF drawing in one year under its special compensatory financing facility, exports fall significantly below reasonable expectations in the second or third year.
- (ii) If, when the IMF drawings were due to be repaid, exports had not recovered sufficiently for this to be possible without disruption of development.
- (iii) If there were a significant shortfall in exports which the IMF adjudged at the outset to be other than of a short-term nature and the IMF had decided that it would be inappropriate for it to provide temporary balance-of-payments support.

Note 3. Among other matters, these could include adverse effects from significant rises in import prices.

B

*The Conference also recommends* that the continuing machinery recommended by this Conference be invited to study and organize further discussion of the following concepts and proposals for financing put forward by the delegations of the developing countries at the Conference:

1. That a fund be set up, financed by contributions from developed countries, as required, and administered by an appropriate agency of the United Nations:
2. That only developing countries should be eligible to draw from the Fund;
3. That disbursements should be in the form of non-reimbursable transfers and/or contingent loans on concessional terms;
4. That the criteria used in deciding upon claims should be as objective as possible and should include the following:
  - (a) The effect of shortfalls in export earnings and the adverse movements in the terms of trade;
  - (b) The effect on the country's development programme;
5. That to complement this longer term approach, facilities be provided for interim financing, when warranted, to assist the developing countries concerned while the longer term problem is being assessed.

DOCUMENT OF INTERNATIONAL MONETARY FUND  
AND NOT FOR PUBLIC USE

FOR  
AGENDA

Secretary - Bank

Room 211

#12

SM/66/104

August 26, 1966

To: Members of the Executive Board  
From: The Acting Secretary  
Subject: Compensatory Financing: A Short List of Repurchase Systems

The attached paper has been prepared to present relevant statistical data and staff evaluations with respect to those repurchase systems on which discussion at Executive Board Meeting 66/73 on August 19, 1966 appeared to concentrate. As noted in SM/66/77, Revision 1, Supplement 1, the subject, Compensatory Financing, is expected to be brought to the Board Agenda during the first week after the recess.

Att: (1)

Other Distribution:  
Department Heads  
Division Chiefs

INTERNATIONAL MONETARY FUND

Research and Statistics Department

Compensatory Financing: A Short List of Repurchase Systems

Prepared by Research and Statistics Department

August 25, 1966

The present paper is intended to present relevant statistical data and staff evaluations with respect to those repurchase systems on which discussion at the Executive Board at Meeting No. 73 of August 19, 1966, appeared to concentrate. These are System (6), System (8), a new system, suggested by Mr. Lieftinck, which we may term System (9), a new system suggested from the Chair as a modification of System (9), which we may term System (10), and a modification of System (1), suggested from the Chair, which we may term System (11). These systems are described below, and (with the exception of System (11)), their performance is measured in Tables 1 to 3.

System (6). Repurchase in five annual installments. However, in considering any request for a compensatory drawing, one half of any repurchases on previous compensatory drawings occurring within the preceding twelvemonths may, at the country's request, be subtracted from exports in computing the shortfall, provided that the member has been cooperating with the Fund in an effort to find appropriate solutions for its balance of payments difficulties, and provided that the resulting shortfall exceeds 2 per cent of the member's quota (the 2 per cent "cut-off").

System (8). Half of any export excess accruing in the first three years following a shortfall for which a drawing has been made to be used for repurchase; in the fourth year either half the amount still outstanding or half the excess, whichever is the greater, to be repurchased, the remainder being paid in the fifth year.

System (9). In each year until full repayment is made an amount will be repurchased equal to 20 per cent of the drawing or one quarter of the export excess, whichever is the greater. In computing shortfalls for compensatory drawings one quarter of any repurchases of previous compensatory drawings made in the preceding twelvemonth period could be subtracted from exports, subject to the same provisos as for System (6) above.

System (10). Same as System (6) except that, in computing shortfalls for a compensatory drawing, one quarter (not one half) of any repurchases on previous compensatory drawings accruing in the preceding twelvemonths could be subtracted from exports.

System (11). The existing system of repurchase within a 3 to 5 year period, but with the recommendation to members that one half of any export excess that may occur in the first three years after the drawing should be devoted to repurchase.

The performance of these systems as measured by statistical criteria is set forth in Tables 1 to 3. System (11) is not explicitly mentioned in these tables but, depending on the extent to which the recommendations are observed or not, its performance could approximate to that for System (8) and that for System (1) (the existing repurchase system) respectively.

The Staff is still inclined to regard System (6), on a balance of considerations, as the best available system. Its statistical performance, in terms of the degree of approximation and smoothness attained, and the cost involved, though not as good as Systems (8) or (9), is significantly better than that of the present system. It gives an assurance to countries that they will not be required to repay more than 20 per cent of the drawing in any year. It does something explicit to meet the UNCTAD request to explore ways to refinance compensatory financing obligations if shortfalls should permit. By so doing repurchases will, to some extent be concentrated on years of export excess, thus applying the compensatory principle to repurchase as well as to drawings. Finally, System (6) is easier to administer than Systems (8), (9), or (11).

Systems (8) and (9) both show good performances by statistical tests, and apply the compensatory principle in a logical way to repurchases as well as to drawings. In addition, System (9) pays some regard to the UNCTAD request referred to above. Both Systems, however, and especially System (9) raise difficult though not unsurmountable administrative problems whenever a country has a number of compensatory drawings outstanding simultaneously, with different and overlapping export periods. Conventions will then have to be adopted to avoid double counting of export excesses.

System (10) is a variant of System (6) which, though it does less than System (6)--and much less than System (5)--to meet the request for a re-financing facility, may for that reason be more acceptable.

System (11) may be regarded as an application of the principle encountered in paragraph 2(a) of Decision No. 102-(52/11) of February 13, 1952, according to which "exchange purchased from the Fund should not remain outstanding beyond the period reasonably related to the payments problem for which it was purchased from the Fund." The repurchase provision of the decision will contain a clause urging that members should use half of any export excesses that they may have in any year to repurchase any outstanding drawings under paragraph 5. In accordance with this clause, the Fund will make the necessary calculations of export excesses at appropriate times, and will bring the results to the attention of the member. It is difficult to know how well a system of this kind would work in practice, and it might appear to be a less effective solution than it would prove in practice. At any rate it may be regarded as an interim solution that would keep the compensatory principle of repurchase alive pending the reconsideration of the question promised in the concluding paragraph of the draft of the new decision.

Table 1. Compensatory Financing: Effect of Various Repurchase Systems,  
48 Countries (1951-64) and Hypothetical Country B<sup>1/</sup>  
(Qualified 50 Per Cent of Quota Limit)

	48 Countries			Hypothetical Country B		
	Approximation ratio <sup>2/</sup>	Smoothness ratio <sup>3/</sup>	Average Drawings outstanding <sup>4/</sup>	Approximation ratio <sup>2/</sup>	Smoothness ratio <sup>3/</sup>	Average Drawings outstanding <sup>5/</sup>
System 1 <sup>6/</sup>	.035	.047	.45	.123	.148	6.2
System 6 <sup>7/</sup>	.041	.060	.38	.135	.160	4.5
System 8 <sup>8/</sup>	.043	.071	.32	.120	.141	3.1
System 9 <sup>9/</sup>	.045	.071	.33	.142	.165	3.4
System 10 <sup>10/</sup>	.040	.059	.37	.133	.158	4.2

1/ Weights of .50, .25 and .25 applied to years t, t-1, and t-2, respectively, for estimating calculated norm. 100 per cent compensation of calculated shortfall.

2/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

3/ Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

4/ Average for all years of total amounts outstanding, in billions of U.S. dollars.

5/ Average for all years of total amounts outstanding, in units. (Exports of country B vary between 100 and 238 units, and its quota is assumed to rise in quinquennial steps from 20 to 40 units.)

6/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

7/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

8/ 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

9/ In each year either 20 per cent of the drawings or 25 per cent of any export excesses, whichever is the greater, applied to repayment; 25 per cent of any repurchase is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

10/ Repayment in five equal instalments, beginning in the year following the shortfall year: one quarter of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

Table 2. Compensatory Financing: Effect of Various Repurchase Systems in Hypothetical Country B

Year	Exports	Standard Norm <sup>1/</sup>	System 1 <sup>2/</sup>			System 3 <sup>3/</sup>			System 4 <sup>4/</sup>			System 5 <sup>5/</sup>			System 10 <sup>6/</sup>		
			Drawings	Repur- chases	Avail- abilities	Drawings	Repur- chases	Avail- abilities									
1	105	101.2	--	--	105.0	--	--	105.0	--	--	105.0	--	--	105.0	--	--	105.0
2	109	105.7	--	--	109.0	--	--	109.0	--	--	109.0	--	--	109.0	--	--	109.0
3	100	103.5	3.5	--	103.5	3.5	--	103.5	3.5	--	103.5	3.5	--	103.5	3.5	--	103.5
4	101	102.7	1.7	--	102.4	2.1	0.7	102.4	1.7	--	102.7	1.9	0.7	102.2	1.9	0.7	102.2
5	115	107.7	--	--	115.0	--	1.1	113.9	--	3.6	111.4	--	1.7	113.3	--	1.1	113.9
6	120	114.0	--	--	120.0	--	1.1	118.9	--	1.6	118.4	--	1.4	118.6	--	1.1	118.9
7	135	126.2	--	1.7	133.2	--	1.1	133.9	--	--	135.0	--	1.5	133.5	--	1.1	133.9
8	100	113.7	8.4	2.6	105.7	6.9	1.1	105.7	5.7	--	105.7	5.7	--	105.7	6.8	1.1	105.7
9	135	126.2	--	0.9	134.1	--	1.8	133.2	--	4.4	130.6	--	2.1	132.9	--	1.8	133.2
10	125	121.2	--	--	125.0	--	1.4	123.6	--	1.4	123.6	--	1.1	123.8	--	1.4	123.6
11	120	125.0	4.6	--	124.6	5.7	1.4	124.3	5.0	--	125.0	5.3	1.1	124.1	5.3	1.4	124.0
12	140	131.2	--	4.2	135.8	--	2.5	137.5	--	4.4	135.6	--	2.2	137.8	--	2.4	137.6
13	160	145.0	--	4.2	155.8	--	2.5	157.5	--	0.6	159.4	--	3.6	156.4	--	2.4	157.6
14	170	160.0	--	--	170.0	--	1.1	168.9	--	--	170.0	--	0.8	169.2	--	1.1	168.9
15	100	132.5	9.8	2.3	107.5	8.6	1.1	107.5	7.5	--	107.5	7.5	--	107.5	8.6	1.1	107.5
16	130	132.5	2.5	2.3	130.2	3.9	2.9	131.1	2.5	--	132.5	2.9	1.5	131.4	3.2	2.8	130.4
17	115	115.0	--	--	115.0	1.3	2.5	113.7	--	--	115.0	--	2.1	112.9	--	2.4	112.6
18	125	123.7	--	--	125.0	--	2.8	122.2	--	0.6	124.4	--	2.1	122.9	--	2.4	122.6
19	130	125.0	--	4.9	125.1	--	2.8	127.2	--	3.4	126.6	--	2.1	127.9	--	2.4	127.6
20	130	128.7	--	6.2	123.8	--	2.8	127.2	--	4.7	125.3	--	2.1	127.9	--	2.4	127.6
21	144	137.0	--	1.2	142.7	--	1.0	143.0	--	1.2	142.7	--	0.6	143.4	--	0.6	143.4
22	160	148.5	--	--	160.0	--	0.3	159.7	--	--	160.0	--	--	160.0	--	--	160.0
23	192	172.0	--	--	192.0	--	--	192.0	--	--	192.0	--	--	192.0	--	--	192.0
24	218	197.0	--	--	218.0	--	--	218.0	--	--	218.0	--	--	218.0	--	--	218.0
25	218	211.5	--	--	218.0	--	--	218.0	--	--	218.0	--	--	218.0	--	--	218.0
26	200	209.0	9.0	--	209.0	9.0	--	209.0	9.0	--	209.0	9.0	--	209.0	9.0	--	209.0
27	232	220.5	--	--	232.0	--	1.8	230.2	--	5.7	226.2	--	2.8	229.2	--	1.8	230.2
28	208	212.0	4.0	--	212.0	4.9	1.8	211.1	4.0	--	212.0	4.5	1.8	210.6	4.5	1.8	210.6
29	238	229.0	--	--	238.0	--	2.8	235.2	--	4.5	233.5	--	2.7	235.3	--	2.7	235.3

<sup>1/</sup> Weights of 0.50, 0.25, and 0.25 applied to years t, t-1, and t-2, respectively.

<sup>2/</sup> Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

<sup>3/</sup> Repayment in five equal installments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

<sup>4/</sup> 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

<sup>5/</sup> In each year either 20 per cent of the drawings or 25 per cent of any export excesses, whichever is the greater, applied to repayment; 25 per cent of any repurchases is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

<sup>6/</sup> Repayment in five equal installments, beginning in the year following the shortfall year: one quarter of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

Table 3. Hypothetical Country B: Amounts Outstanding Under Various Repurchase Systems

Year	System 1 <sup>1/</sup>	System 6 <sup>2/</sup>	System 8 <sup>3/</sup>	System 9 <sup>4/</sup>	System 10 <sup>5/</sup>
1	-	-	-	-	-
2	-	-	-	-	-
3	3.5	3.5	3.5	3.5	3.5
4	5.2	4.9	5.2	4.7	4.7
5	5.2	3.8	1.6	3.0	3.6
6	5.2	2.7	-	1.5	2.6
7	3.5	1.5	-	-	1.5
8	9.2	7.3	5.7	5.7	7.2
9	8.4	5.5	1.4	3.6	5.5
10	8.4	4.1	-	2.5	4.1
11	13.0	8.4	5.0	6.6	8.1
12	8.8	5.9	0.6	4.4	5.6
13	4.6	3.4	-	0.8	3.2
14	4.6	2.3	-	-	2.1
15	12.1	9.8	7.5	7.5	9.6
16	12.3	10.8	10.0	8.9	10.1
17	12.3	9.6	10.0	6.8	7.7
18	12.3	6.8	9.4	4.7	5.3
19	7.4	4.1	5.9	2.6	3.0
20	1.2	1.3	1.2	0.6	0.6
21	-	0.3	-	-	-
22	-	-	-	-	-
23	-	-	-	-	-
24	-	-	-	-	-
25	-	-	-	-	-
26	9.0	9.0	9.0	9.0	9.0
27	9.0	7.2	3.2	6.2	7.2
28	13.0	10.3	7.2	8.9	9.9
29	13.0	7.5	2.7	6.2	7.2

1/ Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

2/ Repayment in five equal instalments, beginning in the year following the shortfall year: one half of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

3/ 50 per cent of export excesses applied to repayment in the first three years. In the fourth year either half the amount outstanding at the end of the third year or half of the export excess (whichever is the greater) applied to repayment. In the fifth year any amount outstanding at the end of the fourth year repaid.

4/ In each year either 20 per cent of the drawings or 25 per cent of any export excesses, whichever is the greater, applied to repayment; 25 per cent of any repurchase is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

5/ Repayment in five equal instalments, beginning in the year following the shortfall year: one quarter of repayments on past drawings is deducted from exports for the purpose of computing shortfalls, provided that the resulting shortfall exceeds 2 per cent of quota.

Supplementary Financial Measures

A. Scale of Operations

1. In the Bank Study the total of requirements, that is, the magnitude of the unexpected shortfalls, is placed at \$1.6 billion a year; net of "overages" [and allowing for use of the Fund's Compensatory Financing Facility, the net total is placed at an average level of \$1.2 billion per year.] There is a range of figures derived from different samples of countries and on the basis of data available for varying time periods; excluding oil exporting countries, and taking the lowest of the projected magnitudes as the basis, net requirements of finance would be \$800 to \$900 million a year. When invisibles and import prices have been considered, there may be a revision in these projections. In due course, it may also be possible to give a more firm estimate for countries other than oil exporters.

*how much just net of overages?*  
*more replant?*  
*reduction?*

*How get?*

2. There are several sources of external finance which deal with the general problem of balance of payments fluctuations, including export instability. These include, in the main, the Fund's Compensatory Financing Facility, the ordinary drawing tranches with the IMF, emergency foreign trade loans of the Export-Import Bank, the contingency fund resources of AID as well as its "Food for Peace" program. Further, not all of the developing countries may qualify under the Scheme, and the amplitude of shortfalls may also be narrowed with the pursuit of more adequate domestic policies as a result of the emphasis by the Agency on adherence to agreed policy guidelines. A country experiencing

a shortfall may use part of its own exchange reserves to make good the shortfall, and also resort to other adjustment measures such as restricting non-essential imports. On these considerations, it is suggested in the Study that the Agency should have total resources of \$1.5 billion to \$2 billion for an initial experimental period of five years, i.e., \$300 to \$400 million a year. It is recognized that neither requirements nor the availability of funds can be postulated with any precision. There is a necessary element of judgment in these estimates.

*do we meet  
point of  
increase  
frequency of  
reserves of  
payments?  
which?*

3. The possibility is noted that the quality of projections may improve, reducing the magnitude and frequency of unexpected shortfalls. On the other hand, the growth in the export trade of LDC's may enlarge the size of shortfalls in future. We may for the present ignore these expectations, retain estimated minimum requirements at \$800 to \$900 million a year, and reconsider the adjustments from this figure that could be made to take account of the factors stated above.

*is covered with  
under  
part  
scheme  
Fed  
agree?*

4. The revision of the Fund's Compensatory Financing Facility now under consideration envisages the use of Fund resources at peak periods of \$400 to \$500 million; the average level for any five-year period is likely to be substantially lower. The revised scheme envisages repurchases out of excess exports; it is expected that 4/5 of all compensatory drawings would be so repaid within five years. Notionally, we may place net outstandings of drawings for any five-year period under this scheme at about \$200 to \$300 million. It is now explicitly stated that the Agency would serve as a refinancing source for such outstandings. Accordingly, the Compensatory Financing Facility of the Fund cannot be a source that could be taken into

*?  
too simplified*

assumes average of magnitude of Fund drawings -

- 3 -

account in considering the resources needed for the Agency; nor can a deduction be made for overages, as the revised Compensatory Financing Facility of the Fund itself assumes repayments out of excess exports. Only to the extent that the overages as computed under the Scheme differ from and are larger than the excess exports that have been utilized for repayments to the Fund can any further allowance be made; this is likely to be small, if any. Another approach would be to take the gross Compensatory Financing Facility made available to developing countries during any five-year period and refinance this total through the Agency, at the same time taking full credit for the overages. The net result in terms of resources requirements for the Agency would be the same.

has this been computed?

not in first 5 years -

always come over time -

5. There are still the ordinary tranche facilities with the Fund. Such drawings have averaged for all developing countries together about \$120 million a year in the last 10 years. It is possible that such drawings would be larger in future. However, a part of this would have been taken into account even at the time of the initial calculations; and not all of it would be available as a source to meet unexpected shortfalls in exports.

6. Thus, on the whole, a realistic assumption for the Scheme would be not to take any credit for resources from Fund operations.

over max. than first period forecast -

7. If the Agency refinances net drawings from the Fund under its Compensatory Financing Facility, it would be logical to extend its refinancing role to other short-term, emergency, balance of payments support which the developing countries may arrange with the Export-Import Bank or with other organizations. Again, insofar

Now that refinancing is introduced, what is the gain to the Agency in forcing a country to borrow short-term from outside? (Earlier, the idea was such borrowing wd. reduce Agency needs).

as the U.S. Government makes sizeable contributions to the Agency for the specific purpose of taking care of unexpected shortfalls, it may be unrealistic to assume that the U.S. Government would also make available additional contingency funds for the same purpose to the AID. While AID has considerable flexibility in program/project selection and in allocating funds to particular countries, its resources are determined by annual appropriations by the U.S. Congress, and with the stationary or reduced levels of these appropriations in recent years, it is doubtful if AID would have any large margin left for additional responsibilities like this. Therefore, for the particular purpose in view, it is unlikely that the AID or the Export-Import Bank would have anything but marginal amounts.

?

why assume?

!!

all we need is for hundred millions?

Really?

8. The gold and foreign exchange reserves of developing countries, other than major oil exporters, are ~~already~~ <sup>now</sup> at levels that cannot be drawn down further; there are only very few exceptions to this. As for the scope for cutting down non-essential imports, such as luxury items of consumption, to the extent that the development programs have been formulated on a sound basis and agreed upon with the Agency, the levels and composition of imports would have been gone over carefully. Thus, both in respect of imports as well as foreign exchange reserves, while there may still be some cushion that could be used, the magnitudes involved would be very limited.

too strong

9. It would seem, therefore, that the several other sources of finance would not really add up to much and the resources required to meet unexpected export shortfalls would be considerably larger than the finances assumed for the Agency of \$300 to \$400 million a year. As the Study itself states, it would also be prudent to assume that most of

the developing countries would be able at some point to participate. No doubt, some countries could be faulted for non-adherence to policy agreements. Unless the policy packages and their enforcement are severely inhibitive, or a number of LDC's are irresponsible in implementing the program after having agreed to one - neither of which assumptions would be valid - one cannot pare down an estimated level of requirements from a minimum of about \$800 to \$900 million to less than half in the expectation that several LDC members would not qualify for assistance or in the hope that many of them would be able to affect adjustments in imports and dip deep into their own limited reserves.

10. At the same time, it seems equally unrealistic now, to assume that the donor countries would together contribute more than \$300 to \$400 million a year, for an initial experimental period of five years. Therefore, the conclusion seems inescapable that the Agency cannot undertake to make good a substantial part of the unexpected shortfalls. The developing countries should be given to understand at the outset that they cannot expect the Agency to cover a considerable part of any shortfall that may arise, but only a proportion of it, say 50 per cent.

*Separate quarter*

B. Means of Financing

11. The question of financing, that is, how the donor countries can or should contribute to the Agency is ~~only an incidental one~~ *not central & this alone*. In any case, this is a question which each of them faces more generally in regard to all development aid, bilateral and multilateral alike.

