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Pearson Commission Recommendations - Correspondence - Volume 5

OFFICE MEMORANDUM

TO: Mr. McNamara

DATE: April 29, 1970

FROM: Michael L. Hoffman

SUBJECT: Pearson Commission Memoranda

You asked for a schedule for the submission to you of memoranda analyzing the remaining seven Pearson Commission recommendations.

(1) Draft memoranda on Recommendations No. 6 (multilateral investment insurance) and No. 30 (Bank/Fund cooperation) are attached.

(2) Memoranda on Recommendations No. 13 (calling for a Board of Governors discussion of governments' plans for meeting the official development assistance target), No. 23 (research in human reproduction), and No. 33 (concerning a conference on machinery for evaluating progress towards DD II goals) will be sent to you early next week.

(3) The memorandum on Recommendation No. 32 (IDA allocation criterion) is being drafted. It should reach you within the next two weeks.

(4) The memorandum on Recommendation No. 2 (supplementary finance) awaits the outcome of the IDA replenishment negotiations and a policy decision.

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This is a poor statement of the problem and the status of a "solution." Include in a revised draft a brief statement of the problem, the proposed solution, and the reasons why some governments have failed to support the "solution."

Marginal note

Insert a paragraph telling the "outsider" of what went on before 3/19/70 in the Bank in relation to this subject.

*This is a poor statement of the problem
+ the status of a solution.
Include in a revised draft a
brief statement of the problem, the proposed solution,
+ the reasons why some parties have failed to support the solution.*

DRAFT
April 27, 1970

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Pearson Commission Recommendation No. 6 Concerning Multilateral
Investment Insurance

Recommendation

"... at the international level, talks leading to the establishment
of a multilateral investment insurance scheme should be pursued vig-
orously ..."^{1/}

Comment

*Insert a
A lettering
the "outline"
the Report sent
on before
3/19/70 in
the Bank
in relation
to this
subject.*

" On March 19, 1970, the Committee of the Whole on international investment
insurance met to consider whether there was a basis for resuming work on the
international investment insurance proposal with a view to arriving at a
draft of Articles of Agreement to be submitted to governments. Interest
in principle was expressed by some Executive Directors representing countries
which had not expressed such interest at the time the second draft of
Articles of Agreement was prepared in 1968. However, several Executive
Directors, representing developed countries, expressed the view, on behalf of
their governments, that provision should be made for some participation by
developing countries in meeting the financial requirements of the proposed
international investment insurance ^{plan} agency, arising from administrative expenses
and from payments which might be made to insured investors. Some of these
governments conditioned their own interest in the investment insurance scheme
on the incorporation of such a provision.

1/ Report, page 109.

~~The question of financial participation by developing countries is a major issue on which governments have not been called upon to take a position since the 1968 draft of Articles was formulated.~~ ^{9/} The Committee of the Whole ^e ~~therefore~~ decided to take up that issue ^{1/ financial participation} before resuming Article-by-Article consideration of the draft. Governments have been asked to convey their views by the latter part of May. Their response will determine whether the Committee proceeds to an Article-by-Article consideration of the draft Articles or decides to suspend indefinitely its study of the proposal. If it appears that there is no consensus on this issue, there would be little point in proceeding.

developing countries

Robert S. McNamara

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DRAFT
April 27, 1970

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Pearson Commission Recommendation No. 30 Concerning Bank/Fund
Collaboration

Recommendation

"The World Bank and the IMF, in countries where both operate, should adopt procedures for preparing unified country assessments and assuring consistent policy advice."^{1/}

Comment

On February 18, 1970, there was distributed to the Executive Directors (SecM70-66) ^{a copy of which is attached} a joint memorandum by the Managing Director of the IMF and the President of the World Bank describing ~~further~~ steps for collaboration between the World Bank and the IMF. The paper refers to the desirability that the Fund and the Bank complement each other, that each make the fullest use of the expertise and information of the other, that the risk of inconsistent policy advice be reduced to a minimum and that duplication of requests for information to member governments be minimized. It takes note of the Pearson Commission recommendation and states that "both organizations will make every effort to avoid duplication of activities and to assure that their appraisals of, and policy recommendations to, each country are broadly consistent". ~~The memorandum has been considered and approved by the Executive Directors of the Fund.~~

1/ Report, page 230.

2/ See also earlier statements on Bank/Fund collaboration: R66-10, dated January 19, 1966, relating particularly to missions and exchange of staff; and SecM66-390, dated December 13, 1966, relating to coordination on economic policy matters.

3/6
Approved
As modified
[initials]
[distribute
this to the
Board]

These agreements go far toward satisfying the objective of the Commission's recommendation, as far as now seems practicable. However, I intend to keep under review the possibilities for further measures of collaboration between the World Bank and the IMF.

Robert S. McNamara

x note the last sentence.

ROUTING SLIP

Date

April 22, 1970

NAME

ROOM NO.

Mr. McNamara

Walt

4/24

*Did we
state Ed
Hamilton's
comments*

*changed as
modified
fixed**

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

Attached is the draft of a memorandum on the Pearson Commission recommendation concerning the financing of buffer stocks, the conclusion of which has been revised in accordance with the understanding reached at your meeting with Burke and Dick on Monday afternoon. This has also involved a change on page 9 for consistency. If you approve the revisions, the paper is ready to go to the Board. However, I think it should be held until we can send with it the memorandum on Recommendation No. 1, a draft of which was sent to you on Monday morning.