*what happens if cut out 1/3 of requirements as means of adjustment*

12. In the Brasseur plan the suggestion was made for supplementary import levies when world prices fall below agreed levels, the receipts being earmarked for use by exporting LDC's. The idea has also figured sometimes in the French exposition of their scheme for organization of markets. For some primary commodities, such as certain tropical products, prices could be raised reasonably for the consumer in the importing industrial country, without affecting consumption levels perceptibly.

13. Even now there are certain tariffs (protective or revenue duties), as well as non-tariff fiscal levies (excise duties), in industrial countries on primary commodity imports, and on imports of manufactures and semi-manufactures, the proceeds of which go into general revenues. Such custom duties are levied mainly on petroleum, sugar and beverages. Much larger amounts are realized through internal excise taxes on petroleum and tobacco; other items subject to excises are sugar, coffee, tea, etc. The excise taxes apply to imported quantities as well as domestic output, and it is not certain that any reduction in them will result in a marked increase in the consumption of these items. However, such a step, insofar as it increases consumption even to a limited extent, would secure for LDC's a welcome gain in their exports of these items to industrial countries. The reduction and elimination of tariffs would have a definitely salutary effect on the prospects for the exports of LDC's. The tariff barriers afford protection to domestic producers and encourage domestic production, as has happened in W. Europe and U.S.A. Primary commodity exports to industrial countries face competition from domestic production of the same commodities or of

substitutes, except in the case of some minerals.

14. Then, from the viewpoint of promoting the export trade of LDC's, both of primary commodities as well as manufactures and semi-manufactures, there is a clear case for the reduction of tariff and non-tariff charges by industrial countries. In the case of semi-manufactures and manufactures, although the import duties may be levied at fairly low rates, they affect disproportionately the exports of such items from LDC's to industrial countries, because of the relatively high incidence of the duties in relation to value added in the process of manufacture. It would be difficult to establish a case for imposing even further duties on these items, even for the purpose of securing resources for compensatory or supplementary financing. The more general argument is also valid, against the desirability or the feasibility of earmarking particular taxes or other sources of finance for specific purposes, national or international.

15. Thus, for the Supplementary Financing Scheme, as for general development aid, budgetary allocations from current revenues or loan finances would seem to be the appropriate course.

16. In an earlier note, I had suggested a variant of the Horowitz proposal as a means of enlarging resources for IDA (please see memo dated February 25, 1966). The suggestion would be valid, in my view, for supplementary financing also, especially if the scheme were to be entrusted to a subsidiary of the Bank or of the Fund or to a joint subsidiary of the two institutions.

FORM No. 75  
(2-60)

INTERNATIONAL BANK FOR  
RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL FINANCE  
CORPORATION

INTERNATIONAL DEVELOPMENT  
ASSOCIATION

ROUTING SLIP

Date

Sept. 7, 1966

NAME

ROOM NO.

Mr. Friedman

Mr. Sarchette

Mr. de Vries

Mr. Collier

To Handle

Note and File

Appropriate Disposition

Note and Return

Approval

Prepare Reply

Comment

Per Our Conversation

Full Report

Recommendation

Information

Signature

Initial

Send On

REMARKS

you might be interested.

From

A.M. Kamarck

## OFFICE MEMORANDUM

TO: Mr. Andrew M. Kamarck

DATE: August 12, 1966

FROM: Rena Zafiriou *Rz*SUBJECT: IMF Lending to Underdeveloped Countries

Some time ago I mentioned to you that in looking at the pattern of IMF operations I had been impressed by the smallness of its contribution to the financing of the underdeveloped countries and by the predominant position which United Kingdom drawings have occupied in total IMF financing. I thought you may want to see the figures:

1. During the six-and-a-half-year period 1960-June 30, 1966, net drawings from IMF averaged \$575 million per annum, with the United Kingdom alone accounting for 57% of the total and the underdeveloped countries combined for 25% of the total. The share of the underdeveloped countries becomes even smaller, only 10% of the total, if one looks at IMF operations during the past three-and-a-half years:

	January 1, 1960 - June 30, 1966			January 1, 1963 - June 30, 1966		
	Total	Average Per	Per cent	Total	Average Per	Per cent
	Million \$	Annum	of total	Million \$	Annum	of total
<u>Net Drawings:</u>						
United Kingdom	2,151	330	57	2,431	695	75
United States	547	85	15	547	155	15
Other developed and relatively developed <u>1/</u>	131	20	3	-13	-3	
Underdeveloped	899	140	25	362	103	10
Total	3,728	575	100	3,327	950	100

1/ Includes Spain, Portugal, Greece, Turkey, Yugoslavia, etc.

2. A comparison with the 1950's shows that while, in absolute amounts, net drawings by the underdeveloped countries had been smaller, the share in total IMF financing had been much larger, averaging 70% of the total during 1952-1959:

	<u>1952-1959</u> Million \$	<u>Average</u> <u>Per Annum</u>	<u>Per cent of</u> <u>total</u>
<u>Net Drawings:</u>			
United Kingdom	58	7	10
United States	-	-	-
Other developed and re- latively developed	119	15	20
Underdeveloped	422	53	70
Other	<u>25</u>	<u>3</u>	<u>-</u>
Total	574	72	100

3. The smaller share of the underdeveloped countries in total IMF financing during the 1960's, and especially during the past three-and-a-half years, reflects mainly the fact that the expanded activity of the Fund during that period has been directed almost exclusively towards meeting the needs of the United Kingdom and the United States. The decline in the share of the underdeveloped countries is most striking in the case of Latin America (due both to a smaller share in drawings and to much larger repayments). Tables 1 to 3 illustrate these developments.

4. The decrease in IMF financing in Latin America obviously cannot be attributed to lack of IMF resources and certainly not to lack of need and one may therefore infer that it reflects mainly IMF reluctance to extend larger credit facilities to the area.

5. In this connection and in view of the current discussions on international liquidity, it is interesting to compare the recent rate of IMF lending with the institution's available resources. Net drawings during the 1960's have averaged \$575 million per annum and during the past three-and-a-half years \$950 million per annum. Outstanding credits on June 30, 1966 totalled \$4.7 billion, the principal borrowers and currencies used being as follows:

<u>Drawings outstanding</u>		<u>Currencies drawn</u>		<u>Net drawings</u>	
United Kingdom	2,997	United Kingdom	566	United Kingdom	2,431
United States	1,180	United States	650	United States	530
India	475	Germany	918	India	475
Brazil	135	France	731	Brazil	135
Argentina	134	Italy	465	Argentina	134
Egypt	121	Netherlands	284	Egypt	121
Yugoslavia	118	Belgium	260	Yugoslavia	118
Chile	111	Canada	253	Chile	111
Colombia	95	Japan	140	Colombia	95
New Zealand	70	Sweden	110	New Zealand	70
Pakistan	63	South Africa	104	Pakistan	63
Ceylon	50	Other currencies	152	Ceylon	50
Other (less than \$50 million each)	421 <sup>1/</sup>	Gold sales for currencies	1,030	Other (less than \$50 million each)	421 <sup>1/</sup>
		Other	320		
	<hr/>		<hr/>		<hr/>
Total	5,980		5,980		4,754

<sup>1/</sup> Includes claims on withdrawing members: \$7.5 million for Cuba, \$63.5 million for Indonesia.

6. In relation to total subscriptions of \$20 billion, the outstanding credits of some \$5 billion at first sight suggest an ample availability of resources for **lending**. In fact, however, only holdings of those currencies for which there is likely to be a demand, as well as gold, represent lendable resources. In estimating the resources that are likely to be in demand one is faced with the difficulty that this will largely depend on which countries will be the borrowers. Drawings by the United Kingdom and the United States call mainly for Continental European currencies, while drawings by Latin America call mainly for U.S. dollars and drawings by other underdeveloped areas probably for a wider range of currencies. The sharp decline in IMF holdings of Continental European currencies during 1963-1965 and large increase in holdings of U.S. dollars and sterling reflect the predominance of United Kingdom and United States borrowings during this period.

7. Since the use of IMF resources involves <sup>mainly</sup> a demand for the currencies of the industrial countries, the total available lendable resources as of June 30, 1966 may be estimated at some \$12 billion, plus about \$2 billion

in gold. However, if the demand continues to be predominantly for the currencies of Continental European countries, the total resources available for lending will probably be less than half this amount. This is illustrated in the following table:

	IMF Quotas			IMF Holdings of Currencies		
	End <u>1959</u>	End June <u>1966</u>	Million \$ <u>Change</u>	End <u>1959</u>	End June <u>1966</u>	Million \$ <u>Change</u>
United States	4,125	5,160	1,035	2,128	4,453	2,325
United Kingdom	1,950	2,440	490	1,885	4,304	2,419
Other industrial countries	4,100	5,648	1,548	3,170	1,924	-1,246
Other	<u>3,783</u>	<u>6,941</u>	<u>3,158</u>	<u>3,275</u>	<u>6,277</u>	<u>3,002</u>
Total	13,958	20,189	6,231	10,458	16,958	6,500
<u>IMF Gold Holdings</u>	1,332	2,562	1,230			
<u>IMF borrowing arrangements</u>		6,000				
of which drawn available		930				
of which:		5,070				
U.S.		2,000				
U.K.		1,000				
Other industrial		2,070				

8. One may assume that if a large part of the demand for IMF accommodation in the coming years is to continue to come from the United Kingdom and the United States, IMF resources are likely to prove inadequate. If, on the other hand, as seems probable, the pattern of IMF operations becomes more balanced and the demand for United States and United Kingdom currency increases, IMF resources for lending should prove sufficient for a considerable time.

9. The inadequacy of IMF holdings of Continental European currencies reflects principally the large United Kingdom and United States demand for such currencies resulting from the relative weakness of the sterling and the dollar (which is due to many and complex factors) but it may also be attributed to the fact that, in spite of repeated increases, the quotas of the major Continental European countries understate, and those of the United States and United Kingdom overstate, the present position of these countries in the world economy. The following comparison shows that the

United States and United Kingdom account for 58% of the quotas but for only 34 to 35% of the foreign trade of industrial countries. The discrepancy in the relative positions of the United Kingdom and Germany is particularly striking:

	<del>1965</del> Exports		Imports		IMF Quotas	
	<u>Million \$</u>	<u>Percent</u>	<u>Million \$</u>	<u>Percent</u>	<u>Million \$</u>	<u>Percent</u>
		<u>of total</u>		<u>of total</u>		<u>of total</u>
United States	27,400	23	23,189	19	5,160	39
United Kingdom	13,710	12	16,138	14	2,440	19
Germany	17,901	15	17,482	15	1,200	9
France	10,053	9	10,341	8	788	6
Italy	7,188	6	7,347	6	625	5
Other industrial countries	<u>42,058</u>	<u>35</u>	<u>45,923</u>	<u>38</u>	<u>3,030</u>	<u>22</u>
Total industrial countries	118,410	100	120,420	100	13,248	100

Table 1

Net Drawings

	<u>1956-59</u>	<u>% of</u>	<u>1960-62</u>	<u>% of</u>	<u>Jan., 1963-</u>	<u>% of</u>
	<u>Million \$</u>	<u>Total</u>	<u>Million\$</u>	<u>Total</u>	<u>June 30, 1966</u>	<u>Total</u>
					<u>Million \$</u>	
	<u>Total</u>					
<u>Underdeveloped</u>						
Latin America	249.4	24	289.0	72	- 23.0	-1
India	187.5	18	75.0	18	200.0	6
Pakistan	-	-	12.5	3	50.5	1.5
Other	<u>52.1</u>	<u>5</u>	<u>160.5</u>	<u>40</u>	<u>134.5</u>	<u>4</u>
Total	489	47	537	133	362	10.5
<u>United Kingdom</u>	324.0	32	-280	-70	2,431	73
<u>United States</u>	-	-	-	-	547	17
<u>Other Developed and Less</u>						
<u>Developed</u>	246	24	145	36	-13	-0.4
<u>Other</u>	<u>-26</u>	<u>-3</u>				
World Total	1,033.0	100	402	100	3,327	100

Annual Rate

<u>Underdeveloped</u>			
Latin America	62	96	-7
India	47	25	57
Pakistan	-	4	14
Other	<u>13</u>	<u>54</u>	<u>39</u>
Total	122	178	108
<u>United Kingdom</u>	80	-93	695
<u>United States</u>	-	-	155
<u>Other Developed and Less</u>			
<u>Developed</u>	<u>60</u>	<u>48</u>	<u>-3</u>
World Total	262	134	950

Table 2

Latin America

Million \$

	<u>1947-1955</u>	<u>1956-1959</u>	<u>1960-1962</u>	<u>1963 - June 30, 1966</u>
<u>Drawings</u>				
Brazil	168.5	92.3	107.7	135.0
Argentina	-	147.8	180.0	80.0
Colombia	25.0	15.0	72.5	84.8
Mexico	45.0	22.5	45.0	-
Peru	-	14.5	-	-
Chile	21.3	42.4	76.0	106.0
Other	<u>3.9</u>	<u>51.7</u>	<u>108.8</u>	<u>105.6</u>
Total	263.7	386.2	590.0	511.4
Annual Rate	30	96	196	147
<u>Repayments</u>				
Brazil	103.0	37.2	37.5	162.5
Argentina	-	-	93.5	164.0
Colombia	-	25.0	15.0	62.0
Mexico	44.9	22.5	45.0	-
Peru	-	14.5	-	-
Chile	8.8	13.2	41.8	71.5
Other	<u>2.7</u>	<u>24.4</u>	<u>68.2</u>	<u>74.4</u>
Total	159.4	136.8	301.0	534.4
Annual Rate	18	34	100	152
<u>Net Drawings</u>				
Brazil	65.5	55.1	70.2	-27.5
Argentina	-	147.8	86.5	-84.0
Colombia	25.0	-10.0	57.5	22.8
Mexico	0.1	-	-	-
Peru	-	-	-	-
Chile	12.5	29.2	34.2	34.5
Other	<u>1.2</u>	<u>27.3</u>	<u>40.6</u>	<u>31.2</u>
Total	104.3	249.4	289.0	-23.0
Annual Rate	12	62	96	-6.0

Table 3

Other Underdeveloped Countries

Million \$

	<u>1947-55</u>	<u>1956-59</u>	<u>1960-62</u>	<u>Jan. 1963 to June 30, 1966</u>
<u>India</u>				
Drawings	100.0	200.0	275.0	425.0
Repayments	<u>87.5</u>	<u>12.5</u>	<u>200.0</u>	<u>225.0</u>
Net	12.5	187.5	75.0	200.0
Annual Rate	1.4	47.0	25.0	56.0
<u>Pakistan</u>				
Drawings	-	-	12.5	63.0
Repayments	<u>-</u>	<u>-</u>	<u>-</u>	<u>12.5</u>
Net	-	-	12.5	50.5
<u>Ceylon</u>				
Drawings	-	-	22.4	42.0
Repayments	<u>-</u>	<u>-</u>	<u>-</u>	<u>15.0</u>
Net	-	-	22.4	27.0
<u>Iran</u>				
Drawings	26.2	24.7	52.5	17.5
Repayments	<u>8.7</u>	<u>37.3</u>	<u>57.4</u>	<u>3.5</u>
Net	17.5	-12.6	-4.9	14.0
<u>Egypt</u>				
Drawings	3.0	30.0	112.2	68.5
Repayments	<u>3.0</u>	<u>2.7</u>	<u>32.2</u>	<u>55.0</u>
Net	-	27.3	79.9	13.5

July 28, 1966

Mr. Polak

Mr. Fleming

Mr. Gold

Mr. Finch

F-504

F-904

F-834

Supplementary Financing and the Fund

Attached are papers relevant to the above. I should like to have a meeting in my office at 4:30 tomorrow afternoon if convenient with you.

Irving S. Friedman

July 28

Mr. Frank	1056
Mr. Sarma	1036
Mr. Macone	0-1038

Supplementary Financing and the Fund

The attached papers have been sent to the relevant people in the Fund. I should like to have a meeting in my office tomorrow afternoon at 4:30.

Irving S. Friedman

Mr. J. Polak

July 28, 1966

Irving S. Friedman

Supplementary Financial Measures

1. The draft paper prepared by the staff of the Fund on the Bank's study raises several points which have been dealt with, perhaps not fully or adequately, in the Bank study itself. The memo attached hereto has been prepared by Mr. Sarma, in consultation with others here, to clear up some of the misunderstandings in the paper. It also raises one or two substantive points.
2. The Fund paper points out that difficulties are likely to arise if the Compensatory Financing Facility of the Fund and the Supplementary Financing Scheme were to operate concurrently and separately, and underscores the need for a high degree of coordination, but offers no suggestions for resolving such difficulties. We, on our part, have been fully cognizant of the need for understanding and coordination, and would welcome suggestions for any modification of the Supplementary Financing Scheme to this end. For instance, the suggestion regarding refinancing of Fund repurchases could be explicitly incorporated as a feature of the Supplementary Financing Scheme, with advantage. It would also be useful to recognize that each financing institution involved will necessarily apply its own performance criteria and that the mutual relationships among the various institutions in implementation of policies towards recipient countries should be carefully coordinated. Differences may well arise from time to time among these institutions, which would need to be resolved by mutual consultation and discussion.
3. The Bank study has not stated which Agency would administer the Scheme. This remains an open question. It is possible that the Fund may experience some difficulty at times in regard to its own compensatory financing operations as well as other functions in reconciling its own approach and criteria with those of the Agency. Similarly, the Bank, too, may have from time to time cause for concern with the Agency's criteria. If anything, being concerned more deeply with the longer term development finance questions, the Bank is likely to have even more frequent difficulties than the Fund. As and when such problems arise, it should, however, be possible to meet them through consultations, as in practice, we now resolve difficulties between the Fund and Bank.
4. The Fund paper states (p.18) that Fund resources are available to members to meet balance of payments disequilibrium, including "irregularities in the supply of capital or in the need for imports," and that the Fund will "assuming these understandings are satisfactory, assist the country to continue its developmental imports until the payments difficulties have been overcome." I would be interested in discussing the full implications of these remarks both for the work of the Fund and for any Supplementary Financing Scheme that may be set up.
5. I hope that we can get together tomorrow for further discussion of these and other aspects.

Attachment

## SUPPLEMENTARY FINANCING AND THE FUND

1. There are two main areas in the Fund staff paper that need to be considered: (1) the interpretation of what the Bank study purports to say, and (2) their approach to the substance of supplementary financing itself. The following paragraphs are addressed mainly to the first of these, and are intended to correct some of the misunderstandings of the Supplementary Financial Measures Scheme involved in the Fund staff paper.
2. The following statements express the concern of the Fund staff: "These problems (in reconciling) relate to the Fund's activity as a whole, including its regulatory and consultative functions as well as its financing functions" (p. 11). "Unless the Agency and the Fund .... were able to achieve a reconciliation in their criteria and policies, undesirable consequences could easily arise .... a member, in dealing with a given export shortfall, might well receive disparate advice from the two international organizations" (p. 12). "At the very least, there would be need for a very high degree of coordination between the prescriptions of the Agency - or of the Bank - with respect to appropriate development policies and the prescriptions of the Fund with respect to appropriate balance of payments adjustment policies .... the marriage of minds .... may not be easily arrived at" (p. 13). "It is the residual financing which is in a sense decisive for the policy to be followed by a country, and it is for this reason that the Fund, as the international agency bearing primary responsibility in the sphere of balance of payments equilibrations, has normally itself played the role of residual financier" (p. 17).
3. The Bank study is predicated on "close collaboration" with the work done by the Bank, Fund and other international agencies. A 'high degree of coordination' is to be normally expected between the prescriptions of the Agency, the Fund, and the Bank. Such coordination is necessary and possible. Broadly, the functions of the Fund, Agency, and the Bank are not identical though they all form parts of the same canvas; at times the approaches may differ. However, it should be possible to arrive at mutually satisfactory working arrangements in dealing with practical problems.
4. The Fund paper points out (p. 4) that the nature of the export shortfalls to be financed by the Fund Compensatory Financing Facility and by the Supplementary Financing Scheme may differ. This is true, as the Supplementary Financing Scheme tries to estimate future export eventualities over a planning period on which a developing country can rely for making its development plans, while the Fund's Compensatory Financing Facility tries to estimate a trend value, based on past experience and projections for two future years only. Differences in the projections would naturally arise because they are being made for different purposes. In fact, it is because of the need to meet these different purposes that the UNGTAD resolution proposed a new scheme, in addition to the Fund's Compensatory Financing Facility. Therefore, the fact that the export projections may differ is not necessarily an argument against the simultaneous operation of two such schemes.
5. At several points, the Fund paper seems to view the Bank scheme as impractical and rigid; here, there is some misunderstanding which has to be corrected. A few of the more important references may be noted:

- a) "The emphasis on 'programs' is important. While 'development' is a continuous and continuously adjusted process, 'development programs', partly for reasons of publicity and legislative convenience, are made' at discrete intervals covering a number of years at a time, and their frequent adjustment is difficult." (Fund paper, p. 3).

"Moreover, .... it would appear that revisions in export expectations and in development plans and policies .... would be of somewhat infrequent occurrence." (Fund paper, p. 9).

The Bank study recognizes the need for consultations at appropriate intervals (p. 10), and even speaks of a rolling plan, i.e. one that is revised every 2 or 3 years, each time for 3 or 4 years ahead (p. 43).

Further, the Fund paper argues that adjustment processes should begin as soon as a disequilibrium in balance of payments is identified or recognized as such. This may be desirable but is often difficult for a country to undertake, as it might disrupt its development program, which is conceived over a medium term. The Supplementary Financing Scheme is an attempt to help a country to adjust to changes without disruption of development program.

- b) "The aim of this (Fund) facility is to keep export availabilities .... as close as possible to the medium-term trend of export receipts, as currently estimated. The scheme presented in the Study, on the other hand, aims at providing countries with export availabilities that are related to levels largely determined one to five years in advance, and though there is provision for annual consultations in which the country could be urged to hew to some more realistic line, it is not clear that a country reluctant to adopt this advice could be faulted or denied its right to export availabilities on the scale originally envisaged. Again, while the Fund lays emphasis on smoothness and continuity of adjustment, the Study lays greater emphasis on fulfilment of predetermined programs. Perhaps the Fund approach could be criticized for taking too little account of the time lag required for the adjustment of development programs to emergent realities, and that of the Study for laying too much emphasis on long-term forecasts in the balance of payments field and too little emphasis on the dangers of persistence in adhering to a development plan which export developments have shown not to be permanently sustainable." (Fund paper, p. 14).

It is stated in the Bank study: "The exact content of the policy package would depend on circumstances in a country, but of central importance would be the government's commitment to good performance in the pursuit of sound policies for development .... In order to make the policy package feasible, it should not be too detailed, but should include the major criteria and policies (p. 9). .... The policy package would not be frozen at the time of the initial consultation. Economic policies require revisions in response to changing circumstances .... This consideration underscores the necessity for consultation at appropriate intervals (p. 10). .... This flexibility would have to be reflected in the content of the policy

package itself and in judging whether a country had adhered to it .... Experience indicates that economic performance in relation to development can be judged correctly even when precision is technically impossible" (p. 49).

The Bank study clearly points out that under certain circumstances a country could be faulted: "In case a member were not living up to agreed policies, it would be informed by the Agency that it would no longer be entitled under the scheme to assistance in case of subsequent shortfalls" (p. 12).

6. It is observed in the Fund staff study at p. 15: "Differences of approach between the Fund and the Agency as to the policy aims to be negotiated with member countries are likely to involve differences in character of the negotiations themselves. Even if the policy package, which is the central feature of the Supplementary Financing Scheme, were entrusted entirely to the Fund, so far as balance of payments policies are concerned, it is difficult to see how the Fund could commit itself to quantitative precision regarding the financial and exchange policies required to implement balance of payments projections over a five-year period, or could make advance prescriptions as to the appropriate method of adjustment in the face of any of the thousand and one events that might tend to falsify the projections."

This is clearly a misunderstanding of the scheme proposed in the Bank study. The Bank study at the very outset says: "The precise nature and degree of detail of such an understanding would vary considerably as among countries. Continuing contact would be maintained, moreover, between the administering Agency and the country throughout the plan period in order to provide the basis for an assessment of the extent to which the agreed criteria of performance were currently being fulfilled or needed adjustment in the light of changing circumstances." (p. 4).

7. The scheme proposed by Bank staff is only an outline and it is quite possible that it may have to be modified during further discussions with Fund staff, in the intergovernmental group set up by Trade and Development Board of UNCTAD and in the course of deliberations by individual governments. For instance, it would be useful to state explicitly that Fund repurchases of any type of drawing be added to the amounts to be financed under the supplementary financing scheme, a suggestion made in the Fund staff study. The nature and content of policy package, and the degree of its operational feasibility, would have to be carefully gone over. There would be scope for further elaborations and precision. But, above all, the Bank study concurs with the UNCTAD view that there is a felt need for supplementary financing. This is the substance of the matter on which the Fund staff paper does not take a view.

Mr. J. Polak

July 28, 1966

Irving S. Friedman

Supplementary Financial Measures

1. The draft paper prepared by the staff of the Fund on the Bank's study raises several points which have been dealt with, perhaps not fully or adequately, in the Bank study itself. The memo attached hereto has been prepared by Mr. Sarma, in consultation with others here, to clear up some of the misunderstandings in the paper. It also raises one or two substantive points.
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3. The Bank study has not stated which Agency would administer the Scheme. This remains an open question. It is possible that the Fund may experience some difficulty at times in regard to its own compensatory financing operations as well as other functions in reconciling its own approach and criteria with those of the Agency. Similarly, the Bank, too, may have from time to time cause for concern with the Agency's criteria. If anything, being concerned more deeply with the longer term development finance questions, the Bank is likely to have even more frequent difficulties than the Fund. As and when such problems arise, it should, however, be possible to meet them through consultations, as in practice, we now resolve difficulties between the Fund and Bank.
4. The Fund paper states (p.18) that Fund resources are available to members to meet balance of payments disequilibrium, including "irregularities in the supply of capital or in the need for imports," and that the Fund will "assuming these understandings are satisfactory, assist the country to continue its developmental imports until the payments difficulties have been overcome." I would be interested in discussing the full implications of these remarks both for the work of the Fund and for any Supplementary Financing Scheme that may be set up.
5. I hope that we can get together tomorrow for further discussion of these and other aspects.

Attachment

## SUPPLEMENTARY FINANCING AND THE FUND

1. There are two main areas in the Fund staff paper that need to be considered: (1) the interpretation of what the Bank study purports to say, and (2) their approach to the substance of supplementary financing itself. The following paragraphs are addressed mainly to the first of these, and are intended to correct some of the misunderstandings of the Supplementary Financial Measures Scheme involved in the Fund staff paper.
2. The following statements express the concern of the Fund staff: "These problems (in reconciling) relate to the Fund's activity as a whole, including its regulatory and consultative functions as well as its financing functions" (p. 11). "Unless the Agency and the Fund .... were able to achieve a reconciliation in their criteria and policies, undesirable consequences could easily arise .... a member, in dealing with a given export shortfall, might well receive disparate advice from the two international organizations" (p. 12). "At the very least, there would be need for a very high degree of coordination between the prescriptions of the Agency - or of the Bank - with respect to appropriate development policies and the prescriptions of the Fund with respect to appropriate balance of payments adjustment policies .... the marriage of minds .... may not be easily arrived at" (p. 13). "It is the residual financing which is in a sense decisive for the policy to be followed by a country, and it is for this reason that the Fund, as the international agency bearing primary responsibility in the sphere of balance of payments equilibrations, has normally itself played the role of residual financier" (p. 17).
3. The Bank study is predicated on "close collaboration" with the work done by the Bank, Fund and other international agencies. A 'high degree of coordination' is to be normally expected between the prescriptions of the Agency, the Fund, and the Bank. Such coordination is necessary and possible. Broadly, the functions of the Fund, Agency, and the Bank are not identical though they all form parts of the same canvas; at times the approaches may differ. However, it should be possible to arrive at mutually satisfactory working arrangements in dealing with practical problems.
4. The Fund paper points out (p. 4) that the nature of the export shortfalls to be financed by the Fund Compensatory Financing Facility and by the Supplementary Financing Scheme may differ. This is true, as the Supplementary Financing Scheme tries to estimate future export eventualities over a planning period on which a developing country can rely for making its development plans, while the Fund's Compensatory Financing Facility tries to estimate a trend value, based on past experience and projections for two future years only. Differences in the projections would naturally arise because they are being made for different purposes. In fact, it is because of the need to meet these different purposes that the UNCTAD resolution proposed a new scheme, in addition to the Fund's Compensatory Financing Facility. Therefore, the fact that the export projections may differ is not necessarily an argument against the simultaneous operation of two such schemes.
5. At several points, the Fund paper seems to view the Bank scheme as impractical and rigid; here, there is some misunderstanding which has to be corrected. A few of the more important references may be noted:

- a) "The emphasis on 'programs' is important. While 'development' is a continuous and continuously adjusted process, 'development programs', partly for reasons of publicity and legislative convenience, are made' at discrete intervals covering a number of years at a time, and their frequent adjustment is difficult." (Fund paper, p. 3).

"Moreover, .... it would appear that revisions in export expectations and in development plans and policies .... would be of somewhat infrequent occurrence." (Fund paper, p. 9).

The Bank study recognizes the need for consultations at appropriate intervals (p. 10), and even speaks of a rolling plan, i.e. one that is revised every 2 or 3 years, each time for 3 or 4 years ahead (p. 43).

Further, the Fund paper argues that adjustment processes should begin as soon as a disequilibrium in balance of payments is identified or recognized as such. This may be desirable but is often difficult for a country to undertake, as it might disrupt its development program, which is conceived over a medium term. The Supplementary Financing Scheme is an attempt to help a country to adjust to changes without disruption of development program.

- b) "The aim of this (Fund) facility is to keep export availabilities .... as close as possible to the medium-term trend of export receipts, as currently estimated. The scheme presented in the Study, on the other hand, aims at providing countries with export availabilities that are related to levels largely determined one to five years in advance, and though there is provision for annual consultations in which the country could be urged to hew to some more realistic line, it is not clear that a country reluctant to adopt this advice could be faulted or denied its right to export availabilities on the scale originally envisaged. Again, while the Fund lays emphasis on smoothness and continuity of adjustment, the Study lays greater emphasis on fulfilment of predetermined programs. Perhaps the Fund approach could be criticized for taking too little account of the time lag required for the adjustment of development programs to emergent realities, and that of the Study for laying too much emphasis on long-term forecasts in the balance of payments field and too little emphasis on the dangers of persistence in adhering to a development plan which export developments have shown not to be permanently sustainable." (Fund paper, p. 14).

It is stated in the Bank study: "The exact content of the policy package would depend on circumstances in a country, but of central importance would be the government's commitment to good performance in the pursuit of sound policies for development .... In order to make the policy package feasible, it should not be too detailed, but should include the major criteria and policies (p. 9). .... The policy package would not be frozen at the time of the initial consultation. Economic policies require revisions in response to changing circumstances .... This consideration underscores the necessity for consultation at appropriate intervals (p. 10). .... This flexibility would have to be reflected in the content of the policy

package itself and in judging whether a country had adhered to it .... Experience indicates that economic performance in relation to development can be judged correctly even when precision is technically impossible" (p. 49).

The Bank study clearly points out that under certain circumstances a country could be faulted: "In case a member were not living up to agreed policies, it would be informed by the Agency that it would no longer be entitled under the scheme to assistance in case of subsequent shortfalls" (p. 12).

6. It is observed in the Fund staff study at p. 15: "Differences of approach between the Fund and the Agency as to the policy aims to be negotiated with member countries are likely to involve differences in character of the negotiations themselves. Even if the policy package, which is the central feature of the Supplementary Financing Scheme, were entrusted entirely to the Fund, so far as balance of payments policies are concerned, it is difficult to see how the Fund could commit itself to quantitative precision regarding the financial and exchange policies required to implement balance of payments projections over a five-year period, or could make advance prescriptions as to the appropriate method of adjustment in the face of any of the thousand and one events that might tend to falsify the projections."

This is clearly a misunderstanding of the scheme proposed in the Bank study. The Bank study at the very outset says: "The precise nature and degree of detail of such an understanding would vary considerably as among countries. Continuing contact would be maintained, moreover, between the administering Agency and the country throughout the plan period in order to provide the basis for an assessment of the extent to which the agreed criteria of performance were currently being fulfilled or needed adjustment in the light of changing circumstances." (p. 4).

7. The scheme proposed by Bank staff is only an outline and it is quite possible that it may have to be modified during further discussions with Fund staff, in the intergovernmental group set up by Trade and Development Board of UNCTAD and in the course of deliberations by individual governments. For instance, it would be useful to state explicitly that Fund repurchases of any type of drawing be added to the amounts to be financed under the supplementary financing scheme, a suggestion made in the Fund staff study. The nature and content of policy package, and the degree of its operational feasibility, would have to be carefully gone over. There would be scope for further elaboration and precision. But, above all, the Bank study concurs with the UNCTAD view that there is a felt need for supplementary financing. This is the substance of the matter on which the Fund staff paper does not take a view.

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## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

DATE: July 27, 1966

FROM: N.A. Sarma *N.A. Sarma*

SUBJECT: Fund Paper on Supplementary Financing

Attached hereto are comments, mainly on the misunderstandings  
in the paper.

(Seen by other members of the group).

cc: Mr. de Vries  
Mr. Hulley  
Mr. Macone  
Mr. Sundrum  
Mr. Tamagna  
Mr. Isaiah Frank

## SUPPLEMENTARY FINANCING AND THE FUND

1. There are two main areas that need to be cleared up in considering the Fund staff paper on the subject: (1) misunderstanding of what the Bank study purports to say, and (2) their approach to the substance of supplementary financing itself. The following paragraphs are addressed mainly to the first of these, and are intended to correct some of the misunderstandings of the Supplementary Financial Measures Scheme involved in the Fund staff paper.

2. The following statements express the concern of the Fund staff: "These problems (in reconciling) relate to the Fund's activity as a whole, including its regulatory and consultative functions as well as its financing functions" (p. 11). "Unless the Agency and the Fund .... were able to achieve a reconciliation in their criteria and policies, undesirable consequences could easily arise .... a member, in dealing with a given export shortfall, might well receive disparate advice from the two international organizations" (p. 12). "At the very least, there would be need for a very high degree of coordination between the prescriptions of the Agency - or of the Bank - with respect to appropriate development policies and the prescriptions of the Fund with respect to appropriate balance of payments adjustment policies .... the marriage of minds .... may not be easily arrived at" (p. 13). "It is the residual financing which is in a sense decisive for the policy to be followed by a country, and it is for this reason that the Fund, as the international agency bearing primary responsibility in the sphere of balance of payments equilibrations, has normally itself played the role of residual financier" (p. 17).

3. The Bank study is predicated on "close collaboration" with the work done by the Bank, Fund and other international agencies. A 'high degree of coordination' is to be normally expected between the prescriptions of the Agency or of the Bank - and those of the Fund, though a 'marriage of minds' may not be arrived at invariably. Such coordination is necessary and possible. Broadly, the functions of the Fund, Agency, and the Bank are not identical though they all form parts of the same canvas; an identity of views is no virtue in itself.

4. p. 4. Nature of export shortfalls to be financed: A distinction is drawn between 'currently estimated export trend' and 'an expected level of actual exports'. While the two need not necessarily differ, it is quite possible that they may differ, as procedures of estimation as well as time span are not the same. It is explicitly stated in the Bank staff study: "there is an important difference between the concept of reasonable expectations suitable for a short-term compensatory finance scheme (such as the IMF compensatory financing facility) and the assumption regarding export prospects which is an integral part of a development plan" (p. 29).

5. At several points, the Fund paper seems to view the Bank scheme as impractical and rigid; here, there is some misunderstanding which has to be corrected. A few of the more important references may be noted:

a) p. 3. "The emphasis on 'programs' is important. While 'development' is a continuous and continuously adjusted process, 'development programs', partly for reasons of publicity and legislative convenience, are made at discrete intervals covering a number of years at a time, and their frequent adjustment is difficult."

p. 9. "Moreover, .... it would appear that revisions in export expectations and in development plans and policies .... would be of somewhat infrequent occurrence."

The Bank study recognizes the need for consultations at appropriate intervals (p. 10), and even speaks of a rolling plan, i.e. one that is revised every 2 or 3 years, each time for 3 or 4 years ahead (p. 43).

The Compensatory Financing Facility argues that adjustment processes should begin as soon as a disequilibrium in balance of payments is identified or recognized as such. This may be desirable but is often difficult for a country to undertake, as it might disrupt its development program, which is conceived over a medium term. The Supplementary Financing Scheme is an attempt to help a country to adjust to changes without disruption of development program.

b) p. 14. "The aim of this (Fund) facility is to keep export availabilities .... as close as possible to the medium-term trend of export receipts, as currently estimated. The scheme presented in the Study, on the other hand, aims at providing countries with export availabilities that are related to levels largely determined one to five years in advance, and though there is provision for annual consultations in which the country could be urged to hew to some more realistic line, it is not clear that a country reluctant to adopt this advice could be faulted or denied its right to export availabilities on the scale originally envisaged. Again, while the Fund lays emphasis on smoothness and continuity of adjustment, the Study lays greater emphasis on fulfilment of predetermined programs. Perhaps the Fund approach could be criticized for taking too little account of the time lag required for the adjustment of development programs to emergent realities, and that of the Study for laying too much emphasis on long-term forecasts in the balance of payments field and too little emphasis on the dangers of persistence in adhering to a development plan which export developments have shown not to be permanently sustainable."

It is stated in the Bank study: "The exact content of the policy package would depend on circumstances in a country, but of central importance would be the government's commitment to good performance in the pursuit of sound policies for development .... In order to make the policy package feasible, it should not be too detailed, but should include the major criteria and policies (p. 9). .... The policy package would not be frozen at the time of the initial consultation. Economic policies require revisions in response to changing circumstances.... This consideration underscores the necessity for consultation at appropriate intervals (p. 10). .... This flexibility would have to be reflected in the content of the policy package itself and in judging whether a country had adhered to it .... Experience indicates that economic performance in relation to development can be judged correctly even when precision is technically impossible" (p. 49).

And, of course, a country could be faulted: "In case a member were not living up to agreed policies, it would be informed by the Agency that it would no longer be entitled under the scheme to assistance in case of subsequent shortfalls" (p. 12).

6. It is observed in the Fund staff study at p. 15: "Differences of approach between the Fund and the Agency as to the policy aims to be negotiated with member countries are likely to involve differences in character of the negotiations themselves. Even if the policy package, which is the central feature of the Supplementary Financing Scheme, were entrusted entirely to the Fund, so far as balance of payments policies are concerned, it is difficult to see how the Fund could commit itself to quantitative precision regarding the financial and exchange policies required to implement balance of payments projections over a five-year period, or could make advance prescriptions as to the appropriate method of adjustment in the face of any of the thousand and one events that might tend to falsify the projections."

This is clearly a misunderstanding of the scheme proposed in the Bank study. The Bank study at the very outset says: "The precise nature and degree of detail of such an understanding would vary considerably as among countries. Continuing contact would be maintained, moreover, between the administering Agency and the country throughout the plan period in order to provide the basis for an assessment of the extent to which the agreed criteria of performance were currently being fulfilled or needed adjustment in the light of changing circumstances." (p. 4).

7. The scheme proposed by Bank staff is only an outline and it is quite possible that it may have to be modified during further discussions with Fund staff, in the intergovernmental group set up by Trade and Development Board of UNCTAD and in the course of deliberations by individual governments. For instance, it would be useful to state explicitly that Fund repurchases of any type of drawing be added to the amounts to be financed under the supplementary financing scheme, a suggestion made in the Fund staff study. The nature and content of policy package, and the degree of its operational feasibility, would have to be carefully gone over. There would be scope for further elaboration and precision. But, above all, the Bank study concurs with the UNCTAD view that there is a felt need for supplementary financing. This is the substance of the matter on which the Fund staff paper does not take a view.

Why jurisdiction? P17  
 Fund loans with diff. pol. criteria (p18)  
 Fund units to be central bank; since this gives max. leverage  
 Fund units program adj. to emergency situation (p14)  
 Do not need 5-year commitment on policy details (p15)  
**Third Draft**

Supplementary Financing and the Fund

Prepared by the Research and Statistics Department  
 in Consultation with the Exchange and Trade Relations Department, the Area Departments, and the Legal Department

July 15, 1966

Introduction

The staff report (SM/66/55) on the meeting of the UNTAD Committee on Invisibles and Financing Related to Trade held in April of this year pointed out that the proposals made in the IBRD staff study on Supplementary Financing Measures, which had been discussed in the UNTAD Committee on Invisibles and are to be examined by a group of government experts set up by that Committee, "have profound implications not only for the Fund's compensatory financing facility but for the general financial operations and other activities of the Fund."<sup>1/</sup>

The present paper is designed to explore briefly some of these implications.

UNCTAD Resolution on Supplementary Financial Measures

The Study by the Bank staff took its start from Recommendation A-IV-18, which, having been originally proposed by the United Kingdom and Sweden, was adopted by the United Nations Conference on Trade and Development in June 1964. A copy of this Recommendation is attached at Annex I.

<sup>1/</sup> SM/66/55, page 2.

As will be seen, the Recommendation invited the Bank to study the feasibility of a scheme under which the IDA, using additional resources, would provide longer-term assistance to developing countries in the form of grants or of contingent loans on concessional terms to the extent necessary to avoid disruption of development programs on occasions when:

(a) export proceeds (including invisibles) had fallen below "reasonable expectations," and

(b) there had been recourse to the IMF's compensatory financing facility but this had, for some reason, proved inadequate.

Illustrative reasons for possible inadequacy of the Fund's facility under (b) above are cited in the Recommendation. They are:

(i) that following a compensatory drawing in one year exports might fall below reasonable expectations in subsequent years;

(ii) that when drawings had to be repaid, exports might not have recovered sufficiently for this to be possible without disruption of development;

(iii) that there might be a significant shortfall in exports which the IMF judged to be not of a short-term nature and which it, therefore, refused to finance.

These illustrations, especially (i) and (iii), appear to assume that the Fund employs a definition of export shortfall similar to that suggested in the Recommendation, but might be unable to provide adequate finance because the shortfalls, so defined, were expected to, or did in fact, go on too long. In reality, however, as will become clearer below, the Fund's concept of shortfall from medium-term trend as at present defined is substantially different from that of "shortfall from reasonable expectations"

however interpreted, and very different from the latter concept as interpreted in the Study.

#### The Bank Staff Scheme

Executive Directors have received copies of the printed version of the study, *Supplementary Financial Measures*, produced by the Bank Staff in response to the foregoing Recommendation. Such of the features of the scheme proposed in that study as appear most relevant to the operations of the Fund are set forth below. Page references are to the printed document, henceforth referred to as the "Study."

#### A. Purpose

In harmony with the UNCTAD Recommendation A-IV-18, the objective to which the Study addresses itself is that of "preventing the disruption of sound development programs or policies by unexpected shortfalls in export earnings which are of a nature or duration which cannot adequately be dealt with by short-term balance of payments support," or, more precisely, that of providing developing countries "with a ready source of long-term assistance to enable them to maintain internationally approved development programs in the face of unforeseen adverse export movements that are beyond their control and beyond their ability to finance..." (p. 2). The emphasis on "programs" is important. While "development" is a continuous and continuously adjusted process, "development programs," partly for reasons of publicity and legislative convenience, are made at discrete intervals covering a number of years at a time, and their frequent adjustment is difficult.