From

Michael L. Hoffman

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711/5/27

3/30

Dick, (Demuth)

please ask Ed Hamilton to read.
I approve the text, as modified, assuming
that Burke (Knapp) and Ronnie (Aron
Broches) concur and assuming Hamilton
has not major comments.

RMcN

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Pearson Commission Recommendation No. 3 Concerning Financing of Buffer Stocks

Recommendation

"Financing of reasonable buffer stocks in support of well-conceived commodity agreements and policies should be recognized as a legitimate object of foreign aid."^{1/}

Background

This recommendation is one of several directed to improving the trading position of countries heavily dependent on production and export of agricultural commodities, tree crops, and raw materials. The Commission was chiefly concerned with the removal of obstacles which face producers of these commodities in the developing countries when they seek to increase exports to the developed countries. It found that in recent years progress had been made towards a solution of commodity problems, noting particularly the international agreements on coffee, wheat, tin, olive oil and sugar, as well as the continuing negotiations on marketing arrangements for cocoa, tea, bananas, and fats and oils. ~~Without citing any supporting evidence,~~

But the Commission concluded that "lack of funds to finance buffer stocks and facilitate diversification programs continues to impede progress in this area" and that easing "financial constraints" would help to promote sound commodity arrangements.^{2/} Then followed the recommendation quoted above.^{3/}

1/ Report, page 97.

2/ Report, page 85.

3/ In the same section of the report the Commission recommended that discussions leading to a new program of supplementary finance to assist countries experiencing unexpected short-falls in export earnings should be expedited. This recommendation is being treated separately.

March 16, 1970

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Analysis

I. Nature of the Commodity Problem

There are two related but separate aspects [?] (to) the commodity problem: adverse long-term trends in prices and export earnings, and wide, [?] short-term swings in these same variables. ~~While the title of the Rio Resolution of 1968, which prompted the Executive Directors' decisions of last June, refers only to the stabilization of prices, the Resolution is addressed to both aspects, referring to the need for a "remunerative level" of prices as well as to the need for stability in such prices.~~

Although reference is frequently made to the "commodity problem" in general, not all primary commodities produced and exported by the developing countries can be placed in the problem category. The commodities which pose the greatest difficulties are for the most part agricultural, and are characterized by sluggish growth in export markets as well as by short-term price instability. The basic reason for price fluctuations lies in the interaction between, on the one hand, an inelastic demand with respect to price and, on the other, unplanned changes in supply due to natural causes, such as weather and pests. This interaction induces wide fluctuations in prices in a direction inverse to changes in production. Shifts in demand in the industrialized countries can ^{many} also trigger market fluctuations, but for agricultural commodities, in contrast

to metals, these are generally of lesser importance. Even for metals, demand-induced instability is less severe than it was prior to World War II, because the degree of business fluctuations in the industrialized countries has been substantially moderated.

The slow growth in world demand is chiefly responsible for adverse longer-term trends in a number of primary commodities. A variety of forces underlies the sluggish growth in demand. Some of the most difficult cases -- rubber, cotton, jute and abaca -- are affected by competition from synthetics. Ignoring for the moment the interconnections between short-term instability and longer-term trends, it is fair to say that adverse longer-term trends present by far the more important problem. For those countries fortunate enough to be exporting commodities for which recent and prospective trends in prices and/or earnings are favorable, such as petroleum and most of the metals, the fact that the prices of some of these commodities are subject to wide short-term fluctuations is of secondary consideration. Similarly, those countries whose exports are concentrated in commodities with adverse long-term trends in prices and earnings are more concerned that their earnings are growing at an unsatisfactory rate than that the level fluctuates widely from year to year.^{1/}

It is true that highly unstable prices may accentuate adverse longer-term trends in commodity markets. Price instability may depress the demand for natural

^{1/} As pointed out in a report to the First U.N. Conference on Trade and Development, the principal concern of exporters "has been with the prospects for their total export proceeds (depending on volume as well as price) and with the average level of export proceeds over a number of years, measured in terms of import purchasing power, not merely with short-term fluctuations in money terms." Gerda Blau, "International Commodity Arrangements and Policies", Proceedings of First UNCTAD, Vol. III, page 142 (1964).

products if close **synthetic** substitutes with more stable and predictable price behavior are available. Temporary high prices reflecting supply shortages due to natural phenomena, such as drought or pests, may induce uneconomic investment in new productive capacity for commodities with a long gestation period (e.g., coffee, cocoa). When the new production ultimately comes onto the market, it accentuates the underlying adverse longer-term trend. It is generally agreed, however, that short-term instability only contributes to the major problem of long-term adverse trends, and that, to handle the latter, the forces determining the trends must be dealt with more directly.

II. Role of Commodity Agreements and Buffer Stocks

Commodity agreements can be useful in connection with both short-term price stabilization and longer-term price trend objectives.

There has long been general support, in principle, for the price stabilization aspects of commodity arrangements. Excessive price fluctuations serve no economic purpose and sometimes even impart the wrong economic signals, as when temporary high prices stimulate excessive investment in new production. Moreover, both importing and exporting countries have an interest in lopping off the peaks and troughs in prices. No transfer of real income from one group to the other over the long term is involved in price stabilization arrangements. Yet, partly because, as noted above, short-term price fluctuations are not a matter of primary concern to exporting countries and partly because, as it appears, "neither exporters nor importers were prepared to pay a substantial premium for this kind of insurance,"^{1/} there has been only limited success in negotiating price stabilization agreements, notwithstanding the general support for their objectives.

^{1/} Ibid.

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There is much greater divergence of view with respect to the desirability of seeking, through commodity arrangements, to alter the long-term trend of commodity prices. An adverse long-term trend reflects over-supply in relation to demand; to change the trend therefore requires controlling the supplies offered on the world market. Arrangements for such controls are designed to alter the terms of trade in favor of the producing countries over an extended period of time, and thereby to accomplish, through higher market prices, a real transfer of resources from the consuming (developed) countries to the exporting (developing) countries. The fact that the interests of the developed and developing countries in this objective of commodity agreements are divergent is a primary reason why such agreements have been so difficult to negotiate.

The role of international buffer stocks in commodity agreements is a limited one. Buffer stocks are a useful device for moderating short-term price fluctuations. But for improving the longer-term price prospects for a commodity through control of supplies on the world market, export quotas and diversification programs are the principal instruments. In fact, an international buffer stock without export quotas would be a risky proposition: if unlimited supplies were thrown on the market, the attempt to maintain a floor price would quickly exhaust its financial resources. It is significant that, in the one case where a buffer stock was successfully negotiated (tin) and in the other cases where it has been seriously discussed (e.g., cocoa), the buffer stock arrangement, designed for short-term stabilization purposes, was coupled with arrangements for export quotas designed to control supplies coming on to the world market over the longer term.

In the case of some commodities, the creation of international buffer stocks could aggravate the long-term problem by easing the pressure on individual countries to reduce production. With export quotas but without international buffer stocks,

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producing countries must themselves carry and finance large national stocks and thus have every incentive to curtail investment output. This is undoubtedly among the reasons why there is no buffer stock arrangement in the coffee and sugar agreements. Experience under the coffee agreement during a long period of over-supply in relation to demand has demonstrated that, without recourse to an international buffer stock, export quotas can bring about a substantial degree of price stabilization, as well as an orderly growth of export earnings above the amounts which would have been realized in the absence of the agreement.

Another consideration points toward possible conflict between buffer stocks and the achievement of the longer-term goals of commodity policy. When a buffer stock is proposed to be included as an integral part of a commodity agreement, the agreement must specify ceiling and floor prices. The difficulties of negotiating a commodity arrangement even under favorable circumstances are sizeable enough; they are increased when specific prices must be agreed upon before the arrangement comes into effect.^{1/}

It should also be noted that the need for international buffer stocks as an adjunct of broader commodity agreements has been appreciably reduced by the existence of the IMF's "compensatory financing" facility. Whereas buffer stocks are designed to reduce instability in export earnings by moderating price fluctuations through market intervention, "compensatory financing" can offset for a time the balance of payments impact of falling prices and consequently reduced export earnings, through virtually automatic three-to-five year loans. Under "compensatory financing," a country may draw up to 50 per cent of its IMF quota (although normally not more than 25 per cent in any 12 months) without in any way affecting its access to

^{1/} Negotiation of a cocoa agreement went on so long, because of controversy over the range of prices to serve as a basis for buffer stock operations, that in the course of the negotiations the market situation changed significantly ~~in~~ and some of the principal participants declined to proceed on the previously agreed basis.

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regular Fund drawings. From the scheme's beginning, in 1963, to through 1969, 19 countries had drawn a total of nearly \$400 million under the compensatory arrangements.

III. Buffer Stocks and the Bank

It follows from what has been said above that there are not likely to be many new international buffer stocks established. Nonetheless, in those few cases where buffer stock arrangements are agreed upon as part of a comprehensive international commodity agreement, they should, if properly designed, be able to contribute to the stabilization and strengthening of the market in the commodities concerned. Any such agreements should therefore be regarded by the Bank as a welcome development.

In the discussions ^{of recent years} ~~preceding the Rio Resolution~~, however, the importance of buffer stocks ^{has} ~~per se~~ tended to escalate and ^{has taken} ~~took~~ on an almost symbolic character as indicative of the international community's willingness to do something concrete about the commodity problem. It seems to have been widely assumed that the availability of adequate sources of finance would remove a major obstacle to the establishment of buffer stocks and thus clear the way for negotiation of broader commodity agreements. ~~This assumption clearly underlies the Commission's recommendation.~~

The true sequence would seem to run the other way. For the reasons already stated, the main constraint on the establishment of international buffer stocks lies in the complex of obstacles which impedes conclusion of commodity arrangements involving limitations on exports and production. These include conflicting producer-consumer views of the long-run price objectives underlying the size of total quotas; differing views among producers concerning the proper basis for allocating country quotas; the need to reconcile the desire for higher prices with the danger of encouraging substitution; the need to build into the agreement both strong incentives for diversification and disincentives for perpetuating over-production; and a variety of negotiating and enforcement problems. The requisite agreement on the maximum and minimum prices at which

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the manager of the buffer stocks should sell or buy the commodity has proved the most intractable problem of all.