B. Administration

The scheme is to be administered by an (unspecified) international agency (hereinafter referred to as the "Agency"), working in close cooperation with the IBRD and the IMF.

C. Nature of Export Shortfalls to be Financed

The scheme is one for the prompt, partial and conditional financing of the export shortfalls of the developing countries. The first question is how these shortfalls are defined. The UNCTAD Recommendation had defined them as "shortfalls from reasonable expectations." This implied that the shortfall would be measured not, as in the Fund scheme, from some currently estimated export trend but from some expected level of actual exports. The Recommendation left it vague how far prior to the time of the shortfall the expectation was to have been formed, and to whom it was to appear "reasonable." The interpretation adopted in the Study is that export projections covering a four or five year period should be made simultaneously with and as part of a development program which, with its associated policies, would be agreed between the country and the Agency.

This implies that the export projections from which the shortfalls are measured would be such as had appeared reasonable at a point of time preceding the shortfall by anything from a few months to more than five years. By contrast, the compensatory financing shortfall of the Fund is measured from a trend value consisting of the average exports over a five year period centered on the shortfall year, as estimated after the end of that shortfall year. The estimation of the Fund shortfall thus involves forecasting exports less than two years ahead, and the influence on the trend estimate of such forecast data is reduced by the inclusion in the trend of figures for past exports.

Can projection be revised during the period?

An important feature of the Supplementary Financing Scheme is its cumulative aspect. Strictly speaking, what is to be financed (to the extent appropriate) is not the shortfall for any particular year but the net cumulative shortfall for the projection period as a whole. Before any assistance was provided with respect to a shortfall for any particular year, an allowance for any "overages" or excesses of actual over projected exports that might have occurred earlier in the projection period would be subtracted from the shortfall, and any "overages" occurring later would entail repayments of assistance provided earlier. "Overages" would not, however, be carried over from one projection period to another.

Is this time?

On the assumption that projected exports would probably follow a less uneven course within the projection period than would actual exports, this arrangement would lead to some smoothing out of current export availabilities (export receipts plus financing) within that period provided that shortfalls accrued throughout the period or in its early years; it would, however, have little or no effect of this kind if "overages" occurred throughout the period or in its early years.

might not need it.

Moreover, if export availabilities are made to approximate projected exports--whether by financing of shortfalls or repayment of overages--in the last years of one projection period, they may change abruptly between then and the first years of the next projection period.

D. Degree of Compensation of Shortfalls

It is not envisaged that the scheme would compensate export shortfalls, even on the cumulative basis described above, in full. In the first place, as discussed below, there would be some sort of prior agreement between Agency and country as to "how much of a shortfall in expected earnings

could be experienced without disrupting the development program." (p. 7)

Secondly, "It would be expected that as far as possible a part or even all of the shortfall would be offset by use of the country's own reserves or by drawings on the IMF. To the extent that export shortfalls, as defined under the Scheme, were to overlap shortfalls under the IMF compensatory financing facility, the IMF should, if possible, be the source of help. Furthermore, the member might well be in a position to combine drawings under the compensatory financing facility with drawings under the ordinary tranche policy of the Fund." (p. 7) "In addition, the Agency would take into account the possibilities of using other sources--for example, the emergency foreign trade loans of the U.S. Export-Import Bank, the program loans and the Food for Peace Program of the U.S. Agency for International Development, the World Food Program, etc.--for offsetting shortfalls." (p. 8)

✓

It will be seen that the Scheme is intended to provide only residual financing of shortfalls as defined in the proposal. "After other sources of finance had been taken into account, the Agency would provide the remaining amount needed to prevent disruption of the development program, according to the prior agreement with the country." (p. 8) Given the need to explore all other sources of finance, the scheme could not indicate what proportion of net shortfalls countries would be expected normally to leave uncompensated or to meet out of their own resources or out of national or international financial assistance that would have been available to them in any case. On p. 64 of the Study it is estimated that total gross shortfalls for all developing countries over the 1959-63 period may have amounted to \$1.6 billion per annum, which is equivalent, net of overages, to \$1.4 billion per annum. However, it is suggested (p. 13) that

the net financial requirement for an initial experimental period of 5 years might be \$300-\$400 million per annum. Part of this difference is accounted for by the assumption that the projections on which the shortfalls are based would improve, and that some developing countries would be unable to qualify under the Scheme; however, the allowance for non-financing of shortfalls or their financing with existing resources is presumably substantial.

W?   
 E. Nature of Performance Criteria

It is an important characteristic of the arrangements for Supplementary Financing put forward in the Study that they attempt to combine conditionality in the provision of assistance with some degree of assurance to the recipient that assistance will in fact be forthcoming. This object is to be accomplished by providing that assistance from the Agency will be conditional on the member's implementation of "an agreement on development policies" to be concluded with the Agency in advance of the occurrence of the shortfall. "A member would qualify for assistance under the Scheme as long as its agreement with the Agency on development policies was being carried out. In case a member were not living up to agreed policies, it would be informed by the Agency that it would no longer be entitled under the Scheme to assistance in case of subsequent export shortfalls." (p. 12)

→ The scope of this prior agreement is exceedingly wide. It is intended to cover:

- (i) the country's export expectations,
- (ii) projections of all the other principal elements in its balance of payments including imports, reserve use, and external financing,

(iii) its development program, with particular reference to the public sector.

*already done* ?  
On all these issues the agreement would cover not only projections but the policies required to implement them. This is explicit with respect to exports and development planning and is strongly suggested (see p. 9) for balance of payments matters also, at least as regards "major criteria and policies."

The agreement would also cover:

- (iv) a judgment on how much of a (hypothetical) shortfall in expected earnings could be experienced without disrupting the development program, and
- (v) the feasible adjustments to unexpected shortfalls without disrupting the agreed development program, including use of available resources and other sources of external credit." (p. 8)

*7/*  
It appears to be envisaged that all of these topics would be dealt with, to some extent, in an initial agreement between the country and the Agency at (or before) the beginning of each projection (planning) period, though it is difficult to see how policies on (ii), (iv) and (v), applicable to the period as a whole, could be established at that time in other than vague terms. Since it is accepted that "no agreement on specific issues can remain valid for the duration of a five-year plan," it is proposed that consultations should take place at appropriate intervals (probably annually) between the member and the Agency, "each having the right to initiate discussions looking to a new agreement on appropriate policies and each remaining bound by an outstanding agreement if no such discussion is underway. The financing plan and balance of payments projection agreed on at

the start of the period would also have to be reviewed at these times."

(p. 10) This formulation leaves it unclear whether the obligations incurred in consideration of the initial agreement, including the obligation to compensate shortfalls from the initial projection, remain effective only until one of the parties has asked for a new agreement, or until discussions to this end have got underway, or, finally, until a new agreement has been reached. The wording on p. 12, however, ("A member would qualify for assistance under the Scheme as long as its agreement with the Agency on development policies was being carried out") would support the last-mentioned interpretation. Moreover, from what is said on pages 42 and 52 of the Study, it would appear that revisions in export expectations and in development plans and policies (points (i) and (iii) above) would be of somewhat infrequent occurrence.<sup>1/</sup> On the other hand, it is envisaged that the adjustment measures (point (v) above) would be adapted from time to time.

Finally, it is proposed that there would be consultations at the time of the shortfall "only ... to ensure that other available sources of financing were being used and that feasible adjustment measures not endangering the development program were being taken." (p. 10)

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<sup>1/</sup> e.g., "...the duration of export projections depends on the duration of the plan or program of which they are an integral part, which, in turn, depends on a large variety of factors including structural changes in export demand." (p. 42) "Adverse export movements reduce the capacity to import and depress incomes with the consequent depression of savings or government revenues, but generally do not invalidate the planned pattern of resource allocation." "...it is generally not possible to judge whether a particular export shortfall is a temporary event or the beginning of a new trend. (See pages 40-41.) So long as there is such uncertainty, it will be more sensible to adhere to the carefully prepared development program than to undertake quick alterations." (p. 52)

F. Terms of (Residual) Financing

As is stated on p. 59 of the Study, "Under the Scheme, the Agency should base the terms of its finance--the rate of interest as well as maturities--on the over-all financial and economic position of the member. The Agency should take account of factors similar to those considered by the existing international financing agencies." Greater precision is given to this statement by the following sentence from p. 60 of the Study: "By and large, it may prove reasonable to extend assistance under the Scheme on about the same terms at which the country is obtaining development finance for other purposes."

G. Relationship to Certain Points in the UNCTAD Recommendation

The Study emphasizes, and gives a particular interpretation to certain key features of the UNCTAD Recommendation while giving lesser weight to other features. The features emphasized include the gearing of assistance to (a) shortfalls in exports from "reasonable expectations," and (b) the avoidance of "disruption of development programs." The special interpretation given to these concepts consists in the use made of discrete projection or planning periods, each covering a term of years though the Recommendation might not have precluded a scheme based on a more continuous process of projection and policy formation.

The elements in the UNCTAD Recommendation given less weight are those which envisage (i) the use of the scheme to finance shortfalls too persistent for the Fund to handle under its compensatory financing facility, and (ii) the refinancing of Fund assistance which falls due for repayment when exports are unsatisfactory. The notion under (i) is largely inapplicable,

*who asked for view on this*

*These rep. should be headed as analytical payments*

as a result of the difference in the definition of "shortfall" presently used in Fund practice and in the Study respectively, though on the Study's own definition of shortfall some account of the element of "persistence" is taken through the provision for using "overages" to offset shortfalls within a given projection period. As regards (ii), it is noteworthy that whereas it is envisaged that Fund drawings, under the compensatory facility or otherwise, might be used to help finance shortfalls (as defined in the Study), it is not provided that Fund repurchases of any type of drawing should be added to the amounts to be financed under the Supplementary Financing Scheme.

*Not done*

Interrelation with the Activities of the Fund

From the description given above it would seem that many problems may arise in reconciling the supplementary financing scheme as set forth in the Study, with the functions of the Fund in the balance of payments sphere, and with the principles on which the Fund has, until now, exercised these functions. These problems relate to the Fund's activity as a whole, including its regulatory and consultative functions as well as its financing functions.

The Agency, as already explained, is to make agreements with and apply conditions to countries desirous of qualifying for supplementary financing assistance on such matters as basic export policies and balance of payments policies in general, and, in the event of unexpected export developments, the measures of balance of payments adjustment to be adopted and the use to be made of the country's reserves and borrowing potential.

All these are matters which fall within the purview of the Fund, and are, indeed, at the center of its concern. Unless the Agency and the Fund in dealing with such questions were able to achieve a reconciliation in their criteria and policies, undesirable consequences could easily arise. For example, in the absence of such reconciliation, a member, in dealing with a given export shortfall, might well receive disparate advice from the two international organizations. To the extent that Fund resources were used to finance part of the shortfall, a part being financed by the resources of the Agency, the member might even be faced with two different sets of conditions for financing. Moreover, since the Agency would provide the residual financing, the country would know that any decline in Fund financing due to failure to adhere to Fund terms could be made good by the Agency, provided the Agency's terms were adhered to.

Again, it has to be borne in mind that the supplementary financing proposal is intended to cover only disequilibria arising from shortfalls in exports, including current invisibles, while the Fund's financial assistance covers disequilibria arising from any and all elements in the balance of payments. This would lead to the anomalous situation that whereas in the event of unexpected declines in exports the Agency, being the residual lender, would often be in a position to secure the adoption of its prescriptions regarding the appropriate adjustment policies, in the event of unexpected changes in other elements, e.g., declines in capital inflows or in import-competing production, the Fund, which in that case would be the residual lender, might be in a position to secure the adoption of its--possibly rather different--prescriptions for adjustment.

*Notes  
Reed*

The Study shows an awareness of the problem of reconciliation referred to above by providing that, in preparing the policy package, "full collaboration would be required with existing international agencies including the IERD and the IMF." (p. 10) "As a consequence," it is believed, "the financing plan would normally be consistent with the financial policy targets and criteria agreed upon between the country and the international financing agencies."

The extent to which this expectation would be realized so far as the Fund is concerned clearly depends on the precise relationship that would be established between the Fund and the Agency, and on the extent to which the Fund's views as to appropriate adjustment policies would be accepted by the Agency. At the very least, there would be need for a very high degree of coordination between the prescriptions of the Agency--or of the Bank--with respect to appropriate development policies and the prescriptions of the Fund with respect to appropriate balance of payments adjustment policies.

Consideration of certain of the features of the proposed scheme--its emphasis on periodic planning, its procedures for arriving at the policy package, and to a lesser extent its provisions as to the terms of lending--imply an attitude towards the balance of payments adjustment process which differs to some extent from that so far adopted by the Fund. No implication is intended that the Fund's attitude is necessarily right and that of the scheme necessarily wrong, but merely that the marriage of minds described above may not be easily arrived at.

In the first place, while the injunction laid upon the Fund in Article 1 of its Articles of Agreement to "shorten the duration and lessen the degree of disequilibria in the international balances of payments of

members' is to be read together with the acknowledgement, in the same Article, of "the development of the productive resources of all members" as a primary objective of policy, it has been the Fund's practice to urge its members to begin the process of adjusting their claims on resources, whether for investment or for consumption, to unexpected trends in outside forces affecting the balance of payments, as soon as these trends can be recognized and distinguished from temporary fluctuations. The Fund's facility for the compensatory financing of export fluctuations is a particular example of this general policy expressed, because of its semi-automatic nature, in a more formal manner than usual. The aim of this facility is to keep export availabilities (i.e., export receipts plus compensatory drawings minus repurchases) as close as possible to the medium-term trend of export receipts, as currently estimated. The scheme presented in the Study, on the other hand, aims at providing countries with export availabilities that are related to levels largely determined one to five years in advance, and though there is provision for annual consultations in which the country could be urged to hew to some more realistic line, it is not clear that a country reluctant to adopt this advice could be faulted or denied its right to export availabilities on the scale originally envisaged. Again, while the Fund lays emphasis on smoothness and continuity of adjustment, the Study lays greater emphasis on fulfilment of predetermined programs. Perhaps the Fund approach could be criticized for taking too little account of the time lag required for the adjustment of development programs to emergent realities, and that of the Study for laying too much emphasis on long-term forecasts in the balance of payments field and too little emphasis on the dangers of persistence in adhering to a development plan which export developments have shown not to be permanently sustainable.

The longer the time given to adjust to adverse changes in the balance of payments the more substantial must be the financial assistance provided for meeting such adverse trends. While all causes of disequilibria will affect the ability of a country to sustain its development program, there is a clear possibility, under the Supplementary Financing Scheme, especially if the Fund and the Agency operate under different criteria of adjustment, that too much financial support will be given to development programs in one contingency (export shortfalls) compared with what is given in others.

Differences of approach between the Fund and the Agency as to the policy aims to be negotiated with member countries are likely to involve differences in character of the negotiations themselves. Even if the policy package, which is the central feature of the Supplementary Financing Scheme, were entrusted entirely to the Fund, so far as balance of payments policies are concerned, it is difficult to see how the Fund could commit itself to quantitative precision regarding the financial and exchange policies required to implement balance of payments projections over a five year period, or could make advance prescriptions as to the appropriate method of adjustment in the face of any of the thousand and one events that might tend to falsify the projections. On the other hand, countries, on their side, might well hesitate to commit themselves in advance to adopting whatever methods of adjustment the Fund might later recommend to deal with unforeseen balance of payments difficulties. So far as balance of payments policies are concerned, therefore, it is not easy to see how the two principal features of the scheme, (a) advance assurance for the countries concerned regarding prospective export availabilities, and (b) assurance for the Agency (and for the countries providing the funds) that suitable

policies will be adopted by countries drawing upon the resources of the Scheme, are to be reconciled. It is no accident that, in the Fund's current practice, both advance assurance of financing--by way of standby arrangements--and agreements as to balance of payments policies to be pursued as a condition of such assistance are confined to periods of one, or at most two, years ahead.

It has been a principle of Fund operation not only that Fund resources should be confined to the financing of temporary deficits but also that drawings should be repaid in the medium term, i.e., the deficit should be not only temporary but also reversible. An essential feature of the Supplementary Financing Scheme is that assistance provided to developing countries should be provided on a more or less long-term basis. Clearly there is a much better case for saying that countries should aim to eliminate their deficits in a relatively short period of years than that they should aim thereafter at producing an (equally temporary) surplus in order to permit early repayment. While the Fund does not provide long-term balance of payments financing, it does not follow that balance of payments financing should never have a long repayment period. In other words, the conception contained in the UNCTAD Recommendation that compensatory financing that cannot be repaid to the Fund in the short run out of export surpluses might be refinanced on a long-term basis is one that deserves serious consideration.

It should be clear, however, that this conception could not be extended to the proposition that all Fund drawings by developing countries should be repayable, if at all, only over a very long period without bringing into question the rationale of the membership of these countries in the Fund.

*Substantive!*  
→ This rationale, as well as the proposition that the developing countries have an important need for reserves, is founded in the belief that these countries are not only in need of long-term capital but are also subject to reversible fluctuations which they can properly meet by short-term credit and short-run fluctuations in their reserves. Many of the developing countries have built up their reserves over time, with short-term fluctuations, and have either never used the Fund or used the Fund as it was intended to be used, for periods of a few years only.

*D*  
*X* | Given the various discrepancies between the principles of balance of payments adjustment that have traditionally been applied by the Fund and those explicit and implicit in the Supplementary Financing Scheme, a system under which the proposed new Agency would urge the member to finance as large a part as possible of any shortfall--as defined in the Scheme--and would itself provide residual financing also calls for a certain amount of examination. It is the residual financing which is in a sense decisive for the policy to be followed by a country, and it is for this reason that the Fund, as the international agency bearing primary responsibility in the sphere of balance of payments equilibration, has normally itself played the role of residual financier.

Where shortfalls in terms of the Fund's compensatory financing scheme happened to coincide in time, though not in magnitude, with shortfalls under the supplementary financing proposal, it might no doubt be possible for a country to draw under the terms of the Fund's facility and then draw further amounts under the Supplementary Financing Scheme. Even in this case, however, the compensatory financing scheme would have missed part of its intention--that of encouraging countries to adjust to the medium-term

trend of their exports--and would be serving a purpose other than its own. Still greater difficulties would obviously arise if the Fund were asked to allow an ordinary drawing, in the credit tranches, to help finance a short-fall under the supplementary financing scheme, in the knowledge that the residual financing provided under the scheme would enable the country to disregard the policy conditions of the drawing.

*Really  
wrong  
no*

In conclusion, it may perhaps be instructive to summarize some of the observations made above by asking the question in what essential respects the Supplementary Financing Scheme would differ from the Fund. Both the scheme and the Fund are intended to give countries protection from temporary difficulties in order to enable them to pursue their policy objectives with a minimum of unnecessary disturbance.

1. Perhaps the most striking difference between the Supplementary Financing Scheme and the Fund is that the Scheme concentrates on one kind of disturbance--export shortfalls--whereas the Fund's resources are available to members to meet temporary disequilibria arising from disturbances in any or all of the items in the balance of payments, including irregularities in the supply of capital or in the need for imports. The latter may often be due to inappropriate financial policies. The Fund will, in that event, reach understandings with the countries concerned as to the policy measures necessary to overcome these payments difficulties but will, assuming these understandings are satisfactory, assist the country to continue its developmental imports until the payments difficulties have been overcome. The Fund's Compensatory Financing facility is only a minor part of the Fund's total assistance to countries within this general framework.

*Not true!*

*What is this??*

*Compensation nearly the proposal*

Time in practice ?

2. The Supplementary Financing Scheme is based on different criteria of balance of payments adjustment than those applied by the Fund. Many of the difficulties described in this paper would disappear if the criteria of balance of payments adjustment applied by the Fund and the Supplementary Financing Agency were brought into harmony. To the extent that modifications to this end are made in the Fund's own policies, however, they should extend across the whole field of Fund operations. It would be illogical for the Fund to facilitate the maintenance of development programs in the event of unexpected export declines to any greater extent than it is prepared to facilitate their maintenance in the event of other unexpected adversities in the balance of payments.

3. Supplementary Financing, primarily because it is based on different criteria of adjustment, is likely to be much larger in scale than the Fund. Net Fund drawings by less developed countries have averaged \$120 million a year over the last 10 years for payments difficulties of any kind.

Supplementary Financing, which addresses itself only to payments difficulties arising from export shortfalls, is expected to amount, on a residual basis, to \$300 to \$400 million a year.

4. Fund drawings are repayable within a 5-year period, although members can make new drawings when their situation and their policies justify such drawings under Fund criteria. Supplementary Financing drawings would be repayable on terms similar to those applicable to development finance.

United Nations Conference on Trade and Development  
Final Act and Report

Annex A.IV.18

Supplementary Financial Measures

A

The Conference,

Recognizing that adverse movements in the export proceeds of developing countries can be disruptive of development, and noting that the International Monetary Fund (IMF) can make available balance-of-payments support to help meet the short-term effects of shortfalls in export proceeds,

Recommends that the International Bank for Reconstruction and Development be invited to study the feasibility of a scheme with the objective set forth in section I below and based on the principles set forth in section II below, and, if appropriate, to work out such a scheme.

I. Objective

1. The new scheme should aim to deal with problems arising from adverse movements in export proceeds which prove to be of a nature or duration which cannot adequately be dealt with by short-term balance-of-payments support. Its purpose should be to provide longer term assistance to developing countries which would help them to avoid disruption of their development programmes.

II. Principles

2. The scheme should be provided with resources by contributions from participating countries, shared between them on an equitable basis.

3. Developing countries only should be eligible for assistance from the scheme; such assistance should be on concessional and flexible terms.

4. The scheme should normally be applicable after a developing country had had recourse to the International Monetary Fund, under its compensatory financing facility, and it had been possible to make a full assessment of the nature, duration and implications of any adverse movement in the export proceeds of the developing country concerned.

5. An adverse movement for the purposes of the scheme should be regarded as a shortfall from reasonable expectations (see Note 1 below) of the level of export proceeds (including, in appropriate cases, invisible exports).

1. That a fund be set up, financed by contributions from developed countries, as required, and administered by an appropriate agency of the United Nations;

2. That only developing countries should be eligible to draw from the Fund;

3. That disbursements should be in the form of non-reimbursable transfers and/or contingent loans on concessional terms;

4. That the criteria used in deciding upon claims should be as objective as possible and should include the following:

(a) The effect of shortfalls in export earnings and the adverse movements in the terms of trade;

(b) The effect on the country's development programme;

5. That to complement this longer term approach, facilities be provided for interim financing, when warranted, to assist the developing countries concerned while the longer term problem is being assessed.

6. A prima facie case for assistance from the scheme should be established by reference to shortfalls from reasonable expectations and to their nature and duration (see Note 2).

7. Once a prima facie case has been established there should be an examination, under the International Development Association, of all relevant economic circumstances (see Note 3) in order to assess how far assistance from the scheme would be required and justified in order to help avoid disruption of development programmes. Subject to these points, assistance could cover a substantial proportion of a shortfall from reasonable expectations.

8. Resources for the scheme, which would be administered under the International Development Association, should be in the form of additional commitments, prescribed in advance, for contributions to the Association; all major Part I member countries of the Association should contribute.

#### NOTES

Note 1. To the extent that these could be prescribed in advance they could be taken account of by developing countries for planning purposes.

Note 2. The following are offered as illustrative circumstances which might constitute a prima facie case for assistance from the scheme to a developing country:

- (i) If, following an IMF drawing in one year under its special compensatory financing facility, exports fall significantly below reasonable expectations in the second or third year.
- (ii) If, when the IMF drawings were due to be repaid, exports had not recovered sufficiently for this to be possible without disruption of development.
- (iii) If there were a significant shortfall in exports which the IMF adjudged at the outset to be other than of a short-term nature and the IMF had decided that it would be inappropriate for it to provide temporary balance-of-payments support.

Note 3. Among other matters, these would include adverse effects from significant rises in import prices.

#### B

The Conference also recommends that the continuing machinery recommended by this Conference be invited to study and organize further discussion of the following concepts and proposals for financing put forward by the delegations of the developing countries at the Conference:

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

DATE: July 22, 1966

FROM: A. J. Macone *AJM*SUBJECT: Draft Fund paper on supplementary financing

Attached for the Group's discussion is a list of possible inaccuracies, misunderstandings or misinterpretations of the Supplementary Financing Scheme that emerge from a reading of the subject paper.

cc: Mr. Kamarck  
Mr. de Vries  
Mr. Hulley  
Mr. Sundrum

Questions on Fund's Interpretation of the Scheme

Page 4, Section C, 4th sentence:

A distinction is drawn here between a "currently estimated export trend" and "an expected level of actual exports", i.e., "reasonable expectations." In fact, there need be no difference between these two concepts. In other words, trying to arrive at reasonable expectations in exports need not be different from trying to estimate the export trend.

Page 5, first paragraph:

This paragraph, particularly the second sentence, may be misleading. In effect, it confuses long term financing of shortfalls with short term. The cumulative shortfall, if any, is financed on a long term basis. However, year-to-year shortfalls are also financed. Also, it should be noted that deduction of previous years' overages from the financing of a particular year's shortfalls presupposes that those previous overages were held as reserves.

Page 5, paragraphs 2-3:

The significance of these paragraphs is not clear to me. The drift of the argument seems to imply that a significant goal of supplementary financing is to "smooth out" foreign exchange availabilities. This may be one effect of the scheme but is not vital to it. The purpose of the scheme is to prevent a disruptive shortfall in the foreign exchange needed at a particular time, not to "smooth out" the flow of such exchange.

Page 6, paragraph 2, 3rd sentence:

The meaning of this sentence is quite obscure. Taken as written, the first half of the sentence is factually wrong. The sentence would be more nearly correct if the clause beginning "to leave uncompensated or."

Page 7, top paragraph:

As written, the last sentence seems to imply that the Bank report did not recognize that part of the shortfalls would not need to be financed and that another part might be financed from the country's own reserves.

Page 9, last paragraph:

The quotation in this paragraph is taken out of context and could be misleading.

Page 10, last sentence under G:

The last clause of this sentence raises the question whether discrete planning periods are necessary for purposes of a supplementary financing scheme. Is the question purely formal or does it reflect a concrete alternative in the minds of the authors?

Page 14, last two lines:

The report states that the scheme will try to avoid this. These lines imply that the report has not focused on this matter.

Page 16, second paragraph, third sentence:

It is not an aim of the scheme to make countries produce "an (equally temporary) surplus in order to permit early repayment."

Substantive questions

1. What is the operative purpose of the Fund paper? Is it intended to become the Fund's official position?
2. Does the Fund paper conclude that the Supplementary Financing Scheme as presented in the report is fundamentally incompatible with the operations of the Fund and that no adjustments in it (short of a completely new approach) will remedy this fault?
3. If not, what changes does the Fund seek?
4. If the reply to question 1 is affirmative:
  - (a) Will the Fund take a formal stand against the scheme when it is asked to do so (France will certainly ask the question) in the DAC, other UN bodies or the next UNCTAD?
  - (b) Assuming the outcome will be that the Scheme is rejected, will the Fund accept a recommendation that it attempt an alternative scheme?

A. J. Macone  
Economics Department  
July 22, 1966

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

DATE: July 19, 1966

FROM: John Hulley

SUBJECT: Draft IMF Paper on Supplementary Finance\*

1. The purport of this draft paper is that IMF might find it easier to live with an alternative form of scheme for supplementary financing.
2. The authors express concern about the overlap between the responsibilities of the Fund and those of the proposed Agency. They foresee differences in objectives and interpretation, despite efforts to coordinate. They argue that the role of the Agency as residual lender will give it overriding influence compared to other lenders such as the Fund (see page 18).
3. They express a degree of interest in the alternative idea of an agency to (a) "finance shortfalls too persistent for the Fund to handle under its compensatory financing facility" and (b) refinance "Fund assistance which falls due for repayment when exports are unsatisfactory" (see page 10, also page 16).
4. They further argue that the proposed Agency will encounter administrative difficulties, from which their alternative might prove to be freer.

Possible reactions include accepting or rejecting the alternative or adding it to the present scheme.

\* "Supplementary Financing and the Fund," Research and Statistics Department in consultation with other departments, IMF, July 15, 1966, Third Draft.

cc: Messrs. de Vries  
Macone  
Sarma  
Sundrum

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

FROM: Barend A. de Vries *BW*

SUBJECT: IMF Paper on "Supplementary Financing in the Fund"

DATE: July 21, 1966

Since writing the attached memorandum I had a brief discussion with the Supplementary Financing Working Party. It seems to me that a reasonable answer to the Fund should include:

1. A positive response to their suggestions that the scheme will include in a country's external financing requirements its re-purchase obligations to the IMF.

2. While in general there are, of course, many possibilities for conflicting policy criteria between a short-term agency and a long-term financing institution, we are working on a day-to-day basis with the IMF experts. We are not, as a matter of fact, experiencing severe difficulties in applying in a ~~conservative~~ *conservative* manner the policy criteria of the two agencies.

cc: Messrs. Kamarck  
Hulley  
Macone  
Pereira Lira  
Sarma  
Sundrum

## OFFICE MEMORANDUM

TO: Mr. I.S. Friedman

DATE: July 22, 1966

FROM: Frank M. Tamagna *FMT*SUBJECT: Comments on IMF Paper on Supplementary Financing in the Fund

The IMF paper raises some basic policy issues which, I feel, have little bearing on the practical approach of supplementary financing. I suggest that we avoid getting entangled in any policy issue, which might broaden the debate and induce a referral of the entire proposal on supplementary financing to further study and possibly to other organs. The best, in my opinion, is to give to the policy question a pragmatic answer.

Whenever a shortfall occurs in the exports of a developing country, it might be caused by one of perhaps three, or more conditions (within the various qualifications provided for in the "scheme"), such as:

- (i) the shortfall might be due to an occasional factor, like a drought in the country concerned, or a price change due to an excessive crop in another country, which is expected to be remedied in the course of the following year. It would seem evident that in such a case the problem might be met by the short-term assistance from the IMF.
- (ii) the shortfall in exports might be due to a more fundamental factor, such as the volcanic explosion in Costa Rica destroying coffee plantations, or some fundamental factor requiring a shift in the technology of production. This might require an adjustment lasting over a number of years, certainly beyond one and, hopefully, within five years. It would seem appropriate for the country, in such case to seek combined assistance from the IMF and the "agency" (or Bank). The IMF could provide the initial assistance for a two-year period, and the "agency" the extension of such assistance to five years. (In effect, this would be a refinancing by the "agency" (or Bank) of the Fund's assistance).
- (iii) A similar case would be when a demand change in foreign markets (due to taste or technology) leads to the obsolescence of a type of culture and a need to redirect resources to a different type of culture. This would definitely be a development problem, which might also involve a larger amount of funds than the IMF could provide under its rigid limitations. Such assistance could presumably be provided entirely by the "agency", or alternatively, part of it could be extended on a short-term basis by the IMF in anticipation of the financing, to be arranged from the "agency" (or Bank). (This would, in effect, be a prefinancing by the Fund of an "agency" (or Bank) loan).

July 22, 1966

In general, one might also consider the need for combined assistance whenever the IMF could not meet the needs of a country requiring temporary assistance in larger amounts than the IMF could extend. In all cases, however, the test for the Bank (or the "agency") should be whether the export shortfall is affecting the continuity of a developing course, or its prospect in the longer run, while the test for the IMF would presumably be the short-term impact on the country's international reserves and exchange stability. Each case, therefore, would have to be considered on its merit and by joint consultation between the "agency", the IBRD and the Fund.

cc: Messrs. Kamarck  
de Vries  
Hulley  
Macone  
Pereira Lira  
Sarma  
Sundrum

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

FROM: Barend A. de Vries *Bdv*

SUBJECT: IMF Paper on "Supplementary Financing in the Fund"

DATE: July 20, 1966

The Fund paper raises some very crucial questions on Fund-Bank relationships which should be explored in connection with the Supplementary Financing proposal:

1. The Fund is concerned with the differences in policy criteria between the Fund and the Bank (page 12).
2. It considers it impractical that it could apply its balance of payments policy criteria within a 5-year span (page 15).
3. It raises jurisdictional questions, considering the IMF as "the international agency bearing primary responsibility in the sphere of balance of payments equilibration" (page 17).
4. It raises the question of maximum policy leverage to be derived from being the lender of last resort. (Also page 17).

The paper is clearly written by theoreticians who are not involved in the day-to-day negotiating and adjusting process through which Bank and Fund attitudes toward country policies are determined and reconciled. Clearly, the authors of this paper consider the Fund as the agency dealing with short-term policies across the board and are afraid that the Bank's longer-term development concern may run contrary to the problems of short-term adjustment. In this respect the authors pose the problem of different, if not opposing, criteria for balance of payments adjustment to fluctuations or declines in export earnings. The Fund, they say, wants adjustments in development programs to emerging realities (page 14). The Bank, on the other hand, wants to give primary emphasis to maintaining the resource flow for an agreed-upon program of expenditures as well as policies.

The problem posed by the Fund authors is a real one in general theory. The logical consequence of their position is to consider the Fund as the responsible agency to cope with exchange stability and adjustments to short-term fluctuations, whether they concern developed or underdeveloped countries and regardless of their effect on long-term development policies. On this position, the Fund can stand on its own and be very strong, indeed, but its posture would be far stronger if, at the same time, they would frankly recognize that their assistance and policies criteria have little, if anything, to do with the objectives of long-term development and growth. Given the short-term stabilization objectives of the Fund, there is ample scope for the application of long-term assistance and long-term development criteria by another agency. In practice, these two can, and have been, worked out although there are always strains.

On this line of reason, we should regard the Bank as fully competent in dealing with exchange rate strategy and monetary policy strategy as they bear on the problem of development programming and financing.

On a secondary level, the Fund's concern with not being able to work out policy agreements for a 5-year period is quite unreal. The supplementary financing scheme will require periodic (no less than two yearly) consultations and will, in practice, make continuous adjustments in policy objectives, export targets, and import requirements. It would be entirely wrong to ask the Fund to be the agency for working out balance of payments policy criteria under the supplementary financing scheme. The supplementary financing scheme is a long-term financing scheme which should not be administered, even in part, by an agency with a short-term view. Fund administration of part of the supplementary scheme would be damaging to both the Fund and the scheme.

On the question as to which agency will have the maximum policy leverage, very little can be said in general. Much will depend on how the financing chips fall in each individual situation and what will be the nature of the policy relationships between the recipient country and the financing agency. Clearly, the Fund has managed to obtain enormous policy leverage for the small amounts of financial assistance provided but against this large policy leverage stands a rather poor performance on the part of the Fund in helping developing countries to maintain adequate levels of reserves.

cc: Messrs. Kamarck  
Hulley  
Macone  
Pereira Lira  
Sarma  
Sundrum



# Office Memorandum

TO : Mr. Friedman  
FROM : J. J. Polak *JJP*  
SUBJECT : Supplementary Financing

DATE: July 18, 1966

The attached document is a draft of a paper on Supplementary Financing and the Fund, which we are planning to circulate to the Executive Board before the end of July. We would be grateful if you could let us have any comments before Thursday, July 28. We would, of course, be anxious to correct any errors of fact or interpretation or anything misleading that may have crept into the draft.

I am sending you three copies of the draft, and am also sending individual copies direct to Mr. Pereira Lira.

cc: Mr. Pereira Lira

July 18, 1966

Mr. Sarma	1036
" Sundrum	"
" Maccone	G-1038
" Halley	1012
" de Vries	800
" <i>Tanagna</i>	
" <i>Frank (7/26/66)</i>	

I would appreciate your comments on the attached paper as soon as possible please.

Fund's Supplementary Financing paper - Third Draft  
July 15, 1966

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

FROM: Paulo H. Pereira Lira

SUBJECT: Fund's Compensatory Facility

DATE: June 27, 1966

Please find attached a draft of the memorandum on the Fund's new paper on its compensatory facility.

*For captioned*

*(Handed to Mr. Saad  
7/5/66)*

*Use  
~~use~~ at Wed.  
managing staff meeting*

## OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman

FROM: Paulo H. Pereira-Lira

SUBJECT: Supplementary Finance Study

DATE: June 23, 1966

I met Mr. Marcus Fleming yesterday, following the idea of establishing an informal channel of communication with the Fund in matters dealing with Supplementary Finance. I told him in a general way that we were doing some further thinking on the problem and that Mr. Sundrum and Mr. Sarma would eventually like to see him about the questions on which they were working.

The Fund is working on its paper on Supplementary Finance from its own point of view. It is intended to deal with several topics such as definition of areas of jurisdiction between the Fund and the new Agency, the question of uniformity of operative criteria between the two bodies (definition of short-falls for example), the general question of what performance items are going to be chosen by the Agency as fundamental given the extensive area covered by the understandings. The paper is framed in terms of raising questions which have to be answered, without implying that the Fund has the right answers for them. He told me he would give us the paper for comment before sending it to the Board. I said we would do the same with further material that we would prepare.

Mr. Fleming also gave me a copy of the recent Fund Paper on Compensatory Financing (SM/66/77) which he said is basically the same one that had been circulated at the end of last year. It is interesting to quote from the last paragraph of the covering note of the paper!

"The Fund's compensatory financing facility might well be affected if any scheme for supplementary financing of the type now under consideration under UNCTAD auspices were brought into existence. However, it would be possible, and seems desirable for the Fund to go ahead with the revision of its compensatory facility without reference to this possibility, while at the same time considering what further amendments to the Fund facility might be desirable if and when arrangements for supplementary financing were brought into existence."

cc: Professor Frank  
Mr. Sundrum  
Mr. Sarma  
Mr. Macone  
Mr. Hulley  
Mr. Jalan

*Copies to Jala + P.L. 6/23/66*  
DOCUMENT OF INTERNATIONAL MONETARY FUND  
AND NOT FOR PUBLIC USE

**FOR  
AGENDA**

This document is not to be  
published or quoted as  
representing the Fund's views.

SM/66/77

June 13, 1966

To: Members of the Executive Board  
From: The Secretary  
Subject: Compensatory Financing of Export Fluctuations: Developments  
in the Fund's Facility

The attached paper "Compensatory Financing of Export Fluctuations: Developments in the Fund's Facility" prepared by the staff is circulated for consideration by the Executive Directors at a meeting tentatively scheduled for Wednesday, June 29, 1966.

Att: (1)

Other Distribution:  
Department Heads  
Division Chiefs

INTERNATIONAL MONETARY FUND

Compensatory Financing of Export Fluctuations:  
Developments in the Fund's Facility

Prepared by the Research and Statistics Department  
in consultation with the Legal Department, Exchange and  
Trade Relations Department, and the Area Departments

June 13, 1966

The attached paper has been prepared on the basis of SM/65/101 ("The Fund's Compensatory Financing Facility Reconsidered") of December 10, 1965, revised in the light of the discussion at the Executive Board seminar of December 17, 1965, and recast in the form of a draft report by the Fund announcing changes in its compensatory financing facility.

It is suggested that the Executive Board should consider this paper with a view to revising its 1963 Decision on Compensatory Financing before this year's Annual Meeting.

The Decision on Compensatory Financing has now been in existence for over three years and is ripe for review and revision as part of the normal operations of the Fund. The revisions proposed, whether their scope is measured in terms of potential cost of Fund resources or of potential use by members, are not comparable in character or in order of magnitude with those involved in any schemes to create international reserves, whether through the Fund or otherwise, and it would seem unnecessary and inappropriate to defer consideration of them until decision has been taken on the other and larger matter.

The Fund's compensatory financing facility might well be affected if any scheme for supplementary financing of the type now under consideration under UNCTAD auspices were brought into existence. However, it would be possible, and seems desirable for the Fund to go ahead with the revision of its compensatory facility without reference to this possibility, while at the same time considering what further amendments to the Fund facility might be desirable if and when arrangements for supplementary financing were brought into existence.

Compensatory Financing of Export Fluctuations:  
Developments in the Fund's Facility

Introduction: the 1963 Decision

In February 1963, in response to an invitation extended by the United Nations Commission on International Commodity Trade at its tenth session in May, 1962, the Fund issued a report entitled "Compensatory Financing of Export Fluctuations." This report, after reviewing the problems involved in Fund financing of fluctuations in exports of primary exporting countries, set forth in its concluding chapter an Executive Board Decision<sup>1/</sup> covering two points: (a) quotas and (b) drawing policies.

With respect to quotas, the Fund declared its willingness to give sympathetic consideration to requests for the adjustment of the quotas of certain primary exporting countries, particularly those with relatively small quotas, to make them more adequate in the light of fluctuations in export proceeds and other relevant criteria.

As regards drawing policies, the Fund introduced a new facility, of which the principal features are as follows:

(1) It is open to all member countries, but designed in particular for primary producing countries.

(2) It is designed to compensate for temporary shortfalls in export receipts, rather than in export prices or in the terms of trade, or in the importing power of exports.

(3) By temporary shortfalls are meant deviations from a medium-term trend in export receipts.

(4) Compensation is paid in the form of a drawing subject to the normal conditions of repayments for Fund drawings, including an outside limit of 3 to 5 years.

(5) Compensation has been paid to the full extent of the calculated shortfall, subject to the proviso that the total of compensatory drawings outstanding should not normally exceed 25 per cent of quota.

(6) The policies of members drawing under the facility do not have to meet the tests that the Fund would apply in the case of a non-compensatory drawing in the same tranche. However, members do have to satisfy the Fund that they are encountering payments difficulties, that the shortfall is of a short-term character, and is largely attributable to circumstances beyond the member's control, and that the member will cooperate with the Fund in an effort to find solutions, where required, for its payments difficulties.

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<sup>1/</sup> Decision No. 1477 (63/8) of February 27, 1963, Selected Decisions, Third Issue, p. 40.

## Subsequent Developments

### I. Quota Adjustments and Export Fluctuations

The Decision on Compensatory Financing has now been in operation for over three years, and the time has arrived when certain of its aspects can appropriately be reviewed.

In Paragraph 3 of that Decision, the Fund recognized that some quota adjustments might be required or desirable, as follows: "The quotas of many primary exporting countries, taken in conjunction with a reasonable use of their own reserves, are at present adequate for dealing with export fluctuations such as have occurred during the past decade. In those instances, however, where adjustment of the quotas of certain primary exporting countries, and in particular of countries with relatively small quotas, would be appropriate to make them more adequate in the light of fluctuations in export proceeds and other relevant criteria, the Fund is willing to give sympathetic consideration to requests for such adjustment."

Since February 1963 the Fund has taken steps--apart from the general quota increase which came into effect on February 23, 1966--to implement this paragraph in several ways.

In the first place, it has approved more than 22 quota increases under a special policy applied to developing countries with relatively small quotas; 15 other countries appear to be eligible for such quota increases under that policy.

Secondly, the Fund facilitates drawings by such countries to enable them to purchase the amount of gold that must be paid in connection with the quota increases referred to above. This gives them the benefit of a quota increase immediately, and makes it possible to spread the reserve cost of the increase over a number of years.

Finally, in considering applications for individual quota increases, even from countries other than the above, the Fund has modified the formula which is taken into account in calculating quotas in such a way as to improve the position of developing countries. Variability of trade, which was a component of the so-called Bretton Woods formula, has now been defined in terms of standard deviation around a five-year moving average. This new definition provides a more accurate measure of variability and is thus more favorable to quota calculations of raw materials exporting countries. The Fund has also modified the formula to give greater weight to trade and the variability to trade, and less weight to national income and international reserves.