If the other conditions were satisfied, it is doubtful that finance would be a serious obstacle to the inclusion of buffer stocks as part of international commodity agreements. The buffer stock may be financed through an export levy, as was contemplated in the cocoa negotiations; to the extent that, over the relevant price range, demand is less elastic than supply, the incidence of such a tax would fall mainly on the importing countries. Where such self-financing is contemplated, outside funds would be needed primarily to pre-finance the buffer stock, enabling it to buy in the market, for perhaps five years, prior to the build-up of internal funds. Had the draft cocoa agreement been in effect during the period 1960-68, the proceeds of the export levy would have been more than sufficient to finance both the acquisition of stocks and their carrying costs, without external assistance. Even if the agreement had come into force in 1965, when it would have been necessary to make large stock purchases immediately, the export levy would have obviated the need for short-term assistance beyond two years.^{1/} Medium-term commercial financing might well be available, although the new IMF financial facility referred to in the pages which follow, provides greater assurance of funds and cheaper access to them. In any event, whatever inhibition may have been created in the past by the absence of an established source of financing for international buffer stocks, I believe the problem has been largely dissipated. This view finds confirmation in the statement made in July 1969 by the Advisory

^{1/} IMF, "Some Aspects of Fund Liquidity and Buffer Stock Financing", March 28, 1969.

Committee to UNCTAD: "The Committee felt that the provision of pre-finance was no longer the most important obstacle to the setting up of a buffer stock scheme". ^{1/}

To place the matter further in perspective, something should be said about the relationship between the IMF and the World Bank in the financing of buffer stocks. As already pointed out, international stocking operations should be designed primarily for cushioning short-term disturbances. Any long-term holding of stocks to facilitate the structural adjustment of production to demand under international commodity agreements should ^{be} /primarily the responsibility of national governments; this is because the cost of stockholding will exert additional leverage on governments to hasten the adjustment. If this premise is accepted, it follows that the major burden of financial assistance to international buffer stocks should appropriately be carried by the IMF, the agency primarily concerned with short-term stabilization.

Under the new IMF buffer stock financing plan, ^{2/} a member may draw up to 50% of its quota to meet obligations assumed under an international buffer stock scheme. This amount may be drawn in a single year, but is subject to an overriding limit of 75% of quota for drawings under the "compensatory financing" facility

^{1/} UNCTAD, "Report of the Advisory Committee to the Board and to the Committee on Commodities on its Third session," July 25, 1969.

^{2/} Decision No. 2772-(69/47), June 25, 1969, The Problem of Stabilization of Prices of Primary Projects, Report of the Executive Directors.

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Committee to UNCTAD: "The Committee felt that the provision of pre-finance was no longer the most important obstacle to the setting up of a buffer stock scheme."^{1/}

Nevertheless, although the pressure for new international machinery to finance buffer stocks has been relieved, I think that we should consider whether the Bank's contribution might not be more forthcoming. To place the matter in perspective, something should be said about the relationship between the IMF and the Bank in the financing of buffer stocks.

As already pointed out, international stocking operations should be designed primarily for cushioning short-term disturbances. Any long-term holding of stocks to facilitate the structural adjustment of production to demand under international commodity agreements should be primarily the responsibility of national governments; this is because the cost of stockholding will exert additional leverage on governments to hasten the adjustment. If this premise is accepted, it follows that the major burden of financial assistance to international buffer stocks should appropriately be carried by the IMF, the agency primarily concerned with short-term stabilization, and that the Bank's role should be supplementary.

new IMF buffer stock financing plan
Under the recent IMF decision, a member may draw up to 50 per cent of its quota to meet obligations assumed under an international buffer stock scheme. This amount may be drawn in a single year, but is subject to an overriding limit of 75 per cent of quota for drawings under the compensatory financing facility

1/ UNCTAD, "Report of the Advisory Committee to the Board and to the Committee on Commodities on its Third session," July 25, 1969.

2/ Decision No. 2772-(69/47), June 25, 1969, The Problem of Stabilization of Prices of Primary Projects, Report of the Executive Directors.

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and the buffer stock scheme together. Neither type of drawing reduces the amount which a member can draw from the IMF on regular conditions; nor, with one minor exception,^{1/} does it affect the degree of conditionality of regular drawings. When the recently authorized increases in IMF quotas become effective, expected to be in late 1970, drawing rights under the buffer stock scheme are to be enlarged proportionately.

Given the sizeable resources now available through the IMF, any role for the ^{World} Bank in the financing of buffer stocks would necessarily be residual, to take care of cases in which, for one reason or another, IMF financing proves inadequate. Any assessment of the amount of ^{World} Bank financing which might be needed if the Bank decided to assume such a role must be highly speculative. Among the relevant variables are the probability of international agreements being negotiated for particular commodities; the prospect that they would provide for the establishment of buffer stocks; the size of the buffer stock; the spread of the agreed price range; the relative emphasis placed in the agreement on buffer stock operations as against other stabilization techniques; the extent to which partial rather than full payment would be made upon the acquisition of buffer stocks (e.g., the half-payment provision in the cocoa agreement); the extent to which a country's drawing rights under the IMF buffer stock scheme may have been reduced by prior drawings under the "compensatory financing" scheme in excess of 25 per cent of quota; and the extent to which disbursements lag behind commitments (the timing of the former depending on the precise state of the market, the latter becoming effective when the agreement enters into force).

Notwithstanding these uncertainties, the ^{World} Bank staff has attempted to

^{1/} Drawings under the buffer stock scheme which might be made while the member still had some automatic drawing rights available would eliminate the automatic rights.

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estimate the possible magnitude of calls for Bank assistance to supplement IMF financing; this has been done through a quantitative analysis^{1/} covering the 14 commodities identified by the UNCTAD Secretariat as candidates for international buffer stocks: coffee, cocoa, tea, sugar, pepper, lauric oils and seeds, rubber, jute and allied fibers, hard fibers, copper, tin,^{2/} lead, zinc and tungsten.