### II. The Fund's Compensatory Facility

It might have been expected that the drawing facility established by the Fund in February 1963 to provide compensatory financing for export fluctuations would by this time have been used often enough to provide

ample illustrations of the type of problems that were liable to arise in applying it, and possibly also to indicate ways in which it could be improved. In fact, however, few countries have had even a prima facie case for using it, and three countries have actually drawn: (1) Brazil in June 1963 for the sum of \$60 million (21 per cent of quota); (2) the United Arab Republic in October 1963 for the sum of \$16 million (18 per cent of quota); and (3) Sudan in June 1965 for the sum of \$11.25 million (25 per cent of quota).<sup>1/</sup> This infrequency of use is largely attributable to the fact, illustrated in Table 1, that price developments over the past three or four years have been such as to permit the export earnings of less developed primary producing countries to show a generally upward trend, though one that tended to flatten out in 1965. Even the substantial declines in price of tropical foodstuffs (other than coffee), which began in spring 1964 and continued through the greater part of 1965 have not reacted sufficiently on earnings to evoke many opportunities for the use of the facility.

Despite the small number of instances of use, there has been enough experience and enough reflection on the variety of situations that might present themselves to permit of a reconsideration of several of the features of the 1963 Decision. Moreover, a number of suggestions have been made both inside the Fund--notably at the recent Annual Meeting of the Board of Governors--and outside the Fund, as to ways in which the Fund's compensatory financing facility might be amended or improved.

Most of these suggestions are summed up in the three recommendations made by the United Nations Conference on Trade and Development of 1964 to Governments members of the Fund as to changes that might be made in the facility, and in the request which it addressed directly to the Fund. The UNCTAD resolution containing these recommendations and request is reproduced at Appendix A. Passages dealing with compensatory financing excerpted from speeches of Governors at the 1965 Annual Meetings are reproduced at Appendix B. It will be seen that most of the points made by the Governors are covered in the UNCTAD Resolution referred to above, except for the reference to automatism in the speech of Governor Pugliese of the Argentine, and the reference to terms of trade and import prices in the speech of Governor Wanninayake of Ceylon.

### Application and Development of the Facility

#### I. Nature of Shortfall

Drawings under Paragraph 5 of the Compensatory Financing Decision of 1963 may be made only when the requesting member experiences payments difficulties produced by a temporary export shortfall, i.e., by an export shortfall which is "of a short-term character." Such shortfalls, according to Paragraph 7 of the Decision, are to be identified on the basis of "estimates regarding the medium-term trend of the member's exports." In the 1963 Decision itself, no definition of the medium-term trend is given.

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<sup>1/</sup> The quotas referred to in these percentages are those applicable at the time the drawing was made.

Table 1. Changes in Prices and Export Earnings for  
Primary Producers in 1962 to 1965

Commodity	Prices <sup>1/</sup>			Export Earnings			
	Percentage increase or decrease (-) from previous year			Countries mainly dependent on specified commodities <sup>2/</sup>	Percentage increase from previous year		
	1963	1964	1965		1963	1964	1965 <sup>3/</sup>
<u>Metals and minerals</u> <sup>4/</sup>	<u>3</u>	<u>21</u>	<u>13</u>	<u>Metals and minerals</u>	<u>9</u>	<u>24</u>	<u>13</u>
<u>Agricultural products</u>	<u>20</u>	<u>-</u>	<u>-12</u>	<u>Agricultural products</u>	<u>12</u>	<u>10</u>	<u>4</u>
Food	<u>31</u>	<u>-</u>	<u>-17</u>	(a) Coffee	12	8	7
Coffee	4	30	-5	(b) Mixed tropical foodstuffs	11	11	3
Sugar	185	-31	-64	(c) Mainly temperate products	14	12	2
Cocoa	20	-8	-26	(d) Fibers and rubber	10	2	9
Wheat	1	4	-5	(e) Mixed	7	11	5
Non-food	4	-	-5	<u>Mixed Mineral and Agricultural</u>	8	7	2
Cotton	2	29	-6				
Wool	18	-	-13				
Rubber	-7	-5	-1				
<u>All exports</u> <sup>4/</sup>	<u>18</u>	<u>2</u>	<u>-9</u>	<u>All countries</u>	<u>11</u>	<u>10</u>	<u>4</u>

<sup>1/</sup> Group price changes are derived from indices published by the NIESR (London). Specified commodity price series relate to world market quotations for representative grades only, and thus exclude the influence of prices determined under contracts.

<sup>2/</sup> Defined as at least one half of export earnings as classified. Excludes countries dependent on petroleum. Data relate to 71 countries.

<sup>3/</sup> Provisional.

<sup>4/</sup> Excluding petroleum.

However, in the earlier Fund report, "Fund Policies and Procedures in Relation to the Compensatory Financing of Commodity Fluctuations,"<sup>1/</sup> the trend or norm was defined for purposes of illustration as the average of actual exports for the five years beginning two years previous and ending two years subsequent to the year for which the trend value was calculated. The same definition was adopted in the staff paper cited on page 10 of the report on "Compensatory Financing of Export Fluctuations,"<sup>2/</sup> and it was on the basis of this definition of the "ideal" trend or norm that certain conclusions were drawn in that report as to the best statistical method of estimating it in the absence of complete information.<sup>3/</sup> This is also the definition that has been adopted in all applications of the Compensatory Financing Decision to particular countries up to the present time.

In the absence of precise quantitative knowledge as to the nature of the economic forces at work in determining trends and fluctuations, a moving average seems the best and most flexible way--better, for example, than fitting a trend line of any a priori shape--of reflecting what is meant by trend. Moving averages of 4 years, 5 years, or 6 years, respectively, might, any one of them, serve as a reasonable definition of a "medium-term" trend. However, a 5-year period is preferable to the others in that it contains a middle year, the trend value of which can be defined as the average of the period. The trend value for any year in any time series must anticipate the figures for subsequent as well as reflect those of previous years in that series. If this is not done--e.g., if the trend values are determined solely as an average of past years--the trend line might lie persistently above, or below, the actual series to a substantial extent, which would be contrary to the normal meaning of the term "trend." Only if the moving average is centered in the manner illustrated above can one expect to find, over a reasonable period of time, a rough balancing of shortfalls and surpluses of actual exports with respect to trend.<sup>4/</sup>

Once the best possible estimate has been made of the medium-term trend, and hence of the shortfall, if any, from that trend, in accordance with Paragraph 7 of the Decision, no separate judgment is required as to whether the shortfall in question is "temporary" or of a "short-term" character.

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<sup>1/</sup> IMF Staff Papers, November 1960, p. 9.

<sup>2/</sup> J. Marcus Fleming, Rudolf Rhomberg, and Lorette Boissonneault, "Export Norms and Their Role in Compensatory Financing," Staff Papers, Vol. X, 1963.

<sup>3/</sup> "Compensatory Financing of Export Fluctuations," pp. 17-18.

<sup>4/</sup> The balancing of surpluses and deficits is far from perfect, however; in any 5-year period there is likely to be either an excess of surpluses over deficits exceeding 50 per cent of gross surpluses, or an excess of shortfalls over surpluses exceeding 50 per cent of gross shortfalls. This, however, appears to be quite unavoidable. There is no way of defining a norm or trend consistently from year to year in such a way as to secure a perfect balance of surpluses and shortfalls over any given period.

The definition of the trend itself is such as to make it likely--though one can never be certain--that shortfalls with respect to it will be of short duration.<sup>1/</sup> Any attempt to make a separate determination as to whether a given shortfall would cease to exist within, say, 2 or 3 years would involve estimating for that period ahead not only actual exports--which, as is indicated in the following section, may be involved in the estimation of the current norm--but also the export trend itself. To forecast the latter would involve estimating exports for still further years ahead. This, in the present state of forecasting techniques, would appear to be impracticable, and a determination that a shortfall of a given magnitude exists should, therefore, be taken as satisfying the requirement that the shortfall is of a short-term character.

## II. Estimation of Trend and Shortfall

In paragraph 7 of the 1963 Decision it is laid down that the Fund will seek to establish reasonable estimates regarding the medium-term trend of the member's exports "on the basis of appropriate statistical data in conjunction with qualitative information about its exports prospects." This phrase appears to foreshadow a two-sided approach--"statistical" and "qualitative"--to the problem of estimation. However, while statistical estimation can be carried out without qualitative appraisal, qualitative appraisal can scarcely be applied without the aid of some statistical information, and the true alternative approaches are those of statistical automatism and the exercise of judgment, respectively.

In the three cases in which the Decision has been applied thus far, the estimation of normal exports has represented a compromise between (a) a figure or figures arrived at through the application of automatic formulae to past statistical data, and (b) an estimate based on a combination of these data with a forecast for actual exports two years ahead, these forecasts in turn being arrived at by a process of market appraisal using all available information.

The combination of the two methods in one form or another is justified by the knowledge that the result of either method is to a considerable extent uncertain. Any formula admittedly gives a precise answer; but no formula can be devised that gives a good approximation of the medium-term trend, as here defined, on the basis of past statistical data. On the other hand, any forecasting exercise must to some extent be subjective and uncertain. Given these facts it is necessary to strike a reasonable balance between these two methods, each less than satisfactory, which at the same time assures countries as much uniformity of treatment as possible from one case to the other.

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<sup>1/</sup> Calculations covering 48 countries show that almost 50 per cent of all shortfalls with respect to a norm defined as above last only 1 year, nearly 85 per cent no more than 2 years, and 96 per cent no more than 3 years.

As regards the automatic statistical approach to the estimation of the norm, the Fund has, in the past, used two types of formula, a "general" formula and a "national" formula, in both of which the norm for any given year is estimated as a weighted average of actual exports for the year in question and the two preceding years. In both cases the weights assigned to the various years are those which experience (of some ten years or more) shows to provide the best approximation to the "true" norm as defined above.<sup>1/</sup>

The "general" formula, used in calculations contained in the Fund's Report on "Compensatory Financing of Export Fluctuations," in all three applications of the Decision to date attaches a weight of .50 to the exports of the year for which the shortfall is being estimated, .25 to the preceding year, and .25 to the second preceding year. These weights were arrived at on the basis of analysis of the experience of some 48 countries over a period of nine testable years (thirteen years of data). While not absolutely the best of the formulae tested, it was chosen as a good formula with rounded weights close to those of the optimal formula.

"National" formulae have differed from country to country, the formula for each country being arrived at on the basis of experience affecting that country alone. It is intended to discontinue the use of "national" formulae on the ground that they are based on too small a number of observations, and complicate the statistical side of the exercise.

As regards the more subjective or "qualitative" estimate primarily based on market analysis, it is in the nature of the case more difficult to describe the method used, which varies from country to country. In all cases the procedure is first to estimate the average exports in the two years following the year for which the shortfall is being determined and then to take an average of the five years centered on the shortfall year. The forecast in question is conducted largely on the basis of commodity analysis, taking into account the prospective price movements for the commodity in question and the prospective volume movements in the country in question. For the great majority of primary exporting Fund members, 60 per cent to 90 per cent of total exports take place in a rather small number (1 to 4) of commodities, thus a large proportion of most countries' trade can be estimated on the basis of commodity market analysis. But there remains a sizeable residual for which no such analysis is possible and it may well prove desirable in particular cases to make a more or less automatic statistical estimate for this part of the exports. In this event the partial results of market analysis for major commodities would be combined with a more mechanical result for the residual to arrive at a global estimate.

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<sup>1/</sup> The "true norm" for exports,  $x$ , in any year  $t$ , i.e.,  $\bar{x}_t$  is defined as  $\frac{x_{t-2} + x_{t-1} + x_t + x_{t+1} + x_{t+2}}{5}$ . The problem is to find weights  $w_0, w_1, w_2$ , such that the estimated norm  $x_t^* = w_2 x_{t-2} + w_1 x_{t-1} + w_0 x_t$  provides the best approximation to  $\bar{x}_t$  for all values of  $t$ . This is found by regression analysis for years in which the relevant export data are available.

In the past, "statistical" and "qualitative" estimates have been given approximately equal weight in determining the final estimate of the trend of exports. However, the "qualitative" estimates, involving a direct forecast of exports two years ahead, have been found in practice to yield better results than the formula. Experience has tended to bear out the judgment that a "better estimate could be made by the exercise of judgment based on an analysis of the causal factors at work than by any mathematical formula, however skillfully contrived, which is based on the mere statistical magnitude of current and previous exports."<sup>1/</sup> In future, it would seem advisable to give somewhat greater weight than in the past to the "qualitative" as against the statistical estimate.

### III. Proposals Regarding the Mode of Determining the Shortfall

#### A. Weight to be Given to Past Years

In the Resolution on the Study of Measures Relative to the Compensatory Credit System of the International Monetary Fund, set forth at Annex A.IV.17 of its Report, the UNCTAD made the following request:

"The Conference

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2. Requests that the International Monetary Fund, in its determination of the shortfall in export receipts, consider giving greater weight to the actual experience of the three preceding years."

The issue here, though it appears to be purely technical, in fact touches on a point of principle. At present, as has been explained above, the Fund's compensatory financing facility is designed to compensate for shortfalls from the presumed current trend level of exports rather than from a previous trend level. It is designed to help countries to bring their export availabilities--export receipts plus compensatory drawings less repayments of such drawings--closer to the presumed trend level rather than to provide them with a financial buffer against reductions as compared with their previous standards. While it might be entirely appropriate to provide countries with such a buffer, it would seem preferable to supply this through the ordinary drawing facilities of the Fund, use of which could be made conditional, where necessary, on the adoption of measures to adapt the economy to new export conditions, or to improve the trend of exports, than through the compensatory financing facility, the use of which is more automatic.

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<sup>1/</sup> Compensatory Financing of Export Fluctuations, A Report of the International Monetary Fund, February 1963, page 10.

It is because the aim of compensatory financing is conceived in the manner described above, that in the assessment of the norm with reference to which the shortfall is calculated account is taken of the expected exports of the ensuing years, that a substantial weight in the determination of the norm is given to the current year's exports, and that no weight is given, for example, to exports three or more years anterior to the year with respect to which the shortfall is being calculated. The weights assigned to the current and preceding years in the estimation of the export norm--insofar as it is estimated by formula--were arrived at on the basis of experience as to which weights gave the closest estimate of the current trend and the best implied forecast of the two years subsequent to the shortfall year.

A formula in which no weight was given to the shortfall year would, for this reason, tend to lead to a higher estimate of the trend value, and hence a larger shortfall and a larger drawing entitlement. Because of the long-term upward trend of exports, however, this effect would generally be offset to some extent by the inclusion in the weighting formula of the third year preceding the shortfall, or of still earlier years. From Table 2 it can be seen that a formula for trend estimation giving equal weights to the three years preceding the shortfall would have led, over the period 1951 to 1964, to somewhat larger drawing entitlements than the present formula. The same table, however, shows that the "performance" of the scheme (as measured by the degree to which compensatory drawings and repurchases bring export availabilities closer the true trend value, and the degree to which they tend to smooth out export availabilities) would not have been improved, but if anything, worsened by such a change in formula. It is not the object of the compensatory facility to aim at the largest possible amount of drawings, and, as will be shown below, there are ways in which it would be possible for an increase in drawings outstanding to improve the performance of the scheme significantly, or even for the scheme to be improved without a net increase in drawings outstanding.

Some further points deserve mention.

The element of forecasting involved in the determination of a current rather than a past trend value of exports, though irksome and subject to uncertainty, is a good discipline for country and Fund alike, and may help to counteract the natural tendency to delay adaptations to changing circumstances.

More important is the fact that measurement solely from a past level would frequently yield "shortfalls" which could not by any means be described as "temporary." While countries with a rising trend of exports, even when the rise was subject to serious interruption, would seldom, if ever, be deemed to have shortfalls, those with a generally falling trend of exports would experience persistent shortfalls. Such a change in formula would necessitate the introduction of a separate determination as to whether or not the shortfall was temporary--a determination which, as already indicated, would involve forecasting much further ahead and hence a higher degree of guesswork than that involved in the determination of the trend by present methods.

The other alternative would be to drop the proviso that export short-falls--or rather declines--should be temporary. But this would scarcely be compatible with the legal requirement of temporariness in the use of Fund resources.

For these reasons it seems on balance undesirable to alter the present concept of the export norm.

Table 2. Fund Compensatory Financing Facility:  
Comparison of Weighting Systems over Years 1951 to 1964<sup>1/</sup>

Limit Per Cent of Quota	Coefficients Applied to Years				Drawing Entitle- ment 2/	Average Drawings Out- standing <sup>3/</sup>	Approximi- nation Ratio <sup>4/</sup>	Smooth- ness Ratio <sup>5/</sup>
	t	t-1	t-2	t-3				
.25	0	1/3	1/3	1/3	1.04	.31	.022	.028
.25	.50	.25	.25		.97	.29	.023	.029
.50	0	1/3	1/3	1/3	1.82	.54	.033	.046
.50	.50	.25	.25		1.61	.48	.034	.046

<sup>1/</sup> Scheme applied to a sample of 48 countries. Drawings are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of the level of exports in those years. The quotas in per cent of which the limits are expressed are not present quotas but those obtaining at the relevant dates during the period 1951 to 1964.

<sup>2/</sup> Cumulative total entitlements over the period in billions of U.S. dollars.

<sup>3/</sup> Average for all years of total amounts outstanding in billions of U.S. dollars.

<sup>4/</sup> Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

<sup>5/</sup> Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

B. Degree of Reliance on Automatic Formulae

Governor Pugliese, of Argentina, speaking at the 1965 Annual Meeting of the Fund on behalf of 19 Latin American countries and the Philippines, mentioned as one of the fundamental aspects of the Fund's compensatory financing decision which it would be advisable to consider,

- "3. In conclusion, we would emphasize the non-automatic nature of the drawings permitted. In the decisions on individual cases submitted to the consideration of the Executive Board there has been some flexibility, although in all of them there has been no lack of a subjective assessment in the determination both of the amount to be compensated and of the circumstances in which the loss of income occurs."

This question, so far as it concerns the determination of the shortfall, has already been considered at some length above.

It has been the experience of the Fund, based not only on its own export forecasts but on those of outside bodies, that a closer estimate of the medium-term trend can be arrived at by the use of short-term forecasts based on commodity analysis than by reliance on the best statistical formula. While greater reliance on formulae might give countries a slightly higher degree of certainty as to the amount of compensation they could rely on, the proposed balance between the two methods of estimation would seem to give as much weight as is prudent to the "automatic" element in the estimation process.

C. Account to be Taken of Terms of Trade

At the 1965 Annual Meeting of the Fund, Governor Wanninayake of Ceylon made a suggestion in the following terms:

"I was encouraged by the reference by Mr. Schweitzer to the work that the Fund is now undertaking to improve the compensatory financing facility. Several speakers have urged that compensatory assistance should be provided for a decline in the terms of trade rather than for a fall in export earnings alone. My own country's experience in recent years vividly illustrates the importance of this reform. We suffered a decline in the terms of trade by 13 per cent in two years alone, but since this was almost entirely due to an increase in import prices we were unable to avail ourselves of the compensatory financing facility. I do sincerely hope that this particular improvement in the scheme will be made effective at an early date."

The terms of trade refer to the ratio between a country's export prices and its import prices. Fluctuations in export prices are, of course, reflected, along with fluctuations in export quantities, in the fluctuations in export proceeds. It might be argued that price fluctuations are more properly

compensable than quantity fluctuations in that they are less easily affected by the policies of the exporting countries. On the other hand, some of the commonest and most genuinely short-run fluctuations in export proceeds are those arising from crop failures. More harm than good would probably be done by attempting to distinguish the specific roles of price and quantity in the fluctuations in export proceeds.

The case is different where price fluctuations are concerned. There is undoubtedly a good economic case for compensating not the money value but the real value, or importing power, of exports. An estimate of the latter could be arrived at by deflating exports (for the purpose of arriving at the trend value of exports) by an import price index based on the shortfall year.

There are, however, a number of practical and other objections to this procedure. Most primary producing countries have no import price index. Of those import price indices that exist many are unrepresentative or unreliable. Moreover, such indices usually become available several months later than the data on export proceeds, so that the lag in the granting of a compensatory drawing behind the occurrence of the export shortfall would necessarily be increased. It might be thought that, where the import price indices of developing countries are unavailable, unreliable, or late in appearing, estimates could be formed on the basis of the export and import price indices of industrial countries. Such data, however, would provide extremely uncertain and disputable estimates for the imports of any individual developing country. It has to be borne in mind that the developing countries that experience the largest fluctuations in import prices do so because they are substantial importers of primary products, often from other developing countries. Apart from such cases, the import price indices of primary producing countries do not, as a rule, show very large movements within a short period of years. For all these reasons, it seems better, at this time, to continue to adhere to the principle of compensating for shortfalls in export proceeds rather than in the importing power of exports.

#### IV. Period for Which Shortfall is Calculated

Thus far it has been the practice of the Fund to require that any request for the use of the compensatory facility shall relate to an export shortfall over the latest twelve-month period for which, at the time of the request, a reliable estimate of actual exports can be made. There must, in any event, be some maximum lapse of time within which any claim for compensation with respect to the exports of a given period should be made, and if the compensatory facility is to fulfil its purpose of enabling countries to stabilize their external expenditures as much as possible in the face of fluctuations in receipts, it seems desirable that the time lag between shortfall and compensatory financing should be as short as possible. (As indicated below, countries need not be deterred from applying for a compensatory drawing as soon as a shortfall appears by the fact that they will thereby preclude themselves from claiming a larger compensation a little later if the shortfall has by then increased.)<sup>1/</sup>

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<sup>1/</sup> See page 14 below.