The analysis confirms that there would be, at best, an exceedingly modest residual role for the ^{would} Bank in financing capital contributions to international buffer stocks. Sixty-one of our developing country members export commodities for which an international buffer stock exists or may conceivably be established. When account is taken of the prospective increases in IMF quotas, those countries will have access to \$3.2 billion of drawings under the IMF buffer stock facility. This should, the study indicates, suffice to meet all, or nearly all, requirements over the period 1973-77. There are at most six countries, according to the study, which might require assistance supplementary to their IMF buffer stock tranches, and the largest amount by which their net cumulative disbursements might exceed their drawing rights

1/ The principal uncertainties underlying the analysis concern the probability of a buffer stock agreement being signed for each of the commodities by 1972; the most likely size of each buffer stock; and the probability distribution of disbursements expressed as a fraction of commitments. To safeguard against understatement, it was assumed that the recent commodity stabilization decisions of the IMF and the ^{would} Bank would encourage international commodity agreements involving buffer stocks.

2/ As noted earlier, an international buffer stock in tin already exists, but serious consideration has been given to increasing its size from 12 per cent of world exports to perhaps 18 per cent.

would be only around \$60 million over the 1973-77 period.^{1/} Given all the uncertainties involved, this figure should be taken as an indication of the order of magnitude of the maximum calls which might be made on the Bank, excluding the possibility that the Bank might refinance IMF drawings.

As for refinancing, the report of the IMF Directors on stabilization of prices, cited above, clearly contemplates that an IMF member may be allowed to make a new drawing for commodity financing, after having reconstituted the IMF facility by repurchasing. It also makes plain that new drawings cannot be taken for granted: the IMF will in each case determine whether a new drawing would be compatible with the intended short-term character of the buffer stock financing facility. If the IMF concluded that such new financing would not be desirable, it seems highly unlikely that the ^{would} Bank would be prepared to undertake it. But even if it were, net cumulative disbursements for refinancing over the 1973-77 period would be unlikely to exceed \$200 million, and would probably be of the order of \$100 million, and this on very optimistic assumptions as to the number of international buffer stock agreements likely to be concluded in the next five years.

In sum, a residual lending role for the ^{would} Bank, to supplement buffer stock drawings from the IMF, would imply, as a probable maximum, a call upon Bank resources of around \$60 million over the five years 1973-77, or an average of about \$12 million a year; the greater likelihood is that the amount involved would be even less or that there would be no call on the Bank at all. Even if

^{1/} This is predicated on the assumption that the full 50 per cent of IMF quotas would be available for buffer stock financing. Up to half this amount, however, would be unavailable if a country had had full prior access to its drawing rights under the IMF compensatory financing facility. Use of the latter has in fact been modest: current outstanding drawings are approximately \$200 million and have never exceeded \$300 million. If allowance is made for the possibility that half of the IMF buffer stock financing might be used up, a few additional countries might look to the Bank for financing. The additional amounts involved would, however, still be small.

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account is taken of the theoretical, although very unlikely, possibility that the World Bank would have occasion to refinance buffer stock drawings from the IMF, the net aggregate call upon the Bank would be very unlikely to exceed an average of \$50 million a year. The amount would in all probability be much smaller.

Conclusion

I have no difficulty in accepting the view of the Commission that the financing of buffer stocks in support of well-conceived commodity agreements is a legitimate object of external assistance. However, it also appears that (a) international buffer stocks have only a limited role to play in dealing with the commodity problem, the buffer stock arrangement for tin being the only one thus far negotiated; (b) insufficiency of finance is not one of the principal constraints upon the establishment of buffer stocks; and (c) the IMF is the ^{PRIMARY} ~~proper~~ ^{primary} and very likely a wholly adequate, source of such international financing as may be needed. In the circumstances, and given the divergence of views among the Executive Directors on the question of direct Bank Group financing of national contributions to buffer stock financing, I do not believe that there is any need at this time to consider whether we should go further than the decision taken

by the Executive Directors in their report to the Board of Governors on the commodity problem in July 1969. ^{1/ Should such a need develop in the future, I will recommend to the Executive Directors that the Bank act to meet it.} ~~Robert S. McNamara~~

1/ The World Bank Group should make every effort to provide long-term financial assistance where this is required to help member countries participate in suitable commodity arrangements, and it can effectively accomplish this purpose by taking account of the additional needs for long-term external borrowing due to participation in appropriate stock holding schemes when it considers its program of development loans and credits to a member country." This approach has the important advantage of harmonizing the developmental objectives of the Bank with its contribution to solution of the commodity stabilization problem.

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account is taken of the theoretical, although very unlikely, possibility that the ^{W-2}Bank would have occasion to refinance buffer stock drawings from the IMF, the net aggregate call upon the Bank would be very unlikely to exceed an average of \$50 million a year. The amount involved would in all probability be much smaller.

^{W-2} There remains the question whether, and if so to what extent, the Bank's Articles of Agreement permit the Bank to make loans to finance participation in buffer stock arrangements. The answer will have to depend on the facts of each particular case. The General Counsel has advised me that he finds it difficult to see how the Executive Directors could justify the financing of participation in buffer stock arrangements, taken by itself, as coming within the Bank's purposes any more than they could the financing of members' increases in IMF quotas or members' contributions to FAO. On the other hand, where, for example, a member country has a sound diversification program, linked with and dependent for its success on international commodity arrangements, including a buffer stock, the General Counsel believes that there is no reason why the support of the diversification scheme could not take the form of a loan to finance the country's participation in the buffer stock.