The present practice enables a claim for a compensatory drawing to be made at any time during the year with respect to the twelve-month period immediately preceding. The question arises whether this right should be restricted in any way. There would seem to be no advantage in a system under which such claims could be made only with respect, say, to calendar years. A more plausible case could be made for ruling that, where exports are marked by seasonality, claims for compensatory drawings should be made only with respect to twelve-month periods which include all those months over which the principal export crop is liable to be marketed abroad. Otherwise, it might be argued, countries which marketed their crops early one year and late the following season might show a shortfall over a twelve-month period that spanned two seasons, whereas no shortfall would appear from a comparison of crop years. Bearing in mind, however, that most countries have a number of export crops with different seasonalities, it is doubtful whether the variability of seasonality is sufficient to justify the introduction of a restriction which would both reduce the value of the facility to the country and complicate its administration. It would be no easy task to determine for each country with respect to which twelve-month periods applications for compensatory financing would not be entertained. It should also be borne in mind that any shortfall that appeared to be artificially induced by deliberate delay in the marketing of a crop would be unlikely to be regarded as "largely attributable to circumstances beyond the control of the member" and in this event would not qualify for a compensatory drawing.

The arrangement outlined in the first paragraph of this section can be criticized from another angle, namely that even a time lag of a few months between the shortfall and the compensatory drawing is undesirable, and that it would be better if the drawing could coincide with the shortfall. This means that the drawing would have to take place at a time when the precise amount of the shortfall was unknown. In order to meet this point and to encourage the use of the stand-by and ordinary drawing facilities for the compensation of export shortfalls, it is intended, subject to what is said below, to allow members, within a six months period of any drawing, to reclassify all or part of it as a compensatory drawing under Paragraph 5 of the Decision. The drawing, when first made, would have to satisfy the ordinary conditions for drawing in the tranche in question, or, if made under standby, the requirements appropriate to drawing under the standby. The reclassification of the drawing would have to satisfy the conditions for a compensatory drawing under Paragraph 5 of the Decision with respect to an export shortfall for the latest twelve months for which data were available prior to the reclassification. The amount reclassified could not exceed the amount of that shortfall. Such reclassification would confer on the drawings the privilege of additionality as defined in (ii) of Paragraph 6 of the 1963 Decision (with any enhancement of that privilege that may result from the separation of the compensatory facility from other drawing facilities, discussed below). It would not, however, reconstitute rights to draw under standby.

It is estimated that if both the compensatory facility and the privilege of reclassification had existed over the period 1959-64, and the latter had been exercised to the full--which might not in all cases have been to the country's advantage--some 20 to 25 per cent of all non-compensatory drawings could have been so reclassified.

#### V. Problem of Double Compensation

It would neither be equitable, nor in accordance with the intention of the Decision on Compensatory Financing, that any member should be compensated twice for the same shortfall, or more precisely, that the sum of any drawings made with respect to any given shortfall should exceed the amount of the shortfall.

Under the Decision a member can draw from the Fund with respect to a payments deficit arising out of an export shortfall either in the form of a drawing under ordinary tranche policies (referred to in Paragraph 4 of the Decision) or in the form of a drawing under the special policies outlined in Paragraph 5 of the Decision. Moreover, it is intended, as indicated in the preceding section, that a drawing originally made under ordinary tranche policies could in certain circumstances be reclassified. The problem of double compensation may arise either with respect to two drawings under Paragraph 5, or with respect to a pair of drawings, one under Paragraph 5 and another under Paragraph 4.

In the case of two drawings under Paragraph 5, it is proposed that, if the period with respect to which a second such drawing is requested to be made (or reclassified) overlaps with that for which a first such drawing has been made (or reclassified), the first drawing would be prorated over the twelve months with respect to which it was given, and such part of it as corresponded to the overlap between the two periods would be subtracted from the drawing entitlement with respect to the second period.

As regards the problem of avoiding double counting as between a Paragraph 5 drawing and an ordinary drawing which can be considered as at least partly undertaken for compensatory purposes, there is no real difficulty if the ordinary drawing follows the Paragraph 5 drawing and is not made under a standby accorded before the latter drawing. In that case, the Paragraph 5 drawing will simply be "taken into account" as one of the many factors affecting the balance of payments situation of the drawing country on the occasion of any subsequent drawing or standby.

The real difficulty arises if a Paragraph 5 drawing or reclassification is requested after an ordinary drawing or standby arrangement. We then have to ask whether the payments situation with respect to which the drawing or standby was given included any part of the export shortfall with respect to which the Paragraph 5 drawing or reclassification is now requested. Such a question would be hard to answer since an ordinary drawing or standby is not usually given to meet the payments deficit of any precisely defined period, still less to meet fluctuations in any specific item in the balance of payments.

One approach would be for some specific statement to be made by the Fund at the time of the ordinary drawing or standby arrangement as to the proportion thereof, if any, that should be regarded as granted with respect to an export shortfall, and as to the period of the shortfall. In the case of standbys, however, account is more often taken of the possibility of future shortfalls than of the accomplished fact of past shortfalls, and it is impossible to be precise as regards either the amount or the timing of future shortfalls. Some conventional rules will, therefore, have to be adopted as to the period and magnitude of the export shortfall deemed to be compensated by ordinary drawings or drawings under standby made prior to the request for a drawing or reclassification under the compensatory facility.

#### VI. Responsibility for Shortfall and Policy Conditions

According to Paragraph 5(a) of the Compensatory Financing Decision of 1963, one of the conditions of a compensatory drawing is that this export shortfall should be "largely attributable to circumstances beyond the control of the member." Where this condition is clearly not satisfied, it would be inappropriate for a drawing to be made under the compensatory facility. However, there may be ambiguous cases where difficulties of interpretation arise. A shortfall can sometimes be attributed with equal propriety to any one of a number of causes, some of which may be under the member's control and others not. For example, suppose a combination of the following:

- (a) a rise in foreign demand for the country's exports;
- (b) a short crop due to weather;
- (c) a rise in home consumption of the export product due to inflation, subsidization, or some other factor for which the government is responsible.

Given the rise in prices resulting from (a), the shortfall in export value may be no greater than could be entirely accounted for by either (b) or (c). Again, suppose that a shortfall takes place in the exports of a given product due to "act of God" but that an increase in the export of other products, which would otherwise have offset the shortfall, fails to occur because of the policies of the member. Again, there may be cases where the shortfall would not have occurred without certain policies of the member but these policies were reasonable in the light of all the circumstances, or cases where the shortfall could have been prevented by certain policies but abstention from these policies on the part of the member was reasonable in the light of all the circumstances.

In such ambiguous cases an interpretation favorable to the member requesting the compensatory drawing should generally be adopted, and whenever the shortfall can be largely attributed to "circumstances beyond the control of the member" it should be so attributed.

One of the conditions for drawing under Paragraph 5 of the 1963 Decision is that "the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties."

In the application of the Decision to individual cases, the Fund, in accordance with the intention of the Decision, has not attempted to reach agreement with the member on what the nature of these solutions would have to be. This has been left to subsequent discussions, and has not stood in the way of prompt action on a request for compensatory drawings. Nevertheless, in one case in which a compensatory drawing was requested, the country concerned made, at the time of the request, a statement of the policies it intended to follow. In the two other cases of compensatory drawings, the Fund subsequently reached agreements on appropriate policies with the countries in question.

#### VII. Separation of the Compensatory Facility from other Drawing Facilities

One of the measures which the UNCTAD proposed for consideration by Fund member governments runs as follows:

"(2) To place compensatory credits entirely outside the structure of the gold and successive credit tranches, so that the drawing of compensatory credits would not directly or indirectly prejudice a member's ability to make an ordinary drawing."

Presumably the measure recommended is to be interpreted in the sense that the amount drawn under the compensatory financing facility would be ignored by the Fund in computing the amount of drawing facilities still available to members under the principles applicable to the gold tranche, the first credit tranche, etc., as well as in computing the practical maximum drawing facilities open to members. In other words, the Fund would treat a drawing request by a member as if its holdings of member currency were less than its actual holdings by the amount of any drawings outstanding under the compensatory financing facility. At present the Fund is prepared to waive the 200 per cent limit to the extent that compensatory drawings are outstanding. If the UNCTAD recommendation were accepted, the limits for gold tranche and first credit tranche policies would be extended beyond 100 per cent and beyond 125 per cent of holdings, respectively, to the extent that compensatory drawings were outstanding. Most compensatory drawings are likely to occur after a country has used its gold tranche and probably also its first credit tranche. To ignore the compensatory drawings not only from the standpoint of the total drawing facilities of a member but also from the standpoint of tranche policies to be applied to the member would have the advantage of rendering the facility clearly additional in all respects. On the other hand, at any given level of holdings it would somewhat reduce the Fund's ability to secure satisfactory corrective programs in the case of ordinary drawings. It would not

affect the level of charges corresponding to any given level of Fund holdings, nor would it affect the applicability to compensatory drawings of the repurchase provisions of Article V, Section 7(b). The Fund is prepared to separate the compensatory facility from other drawing facilities in the sense described above.

#### VIII. The Limit on Compensatory Drawings

One measure recommended by UNCTAD to Governments members of the Fund for study is:

"(1) To increase as soon as possible the amount allocated by the Fund to compensatory financing over and above its current transactions, from 25 per cent to 50 per cent of a member country's quota."

It should be noted that the limit of 25 per cent of quota on outstanding compensatory drawings under Paragraph 5 of the Decision is not an absolute one, but applies only "normally." However, it would clearly be undesirable for compensatory drawings to be accorded frequently or as a general rule in excess of the "normal" maximum. This would raise issues of discrimination, both with respect to the compensatory drawing facility and total drawing facilities accorded to different countries. It would also defeat one purpose of the compensatory facility, namely that a country can, to a large extent, rely on obtaining compensatory financing in the circumstances for which it is designed, and should, therefore, not have to rely on "rallonges" of this facility.

It is also important to bear in mind that the limit on drawings under the facility is not the limit on the amount a country may draw as a result of a payments difficulty arising out of an export shortfall. It is always open to the country to request an additional drawing under the ordinary drawing policies applicable to its tranche position with the Fund. Admittedly, this would reduce the amount of drawing facilities available for other purposes.

If one disregards the foregoing considerations, there can be little doubt but that over any extended period of years an expansion of the 25 per cent limit on outstanding compensatory drawings would add significantly to the value of the assistance provided. Calculations as to how the Fund's compensatory facility might have worked if it had been applied, on a pure formula basis,<sup>1/</sup> to the export earnings of primary producing

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<sup>1/</sup> It is, of course, impossible to establish in retrospect precisely what compensation would have been payable over the period 1951 to 1964 under the present scheme and with a higher limit respectively, inasmuch as estimates of trend and shortfall would have been affected by qualitative appraisal as well as by formula.

countries over the period from 1951 to 1964, and if it had been used to the full, indicate that an extension of the limit on outstanding drawings from 25 to 50 per cent of quota would have increased the effectiveness of assistance provided under the facility in a proportion roughly commensurate with the increased "cost" involved. The extent to which export availabilities are brought closer to the trend value of exports would have been increased by almost 50 per cent, the extent to which availabilities are smoothed out would have risen by some 60 per cent, while the average drawings outstanding would have risen by some 65 per cent. The data are set forth at Table 3.

In the rather favorable circumstances which have prevailed since the compensatory financing decision, only three compensatory drawings have taken place. It is noteworthy, however, that in one of them (the case of Sudan), the amount of compensation which would prima facie have been paid under the facility was restricted by the existence of the 25 per cent maximum. In the other two cases the amount of compensation paid was not so restricted but in each case a single compensatory drawing absorbed, respectively, 86 per cent and 71 per cent of a quota tranche.

Table 3. Compensatory Financing: Fund Scheme with Varied Limits Applied to Data for Years 1951-64<sup>1/</sup>

Limit	Approximation Ratio <sup>2/</sup>	Smoothness Ratio <sup>3/</sup>	Average Drawings Outstanding <sup>4/</sup>
.25 of Quota	.023	.029	.29
.50 of Quota			
(a) Unqualified	.034	.046	.48
(b) Qualified as to rate of use <sup>5/</sup>	.035	.047	.45
None	.100	.121	1.36

<sup>1/</sup> Scheme applied to a sample of 48 countries. Coefficients of .5, .25 and .25 applied to years t, t-1, and t-2, respectively, to compute shortfalls. Drawings are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of the level of exports in those years. The quotas in per cent of which the limits are expressed are not present quotas but those obtaining at the relevant dates during the period 1951 to 1964.

<sup>2/</sup> Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

<sup>3/</sup> Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

<sup>4/</sup> Average for all years of total amounts outstanding, in billions of U.S. dollars.

<sup>5/</sup> Drawings outstanding may not increase in any year by more than 25 per cent of quota.

From a compensatory financing standpoint there is much to be said for extending the limit of the facility from 25 to 50 per cent. Since, however, it would involve an addition to the amount of liquidity which the Fund provides on liberal conditions, it might tend to reduce countries' willingness to have recourse to facilities of a more strictly conditional character. This weakening of conditionality, which will be somewhat intensified by the separation of the compensatory facility from other drawing facilities which has been recommended in the preceding section, is perhaps the most important disadvantage of the proposal under consideration.

Account should also be taken of the possible effect on the Fund's own liquidity, i.e., its effect on the probable level of drawings relative to resources provided by quotas in the Fund. As shown in Table 3, if the compensatory facility had existed over the period 1951-64, and if all the 48 countries covered by the table had made full use of that facility, an extension of the limit from 25 per cent to 50 per cent of present quotas would have increased the average amount of compensatory drawings outstanding from \$290 million to \$480 million. From the standpoint of Fund liquidity, however, what matters is not so much the average amount of compensatory drawings outstanding as the amount liable to be outstanding at peak periods. It is estimated that, on the assumptions set forth above, the extension of the limit from 25 per cent to 50 per cent would have raised the maximum amount of compensatory drawings outstanding within the period from \$400 million to \$740 million or, say, from 18 per cent to 33 per cent of the quotas of the countries concerned in the year--1955--in which these maxima occurred. On the assumption that potential peak year compensatory drawings outstanding at any given percentage limit have expanded since 1955 in proportion to quotas it may be estimated on the basis of the new quotas becoming effective in 1966, that outstanding drawings for a peak year like 1955 would now amount to somewhat more than \$1,100 and \$2,000 million for the 25 per cent and 50 per cent limits, respectively. Since, however, countries with adequate reserves will often not use opportunities for compensatory drawings that are open to them, or will not exercise their full entitlement to such drawings, and since any use made of the compensatory facility is likely to reduce to some extent requests for ordinary drawings, the true magnitude of the additional use of Fund resources at peak periods involved in the extension of the limit would be unlikely to exceed, say, \$400 million to \$500 million. Moreover, past experience would suggest that while peak years for compensatory drawings outstanding

would be likely to occur in years when non-compensatory outstandings were relatively high, they would not be likely to coincide precisely with the peak years for non-compensatory drawings outstanding.<sup>1/</sup>

Balancing the divergent considerations discussed in this section, it is intended that:

- (i) the limit on the use of the compensatory facility under Paragraph 5 of the Compensatory Financing Decision of 1963 should be raised from 25 per cent to 50 per cent of quota; but that
- (ii) the new limit should apply in all circumstances and not merely as with the present limit, "normally";<sup>2/</sup>
- (iii) in any twelve month period the net expansion in drawings outstanding under Paragraph 5 of the Decision should not exceed 25 per cent of quota; and
- (iv) any drawings the effect of which would be to raise drawings outstanding under Paragraph 5 of the Decision beyond 25 per cent of quota will be granted only if the member country, in addition to fulfilling the requirements of the Decision, is found to have been following policies reasonably conducive to the development of its exports.

1/ Outstanding Drawings in Relation to Fund Quotas, 1951-64  
(in per cent of total Fund quotas)

	Actual Fund Drawings		Hypothetical compensatory drawings <sup>2/</sup>
	All countries	Less developed countries	
1951	12.1	3.5	0.1
1952	11.0	3.0	2.6
1953	10.5	3.7	5.0
1954	8.3	4.0	4.5
1955	6.0	3.3	4.0
1956	11.9	3.8	3.9
1957	21.8	7.9	3.2
1958	21.2	8.6	4.6
1959	11.0	5.8	2.3
1960	6.9	5.9	1.3
1961	18.0	8.7	1.4
1962	11.6	9.0	1.6
1963	11.6	9.6	0.9
1964	16.1	8.9	0.7

1/ Mixed Repurchase Scheme with qualified 50 per cent limit.

2/ The relevant words of the Decision are: "The amount of drawings outstanding under this decision will not normally exceed 25 per cent of the member's quota."

The limitation suggested under (iii) above will impose a delaying effect in utilizing the compensatory facility to the full extent proposed under (i). As will be seen from Table 3, this arrangement would probably yield slightly better results with respect both to approximation to export trend and to smoothness of export availabilities than would an unqualified limit of 50 per cent of quota, and would be slightly less expensive to the Fund in terms of drawings outstanding.

In connection with the delaying effect of proposal (iii), it should be borne in mind that Consultations under Article XIV or Article VIII would provide an opportunity for testing the extent to which a member had implemented its undertakings under earlier compensatory drawings to "cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties," and also the extent to which it was complying with the conditions set forth at (iv) above.

If the resources needed by a member to deal with a particular shortfall exceeded the amount permitted under condition (iii) above and the member desired additional assistance from the Fund, it would enter into discussions with the Fund for a drawing on the terms normally applicable to the tranche in which the country found itself.<sup>1/</sup> This would be a drawing under Paragraph 4 of the 1963 Decision, and, as such, would not be limited in magnitude to any a priori percentage of the member's quota.

#### IX. Repurchase of Compensatory Drawings

The third measure recommended by UNCTAD for study by Fund member governments is:

"(3) To explore ways to secure possible refinancing of compensatory financing obligations of the developing countries in the event of a persistent shortfall in export receipts beyond the control of the country affected."

While there is no specific provision in the Compensatory Financing Decision of 1963 for refinancing of compensatory drawings, refinancing on a short- to medium-term basis would, in effect, be possible under present procedures in the circumstances that appear to be envisaged in the recommendation, viz., in the case where at the time when the repurchase falls due there is a shortfall in export receipts beyond the control of the affected country. The repurchase would, of course, restore the compensatory financing facility pro tanto, and if at that time an export shortfall of the type described persisted, the member would be in a position to apply for a new drawing under this facility. It would not, however, be able to increase its outstanding compensatory drawings as much as if there had been no repurchase obligation. Moreover, a country that had

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<sup>1/</sup> In accordance with the proposal at p. 16 above, the terms in question would, of course, be determined by the Fund's holdings of the member's currency, exclusive of those arising from drawings outstanding under Paragraph 5 of the Compensatory Financing Decision.

made a compensatory drawing might suffer hardship by having to repurchase in a year in which, even though it had no shortfall, neither had it any excess of exports over the norm out of which it could afford to make repayment.

This raises the much more fundamental issue as to whether repayments for compensatory drawings should take place according to the normal 3 to 5 years rule, or whether they should take place, entirely or to a considerable extent, in years in which exports exceed the estimated trend value. As can be seen from Table 4 below, schemes in which (a) repurchases were made exclusively out of export excesses, and (b) the full amount of such excesses was directed to repurchases would probably, over the years 1951 to 1964, have enhanced the degree of approximation to the export trend by over 20 per cent, and the smoothing effect of the facility on export availabilities by over 50 per cent as compared to schemes involving repurchase under the 3 to 5 year rule. This holds true whether the limit on outstanding drawings is 25 per cent or 50 per cent of quota. For schemes without limits the superiority of compensatory repurchase would have been still greater.

Contrary to what might perhaps at first sight be assumed, the change in the timing of repurchases would also, save in the "no limit" case, have reduced the average length of time for which compensatory drawings remained outstanding and hence have reduced the average amount of compensatory drawings outstanding at any one time. It seems probable, therefore, that a system whereby compensatory drawings are repaid out of export excesses rather than under the 3 to 5 year rule would do much to improve the performance of the facility without any additional "cost"--indeed with a reduction in cost--in terms of drawings outstanding.

In order to apply this method of repayment for compensatory drawings, calculations would have to be made at twelve-monthly intervals to see whether or not export excesses had occurred. These calculations might be made with respect to calendar years or Fund financial years, beginning with the first complete year following the drawing. Alternatively, and preferably, they might be made for each twelve-months period, beginning with the twelve months immediately following that with respect to which the drawing had been granted. Since it would be a matter not of a drawing facility, but of a repayment obligation, it would be inappropriate to rely to any extent on qualitative estimation of a necessarily subjective kind in calculating the export excess. This should be done on the basis of the statistical formula adopted as an element in the calculation of shortfalls.

[The following passage, to the end of the section on "Compensatory Facility and Fund Liquidity," diverges substantially from the corresponding passage from the foot of p. 22 to p. 26 inclusive in SM/65/101, and proposes a type of mixed repayment system for compensatory drawings different from that proposed in SM/65/101. These changes were made to meet the point made by a number of Executive Directors that repurchases out of export excesses, though avoiding the difficulties that would arise from repurchase requirements occurring at a time of poor or mediocre exports, might have difficulties of their own in that the amount of the repurchase obligation would not be known in advance. The system now proposed attempts to avoid or mitigate both sets of difficulties, in a manner not unduly expensive to the Fund.]

Two difficulties arise with respect to this fully compensatory system of repurchases out of export excesses. The first concerns the predictability of repurchase obligations. Countries might occasionally find it difficult to repurchase compensatory drawings to the full extent of any excess of actual over trend value of exports, partly because an expansion in exports would probably entail some increase in import requirements, and partly because the obligation to repay would not be known with certainty until after the event. This difficulty should not be exaggerated. Owing to the manner in which export excesses are calculated, only one half of any increase in exports over the average level in the two years preceding the excess year could give rise to a repurchase, and if serious problems on repurchase should nevertheless arise owing to circumstances affecting other items in the balance of payments, it would always be possible for the Fund, under appropriate conditions, to agree to an ordinary drawing at the time of the compensatory repurchase. Nevertheless, it is possible that countries might prefer to have their repurchase obligations expressed in a more predictable form.

The second difficulty arises from the fact that under the system of repurchase out of export excesses a proportion of the repurchases of compensatory drawings would probably remain outstanding for longer periods than has hitherto been deemed compatible with the temporary character of Fund assistance. This does not mean that repayment would normally be more delayed than under the 3 to 5 year rule. Indeed, if, as indicated in Table 4, the amount of compensatory drawings outstanding is generally likely to be less when repayments are geared to exports than when they are made under the 3 to 5 year rule, the average length of time for which a drawing remains outstanding will probably be less in the former than in the latter case. More direct measurements of probable periods for which compensatory drawings would remain outstanding if repayments were also on a compensatory basis are given in Table 5, which is based on the experience of the years 1951-64. From this it can be seen that, even with an unqualified limit of 50 per cent of quota, some two thirds of all compensatory drawings would be repaid within 3 years, and more than four fifths within 5 years. The residue remaining outstanding beyond 8 years might be about 1 per cent. In considering these results, it should be borne in mind that the repurchase obligations under Article V, Section 7, would, of course, continue to apply--a fact which could not be taken into account in the calculations set forth at Table 5.

Table 4. Compensatory Financing: Fund Scheme  
with Varied Forms of Repayment, 1951-64<sup>1/</sup>

Repayments System	Fixed Term <sup>2/</sup>	Compensatory <sup>3/</sup>	Mixed <sup>4/</sup>
<u>25 Per Cent of Quota Limit</u>			
Approximation Ratio <sup>5/</sup>	.023	.028	.026
Smoothness Ratio <sup>6/</sup>	.029	.045	.036
Average Drawings Outstanding <sup>7/</sup>	.29	.17	.26
<u>50 Per Cent of Quota Limit (Unqualified)</u>			
Approximation Ratio	.034	.042	.041
Smoothness Ratio	.046	.072	.060
Average Drawings Outstanding	.48	.36	.48
<u>50 Per Cent of Quota Limit (Qualified)</u>			
Approximation Ratio	.035	.043	.042
Smoothness Ratio	.047	.071	.060
Average Drawings Outstanding	.45	.28	.42
<u>No Limit</u>			
Approximation Ratio	.100	.155	.160
Smoothness Ratio	.121	.216	.205
Average Drawings Outstanding	1.36	1.49	1.77

<sup>1/</sup> Weights of .50, .25 and .25 applied to years t, t-1, and t-2, respectively, for estimating calculated norm. 100 per cent compensation of calculated shortfall.

<sup>2/</sup> Amounts outstanding at end of three years are assumed to be repaid one half in the fourth and one half in the fifth year after drawing, regardless of level of exports.

<sup>3/</sup> 100 per cent of export excesses applied to repayment in all years.

<sup>4/</sup> Repayment in five equal instalments, beginning in the year following the shortfall year: repayments on past drawings are deducted from exports for the purpose of computing shortfalls.

<sup>5/</sup> Proportionate decline in root mean square percentage deviation of export availabilities from trend value of exports.

<sup>6/</sup> Proportionate decline in root mean square percentage deviation of export availabilities from trend value of such availabilities.

<sup>7/</sup> Average for all years of total amounts outstanding, in billions of U.S. dollars.

If the requirement that the Fund assistance be "temporary" could be deemed to be adequately met by the manner in which export shortfalls and excesses are calculated, and by the statistical probability that the average period of repayment will be short, this change is one which it would be advisable to adopt. However, it is considered that this requirement calls for a fixed maximum term for every drawing, which would make it difficult to adopt the repayment system under consideration in an unmodified form.

A "mixed" system on the following lines would seem to meet both of the difficulties referred to above and to combine many of the advantages of "compensatory" and "fixed term" repurchase respectively:

- (a) Compensatory drawings would be repaid in equal annual instalments over a five-year period.
- (b) In estimating export shortfalls for the purpose of making compensatory drawings, the Fund would, if the member so requested, deduct from the figure for actual exports any repurchases on past compensatory drawings that had been made within 12 months prior to the new compensatory drawing. Such deductions would not affect the computation of the export norm for the shortfall year.
- (c) Any request for compensatory drawings involving a deduction such as that described at (b) above would be met only if the Fund was satisfied that the member, in addition to fulfilling the requirements of Paragraph 5 of the Compensatory Financing Decision, had been following policies reasonably conducive to the development of its exports.

To the extent that a member took advantage of the deduction, the effect of this arrangement would be that the member would repay, with respect to any compensatory drawing, either the due instalment for the year or its export excess, whichever was the less. This would be easier on the member, in respect of the predictability and possibly the amount of the repayment in certain years, than the system of full compensatory repayment out of export excesses. It would differ from that system in two other ways: (i) Normal repurchases would be the occasion for a new compensatory drawing provided an appraisal partly on a qualitative and not entirely on a formula basis justified such a drawing, and the member declared that it was prepared to discuss its policy with the Fund. (ii) The addition of paragraph (c) introduces the concept that the country would have to satisfy the Fund that it had been pursuing reasonable export policies even where the drawing, insofar as it was occasioned by a repurchase, would fall within the first compensatory tranche. The latter feature would eliminate one of the possible defects of the fully compensatory repurchase system, viz., that a country will never repurchase if its exports, having once declined, continued to stagnate--insofar as the stagnation was attributable to faulty policies.

Table 5. Duration of Drawings under Compensatory Repayments System<sup>1/</sup>  
(Period = 1951-64)

	25% of Quota Limit		50% of Quota Limit (Qualified)		50% of Quota Limit (Unqualified)	
	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings	Billions of U.S. Dollars	Per Cent of Drawings
Total drawings	.89	100	1.24	100	1.45	100
Repaid:						
Within 3 years	.74	83	.97	78	.97	67
Outstanding after:						
Fifth year	.09	10	.15	12 <sup>2/</sup>	.27	18 <sup>2/</sup>
Eighth year	.01	about 1 <sup>2/</sup>		about 1 <sup>2/</sup>		about 1 <sup>2/</sup>

<sup>1/</sup> Coefficients of .5, .25 and .25 applied to years t, t-1, and t-2, respectively, to compute shortfalls. Full compensation of shortfalls is assumed. One hundred per cent of excesses applied to repayment.

<sup>2/</sup> Since some of the drawings in question were still outstanding at the end of the period but had not yet reached their eighth year, this figure is an estimate.

As will be seen from Table 4, the performance of this "mixed" system of repurchase, over the years 1951-64, as measured by the approximation ratio and the smoothness ratio, would probably have been better than that of the "fixed term" (3 to 5 years) system of repurchase, and only slightly inferior--except where there are no limits to outstanding drawings--to that of a fully compensatory system of repurchase out of export earnings.

The "cost" in terms of drawings outstanding is higher for the "mixed" system than for a fully compensatory system of repurchase. This is the price that has to be paid for increasing the predictability of repurchase obligations. The cost is, however, no greater--so long as the outstanding drawings of individual countries are limited to 25 per cent or 50 per cent of quota--than under the present system of repurchase within 3 to 5 years.

#### X. Changes in the Compensatory Facility and Fund Liquidity

On page 19 above an estimate was made of the possible charge on Fund liquidity that might arise from additional drawings associated with an extension of individual country limits on outstanding compensatory drawings from 25 per cent to 50 per cent of quota. At this point, a similar calculation is in order as to the charge on Fund liquidity that might result from adopting both of the principal measures suggested above, viz., (a) the

extension of the limit from 25 per cent to 50 per cent with the qualification that the increase in outstandings in any year should not exceed 25 per cent, and (b) the adoption of the "mixed" system of repurchase discussed above in place of the fixed-term system of repurchase which applies at present. Some additional claims on Fund resources might also arise from the proposed separation of the compensatory facility from the other drawing facilities of the Fund, but this cannot be quantified and is unlikely to be large.

As can be seen from Table 4, the transition from "fixed term" repurchase with a 25 per cent of quota limit, to a "mixed" system of repurchase with a qualified 50 per cent of quota limit would, over the 1951-64 period, have involved an increase in the average level of potential compensatory drawings outstanding from \$290 million to \$420 million, i.e., an increase of \$130 million. The maximum level of potential compensatory drawings outstanding would likewise have risen from \$400 million (in 1955) to \$560 million (in 1958), i.e., by \$160 million. On the assumption that peak year potential compensatory drawings outstanding have expanded since 1955-8 in proportion to quotas, the proposed changes in limits and repurchase systems might, under present conditions, raise maximum potential compensatory drawings from \$1,100 million to \$1,500 million, i.e., by \$400 million. Allowing for failure to use the full entitlement to compensatory drawings and other factors, it seems unlikely that the increase in peak year drawings occasioned by the proposed changes would in practice exceed \$200 million.

#### XI. Conclusions for Action

More than three years have now elapsed since the creation of the compensatory financing facility, and though it has not been extensively used the Fund has had sufficient experience with it to review and reappraise its application and scope. As a result it has been deemed desirable both to clarify the circumstances under which the facility can be used and to introduce into it certain modifications designed to increase the effectiveness of the assistance which the Fund provides to members.

In determining the medium-term export trend for the purpose of calculating the export shortfall the practice hitherto has been to give approximately equal weight to statistical and qualitative estimates, respectively. Experience suggests that qualitative estimates based on commodity analysis gives a closer estimate of the trend; consequently qualitative estimates will receive a greater weight in the future.

At present, the Fund is prepared to waive the requirement that total outstanding drawings may not exceed the Fund holdings of a member's currency beyond 200 per cent of quota either to accommodate compensatory drawings or, to the extent that compensatory drawings are outstanding, to accommodate other drawings. However, drawings under the compensatory facility are included in Fund holdings of the member's currency in applying the tranche

policies of the Fund to subsequent drawings. Full recognition of the special circumstances which give rise to compensatory drawings would make it desirable to separate this facility from normal drawing facilities of the Fund so that additions to the amount of compensatory drawings outstanding would not in any way affect the tranche policies applicable to other drawings.

While the use of the compensatory facility is most needed when a shortfall appears, members may be precluded or deterred from requesting use of the facility at that time since the full amount of shortfall can be known only after the interval of several months. To meet this problem it is proposed that within six months of any drawing, members should be enabled to reclassify all or part of it as a compensatory drawing and thus to restore to that extent their normal drawing rights for future contingencies.

Under the 1963 Decision outstanding drawings under the compensatory facility are limited normally to 25 per cent of quota. It is believed that an extension of the limit on outstanding drawings from 25 to 50 per cent of quota would add substantially to the value of the assistance provided. At the same time it is important to avoid such changes as would tend to weaken the ability of the Fund to exert its influence with members toward early adoption of sound corrective policies. It is, therefore, proposed that compensatory drawings outstanding may amount to a maximum of 50 per cent of quota, but that during any twelve-month period the amount of such drawings outstanding may not increase by more than 25 per cent of quota and that requests which would increase outstanding compensatory drawings beyond 25 per cent of quota should be met only if the Fund is satisfied that the member has been following reasonably sound export policies.

The question of repurchases of compensatory drawings has also been reconsidered in light of the possibility that the course of export receipts may make it difficult for a member to repurchase drawings fully within 3 to 5 years. On the other hand, repurchase terms should not be so changed as to undermine the revolving nature of Fund resources. Balancing these considerations, it is proposed that compensatory drawings should be repayable in equal annual instalments over a five-year period but that the member should be able to offset such repurchases against actual export receipts for the purpose of determining the amount of any new compensatory drawings if it is able to satisfy the Fund that it has been pursuing reasonably sound export policies.

## XII. Decision

In the light of the foregoing considerations, Decision No. 1477-(63/8) of February 27, 1963, on Compensatory Financing of Export Fluctuations is hereby amended by the deletion of paragraphs (5) through (8) and the substitution of the following paragraphs:

"(5) The Fund has reviewed its policies to determine how it could more readily assist members, particularly primary exporters, encountering payments difficulties produced by temporary export shortfalls, and has decided that such members can expect that their requests for drawings will be met where the Fund is satisfied that

- (a) the shortfall is of a short-term character and is largely attributable to circumstances beyond the control of the member; and
- (b) the member will cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.

Drawings outstanding under this paragraph may amount to 50 per cent of the member's quota provided that: (i) such drawings will not be increased by a net amount of more than 25 per cent of the member's quota in any 12-month period, and (ii) requests for drawings which would increase the drawings outstanding under this paragraph beyond 25 per cent of the member's quota will be met only if the Fund is satisfied that the member has been following policies reasonably conducive to the development of its exports.

(6) A member requesting a drawing under paragraph (5) will be expected to represent that it will make a repurchase corresponding to the drawing in equal annual instalments to commence one year after the drawing and to be completed not later than five years after the drawing. However, in estimating export shortfalls for the purpose of drawings under paragraph (5), the Fund will, if the member so requests, deduct from the figures for actual exports an amount equivalent to any repurchases made with respect to past drawings under paragraph (5) within 12 months of the request for the new drawing. A request for a drawing with respect to a shortfall which results in whole or in part from such deductions will be met by the Fund if it is satisfied that the member, in addition to fulfilling the requirements of paragraph (5), has been following policies reasonably conducive to the development of its exports.

(7) Whenever the Fund's holdings of a member's currency resulting from an outstanding compensatory drawing under paragraph (5) are reduced, by the member's repurchase or otherwise, this will restore pro tanto the member's facility to make a further compensatory drawing under that paragraph, should the need arise.

(8) When drawings are made under paragraph (5), the Fund will so indicate in an appropriate manner. Within six months from the date of any drawing which is not under paragraph (5) and to the extent that it is still outstanding, a member may request that all or part of the drawing be reclassified and treated, for all purposes of this decision, as a drawing made under paragraph (5). The Fund will agree to such a request if at the time of the request the member meets the requirements for a drawing of an equal amount under paragraph (5) and makes the representation as to repurchase appropriate to such drawings, which representation will then be substituted for the original repurchase representation.

(9) In order to implement the Fund's policies in connection with compensatory financing of export shortfalls, the Fund will be prepared to waive the limit on Fund holdings of 200 per cent of quota, where appropriate. In particular, the Fund will be prepared to waive this limit (i) where a waiver is necessary to permit compensatory drawings to be made under paragraphs (4) and (5) above, or (ii) to the extent that drawings in accordance with paragraph (5) are still outstanding.

Moreover, the Fund will apply its tranche policies to drawing requests by a member as if the Fund's holdings of the member's currency were less than its actual holdings of that currency by the amount of any drawings outstanding under paragraph (5).

(10) In order to identify more clearly what are to be regarded as export shortfalls of a short-term character, the Fund, in conjunction with the member concerned, will seek to establish reasonable estimates regarding the medium-term trend of the member's exports on the basis of appropriate statistical data in conjunction with qualitative information about its export prospects.

(11) The provision of credit to deal with the balance of payments effects of export fluctuations provides immediate relief for a country's short-term difficulties. In many cases, however, it will also be necessary to introduce measures of a policy character in order to attain a satisfactory and lasting solution to a country's balance of payments problems. Members generally have actively cooperated with the Fund to find and adopt the measures necessary to this end. Beyond immediate balance of payments difficulties, the primary exporting countries are, in many instances, facing unfavorable long-term export trends, and all are trying to meet the challenge of achieving more rapid and sustained development through a strengthening and broadening of their economies. The last mentioned problem will require action in many fields and over many years by both the primary exporting countries and the industrial countries, separately and in concert, including readier access to the markets of the developed countries for the products of the developing countries and an appropriate and sustained flow of technical and financial assistance to the developing countries. The Fund considers that its activities can provide valuable assistance in helping to establish a climate within which longer-term measures can be more effectively pursued."

United Nations Conference on Trade and Development  
Final Act and Report

Annex A.IV.17

Study of Measures Related to the Compensatory Credit System  
of the International Monetary Fund

The Conference,

Considering that the compensatory credit system put into operation by the International Monetary Fund since February 1963 constitutes a definite step towards the solution of short-term financing problems,

Considering that, in view of the short-term needs of developing countries derived from fluctuations in their export receipts, this system should be reviewed,

1. Recommends that Governments members of the International Monetary Fund study the following measures:

(1) To increase, as soon as possible, the amount allocated by the Fund to compensatory financing, over and above its current transactions, from 25 per cent to 50 per cent of a member country's quota;

(2) To place compensatory credits entirely outside the structure of the gold and successive credit tranches, so that the drawing of compensatory credits would not directly or indirectly prejudice a member's ability to make an ordinary drawing;

(3) To explore ways to secure possible refinancing of compensatory financing obligations of the developing countries in the event of a persistent shortfall in export receipts beyond the control of the country affected.

2. Requests that the International Monetary Fund, in its determination of the shortfall in export receipts, consider giving greater weight to the actual experience of the three preceding years.

Excerpts from Speeches of Governors  
at the 1965 Annual Meetings

AFGHANISTAN (Governor Achaczai)

The recent fall in basic commodity prices and difficulties in marketing total available supplies will necessitate compensatory financing in the coming months. To meet these needs, the facilities of the Fund need improvement.

ARGENTINA (Governor Pugliese, on behalf of 19 Latin American countries and the Philippines)

We should like to reiterate our opinion once more regarding the decision adopted in 1963 by the Executive Board of the Fund on the compensatory financing of losses in the export proceeds of primary-producing countries. We recognize that this represents a contribution toward the partial solution of this very important problem. However, it would be advisable to consider three fundamental aspects:

- 1) The need for considering the compensatory tranche in addition to the normal credit facilities of the Monetary Fund. The decision of February 1963, indeed, permits the drawing without taking into consideration the position of the requesting country with regard to the credit tranches. Nevertheless, the drawing has been added to those already made and thus may affect the country's position in respect of future transactions with the Fund. In our opinion it is of the greatest importance that the compensatory drawing be allotted quite separately from the others and invested with the supplementary nature that the different schemes favored by our countries have always upheld.
- 2) The amount available under this type of loan, limited to 25 per cent of each member's quota, is of insufficient size even in the case of very moderate depressions. If this ceiling were raised from 25 to 50 per cent, more significant resources would be made available to the countries exporting primary products, without this entailing a very heavy burden on the resources of the institution.
- 3) In conclusion, we would emphasize the non-automatic nature of the drawings permitted. In the decisions on individual cases submitted to the consideration of the Executive Board there has been some flexibility, although in all of them there has been no lack of a subjective assessment in the determination both of the amount to be compensated and of the circumstances in which the loss of income occurs.

CEYLON (Governor Wanninayake)

I was encouraged by the reference by Mr. Schweitzer to the work that the Fund is now undertaking to improve the compensatory financing facility. Several speakers have urged that compensatory assistance should be provided for a decline in the terms of trade rather than for a fall in export earnings alone. My own country's experience in recent years vividly illustrates the importance of this reform. We suffered a decline in the terms of trade by 13 per cent in two years alone, but since this was almost entirely due to an increase in import prices we were unable to avail ourselves of the compensatory financing facility. I do sincerely hope that this particular improvement in the scheme will be made effective at an early date.

CHINA (Governor Lee)

However, the scanty application that developing countries have made of the compensatory financing facility of the Fund would seem to indicate that the economic problems of developing countries cannot readily be solved through temporary accessibility to credit.

GREECE (Governor Zolotas)

. . . improved facilities for compensatory financing and more flexible conditions for drawings and repurchases should also be envisaged to provide for a direct contribution to the liquidity position of developing countries.

IRAQ (Governor Haseeb)

May I point out in this connection that the compensatory financing scheme of the Fund, though admirable in itself, suffers from one drawback. The borrowing facility under this scheme is available to primary producing countries when the shortfall in their exports is due to factors beyond their control. Since the decline in exports in such cases would be temporary and self-correcting, the Fund should not make the facility conditional on the pursuit by the country concerned of particular policies about its general balance of payments position.

SUDAN (Governor El Hindi)

Appreciative as we are of the Fund's efforts in this respect, we strongly feel that the terms and conditions under which the Fund provides such compensatory assistance (and, indeed, any other assistance) should be reconsidered with the view of softening them. It is no secret that a very limited number of members have so far made use of these arrangements, in spite of the pressing need of many for such assistance.

UGANDA (Governor Kalule-Settala)

While the Fund's operations are properly concerned with short-term balance of payments aspects, it may not be possible under conditions of fluctuating export earnings to differentiate between the short- and the long-term aspects. Such conditions tend to make public debt burdens unduly onerous on developing countries which base the servicing of their public debt burden on the expectation of a steady and reasonable growth in export earnings. It is therefore important in my view that both the Bank and the Fund should continue their efforts to find solutions to these problems. The Fund, on the one hand, should review the present compensatory financing arrangements to take account of the problems of fluctuating export earnings. The Bank, on the other hand, should continue to play a prominent role in evolving price stabilization machinery for primary products in association with UNCTAD.

UNITED ARAB REPUBLIC (Governor Kaissouni of the Bank)

Thus, the compensatory financing facility could be increased from one tranche to two tranches and the criteria for using this facility could be improved to take into account results to date and discussions in UNCTAD.

VIET-NAM (Governor Truong Thai Ton)

In particular, the nonliberal trade policy adopted by developed countries has obstructed the entry into these countries of primary manufactured products from the underdeveloped countries. To be sure, the action of the Bank and Fund in the form of compensatory financing granted to countries exporting primary products or in the form of assistance for the development and expansion of trade has been highly effective. However, the action necessary for the removal of discriminatory trade practices or other obstacles to the development of international trade should be hastened. This action should be supplemented by a complete revision of the present system of international payments. We also have high hopes that with the general increase in Fund quotas, the Fund will be able not only to grant compensatory financing facilities on a broader basis, for example, by increasing the percentage of this financing, but also to consider ways to aid countries which have experienced a temporary export shortfall as a result of crop losses caused by war, floods or other natural calamities.