Conclusion

I have no difficulty in accepting the view of the Commission that the financing of buffer stocks in support of well-conceived commodity agreements is a legitimate object of external assistance. However, it appears that (a) international buffer stocks have only a limited role to play in dealing

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with the commodity problem, (b) insufficiency of finance is not one of the principal constraints upon the establishment of buffer stocks, and (c) the IMF is the proper, and very likely a wholly adequate, source of such international financing as may be needed. Any residual financial requirement would, in my judgment, be small. But should there be such a requirement, I see no reason why the ^{World} Bank should not meet it. Indeed, because of the importance which has been attached by the developing countries to the Bank's attitude towards buffer stock financing, I believe we should make clear that that attitude is affirmative. I therefore suggest that the June 1969 decision of the Executive Directors on stabilization of commodity prices be interpreted as indicating that the ^{World} Bank is prepared, although only as residual source of finance, to lend to member countries directly for the purpose of assisting them to participate in international buffer stock arrangements provided that (a) the ^{World} Bank, after consultation with the IMF, determines the arrangements to be sound, and (b) the circumstances are such as to satisfy the Articles of Agreement.

Robert S. McNamara

ROUTING SLIP		Date April 20, 1970	
NAME		ROOM NO.	
Mr. McNamara			
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			
<p>Attached is a draft of a memorandum analyzing the Pearson Commission recommendation on commodity prices. It has been cleared by Messrs. Friedman and Kamarck. It should, if possible, be distributed to the Executive Directors together with the memorandum analyzing the recommendation on buffer stocks.</p> <p>4/24 I agree that it has been reviewed by Burke. If so, release as indicated.</p>			
<p>From Richard H. Demuth</p> <p style="text-align: right;"><i>Open</i></p>			

I 11/5/26

Draft
April 17, 1970

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Pearson Commission Recommendation No. 1 Concerning Impact of
New Productive Capacity on World Market Prices

Recommendation

"... international agencies such as the World Bank should take into account in considering loans for agricultural projects not only the rates of return in the borrowing country, but also the impact of new production capacity on world market prices." 1/

Background

This recommendation appears in the context of the Commission's discussion of trade policy for primary products, particularly long-gestation crops such as coffee, cocoa and tea. The Commission comments, with respect to these commodities, that (a) demand and marketable supply are unresponsive to price changes in the short run; (b) production is subject to wide fluctuations; and (c) there have been both short-run price instability and serious price declines over the past 15 years. The Commission attributes these developments to high plantings during times of favorable prices and to the failure of producing countries as a whole to take into account the impact of their production plans on future prices.

The Commission felt that stable and remunerative prices for these commodities could be assured only by coordination of the production plans of all producing countries to bring supply into balance with demand. For this purpose, it recommended international schemes for individual commodities which would include: (a) provision for gradual expansion of the shares of new and efficient producers; (b) national production controls, preferably

1/ Report, page 83.

through imposition of special taxes; and (c) generous assistance for diversification programs. The Commission pointed out that for some commodities such planning is already in sight, but that it would be very difficult to achieve agreement on a global production plan for others. Nonetheless, it believed that both coordination of production and marketing and "associated measures" were necessary. It did not specify what the associated measures might be, beyond the action suggested for international agencies in the recommendation which is the subject of this memorandum.

Analysis

When the Bank calculates the rate of return on a commodity-producing project, it ~~always~~ takes into account the estimated impact on world market prices of planned new production, including the production which it contemplates financing. The price forecasts used in this calculation reflect judgments about the response of production to price changes in countries other than the one in which the particular project is located. ~~Our present practice, therefore, is consistent with the Commission's recommendation.~~

However, I believe that the Bank is likely to be financing commodity producing projects on a scale that makes it desirable for us to take a somewhat more sophisticated approach to the cost-benefit calculation applied to such projects. Normally we consider the implications of a prospective decline in the price of a commodity for the export earnings and national income only of the borrowing country, but not of other countries that produce and export the commodity. If, in the light of our best estimate of future price trends, a project in country A promises to yield a satisfactory rate of return, we have generally concluded that the project could appropriately be financed by the Bank Group. The only significant exception to this practice has been that, if an appropriate international commodity agreement exists, we will not finance a project that would lead to production for

export of amounts of the commodity in excess of the agreed quota for the country in question.

Up to now, Bank Group financing of commodity-producing projects has probably not been extensive enough to make a perceptible impact on world prices.^{1/} In view of the growth of Bank operations likely to affect commodity production, however, I believe that we should attempt, at least as an experiment, to produce somewhat broader assessments of probable future developments affecting key commodities, as a basis for deciding whether we should or should not finance particular commodity-producing projects. Demonstration that a project in country A, in the light of the best price forecast we can obtain, will yield a satisfactory rate of return to country A would still be an essential pre-condition for Bank Group financing of the project. But it is at least conceivable that a series of projects meeting this criterion in countries A, B, C and D would have measurable and serious adverse effects in other member countries with important stakes in the commodity in question. It is certainly not possible to devise an error-proof procedure for deciding whether potential gains in one country are equivalent to, greater than, or less than potential losses to another country or countries. The time scale within which evaluations are made, the difficulty of evaluating a monetary loss in a country with a very low per capita GNP as against a monetary gain in a country with a significantly higher per capita GNP or vice versa, and other technical problems mean that we shall frequently have to make judgments in cases in which none of the alternatives is unequivocally best.

^{1/} It should be noted, in this connection, that there is an inevitable margin of error in all price forecasts. Small changes in the output of a commodity cannot with any great confidence be credited with measurable price effects, as distinct from price changes consistent with the normal errors in price forecasts.

Nevertheless, I believe that, in view of the number of commodity-producing projects likely to come before us, we cannot escape the responsibility for making judgments in such cases, and that we should therefore institute studies, ~~as staff permits,~~ to provide us with a better foundation than we now have for making decisions on these projects. The studies I have in mind would have three stages:

(a) The first stage would be an analysis of the most likely developments in demand, production and prices for the commodity in the absence of any action by the Bank ~~beyond the financing of projects already in the pipeline, of any new commodity agreements, of any other international intervention in the market or of~~ ^{new} ~~and assuming~~ ^{and} ~~changes in the trade, tax or subsidy policies of~~ developed countries that would significantly affect the commodity. Particular attention would be given to the projection of production, generally the weakest element in commodity forecasts. This would require a review of production policies and investment plans, and an analysis of the response of production to prices. This step would ~~merely~~ call for an expansion and regularization of work on commodity projections already being carried out by Bank staff. In this work our staff does not start from scratch. Indeed, we draw as fully as possible on the commodity studies made by other organizations, notably the FAO and UNCTAD, and the forecasts of production, consumption, prices and exports that emerge from the periodic reviews made by the various commodity study groups and international commodity organizations, such as the International Coffee Organization, the Tin Council and the Sugar Council.

(b) The second stage would be to examine how these "most likely" developments could be affected by possible changes in any of the assumed conditions, particularly by changes in the Bank's plans for investments in commodity-producing projects. Simulation techniques can be very helpful at this stage. One object of this stage of the analysis would be to try to account for the

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effects of a given change in production of a commodity not only on the country in which the change takes place but on other producing countries.

(c) The third stage would be to attempt, in the light of the analytical work of stage two, to reach whatever findings prove possible as guidance for future Bank operations affecting the commodity, and as a foundation for such advice on investments in the production of the commodity as the Bank may be asked to give to member governments.

There may be cases in which the studies could provide clear guidance. ~~It might be evident that investment would be justified in any project yielding an acceptable rate of return. On the other hand, it might be clear that no future investments in production of the commodity could be justified, whatever the estimated rate of return on a particular project. In some cases, existing international commodity agreements would provide norms with respect to prices, or output, or both, which the Bank could safely regard as acceptable. Any project yielding a satisfactory rate of return that would not cause prices or quantities to move beyond the agreed parameters would then be acceptable.~~ In many, perhaps most, cases the conclusions of such studies would not be unequivocal, but even in those cases the studies would give us a better basis than we now have for making the judgments which have to be made implicitly in any case each time we pass on a commodity-producing project.

Conclusion

~~While~~ ^{but} the Bank's present policies with respect to loans for agricultural projects and assistance to diversification programs ^{go far to meet} ~~are in accord with~~ the Commission's recommendation, [^] I believe that we should try to go further. I propose that, to assist us both in considering Bank financing and in formulating policy advice, we carry out, on an experimental basis, appropriate studies,

along the lines outlined in this memorandum, for ^{certain} ~~a few~~ commodities that
are of major importance to our developing member countries.

Robert S. McNamara

OFFICE MEMORANDUM

7/11/5/25

TO: Mr. McNamara

DATE: April 9, 1970

FROM: Richard H. Demuth

SUBJECT: Pearson Recommendation No. 8 - Bank Assistance in Appraising
Terms of Export Credits

I attach a redraft of this memorandum designed to cover the points which you discussed with Mr. Hoffman. It also incorporates some suggestions of Raymond Cope.

4/24
Reviewed
as modified
Shen

DRAFT
April 9, 1970

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Pearson Commission Recommendation No. 8 Concerning Bank Assistance in Appraising the Terms of Export Credits

Recommendation

"The Commission urges international institutions such as the World Bank to give suitable technical assistance to developing countries in appraising the terms of export credits offered to them."1/

Background

In its discussion of export credits as one form of private foreign investment, the Commission points out the dangers stemming from their imprudent use, and addresses its principal recommendation in this context to the balance of payments problems created by the excessive accumulation of short-term credits.^{2/} The recommendation quoted above is made in the context of critical reference to the high cost often associated with export credit financing (high equipment prices or high interest rates) and to the doubtful economic justification of some of the projects undertaken with the help of such financing.

The Commission enumerates various factors which have led to imprudent use of export credits: pressure to invest despite insufficient local savings; investment decisions taken in the misleading context of distorted tariffs or exchange rates; reluctance of aid-givers, bilateral

1/ Report, page 121.

2/ See the memorandum analyzing Recommendation No. 11, concerning an "early warning" system (R70-56, dated April 6, 1970).

and multilateral, to finance industrial projects in the public sector; hesitancy to submit projects for consideration by international financing institutions, sometimes because the prospective borrower believed that excessive delays would be involved, more often because it feared that the project would not satisfy tests of economic soundness.

The Commission comments that it will take time to achieve the better economic policies, better project evaluation and greater availability of concessional finance which would provide "fundamental solutions" to the problems created by excessive use of export credits. It therefore briefly surveys "second-best" short-run measures to improve the terms on which export credits are available to the developing countries. These include avoidance of such credits where the only project feasibility study has been prepared by the supplier, and procurement after competitive bidding, either internationally or within countries offering buyers' credits. The Commission also calls attention to, and supports, joint financing, under which export credits are pooled with financing from multilateral sources, a technique which "combine s these credits with all the advantages of international competitive bidding." ^{1/} The recommendation analyzed in this memorandum then follows.

Analysis

The Commission characterizes as "the most unfortunate aspect" of export credit finance the fact that "it provides a temporarily painless way of financing projects conceived by over-optimistic civil servants, by politicians more

^{1/} See the memorandum analyzing Recommendation No. 16, concerning joint or parallel financing (R69-232, dated December 11, 1969).

concerned with immediate political advantage than with potential future economic problems, and by unscrupulous salesmen for the manufacturers of capital equipment in developed countries."^{1/} At the same time, the Commission recognizes that export credits "have a part to play in development" and that the **dangers** come from excessive or inappropriate use. The Commission has recommended the institution of an "early warning" system, based on the external debt reporting system being evolved by the World Bank and the Organization for Economic Co-operation and Development, as a means of helping to discourage the further extension of credits to countries in a difficult debt position. As indicated in another memorandum, I believe we can play a useful role in this respect.^{2/}

In addition to assisting developing countries to avoid excessive commitments for export credits in general, there are some things the World Bank can do, ~~and is to some extent doing,~~ to help borrowers to get better terms on credits for particular projects, and to avoid incurring debts on unsuitable terms or for poorly designed projects. Our most effective contribution in this area can be made in the stages of project selection and preparation, and of procurement arrangements, where the World Bank can bring to bear a fund of experience not duplicated elsewhere. ^{Many} ~~Most~~ of the problems with **export credits** which the Commission was concerned in connection with/do not arise when project selection and preparation are effectively carried out and appropriate procurement practices are followed.

The financial terms of export credits are usually not difficult to understand or to compare. The real problem lies in identifying the credit costs which are concealed in the prices of the equipment being financed.

^{1/} Report, page 120.

^{2/} See the memorandum analyzing Pearson Commission Recommendation No. 11 (R70-56, dated April 6, 1970).

It is never easy, and usually impossible, to identify this concealed cost, as that would require ascertaining what the cost would have been on a cash basis. The best way of meeting this problem is to point out by example and precept, as the World Bank does, the merit of procurement by international competition. While this does not reveal the concealed cost of financing, it does usually insure that the borrower gets the best terms available for the equipment and the financing taken together.

The World Bank can also help to mitigate the problem of inappropriate use of export credits by assisting its developing member countries in the proper selection and preparation of their investment projects. We ~~are now~~ *have begun to* emphasizing assistance in the formulation of sectoral investment strategies, which help to identify project priorities. This kind of assistance, in the provision of which we are cooperating with the UNDP and the other specialized agencies, may be expected to increase significantly as our lending rises and broadens its scope. These efforts should lead to more and better projects, including projects to be financed from sources other than the Bank Group. They should also help to build up or to strengthen, particularly in the less experienced countries, project-oriented planning units capable of screening commercially sponsored projects more effectively and of ensuring procurement and financing arrangements along the lines endorsed by the Commission. ~~The project evaluation courses of our Economic Development Institute are also helping to produce the relevant expertise in developing countries.~~

Similarly, the technical assistance we provide in the form of advice on the structure and capability of organizations such as power, telecommunications and railway authorities and development finance companies will help to develop a capacity within the developing countries for making better use of export credits. Some of the beneficiaries of our financing have, with our encouragement, obtained export credit financing on satisfactory terms for items of

equipment particularly suitable for such financing, for example, power-generating plants or rolling stock, after seeking offers on both a cash and credit basis from a number of manufacturers. And in the joint and parallel financing operations in which the Bank has participated involving export credits, the recipient countries have benefitted from the advantages of wide international competitive bidding. As noted in my memorandum analyzing the Commission's recommendation on joint ~~or~~ parallel financing, the staff has been instructed to examine every project with a heavy external financing requirement to see whether it has possibilities for joint financing. ^{1/} Aid coordinating groups provide another channel through which progress may be made in improving the terms on which external finance, including export credits, is made available to the developing countries.

~~Export credits will, however, continue to be offered by suppliers of capital equipment to governments or public agencies in developing countries, for projects with which the World Bank has had no connection and which may not meet reasonable project standards. Credits will also continue to be offered on terms that are clearly inappropriate from the point of view of the borrowing country's debt position. If the World Bank has not been involved at earlier stages in the process of project formulation, there is very little that we could do, even if asked, at the stage at which the prospective buyer must decide whether or not to accept a particular credit as offered. At this stage alternative choices of projects, suppliers, and sources of finance are usually not available, and political pressures often make it impossible to delay decisions long enough to reconsider proposals.~~

Conclusion

The Commission has identified the serious consequences for developing countries of an injudicious and excessive reliance on export credits. I believe that the Bank's efforts to deal with the problem should be addressed

^{1/} R69-232, dated December 11, 1969.

can assist developing countries in avoiding such penalties
Can assist developing countries in avoiding such penalties

~~to a stage of the investment process earlier than the point of appraisal of credit terms which the Commission has suggested: they should be directed~~ *In particular, the Bank can*
~~principally to helping~~ the developing countries to improve the quality of projects which might be financed with export credits and to adopt appropriate procurement practices in connection with such projects. This will be one of the consequences of our stepped-up lending, the increased emphasis on assistance in project identification and preparation, and our efforts to help member countries to build or strengthen their development institutions. While these activities relate to what the Commission has described as "fundamental solutions", they should also contribute significantly in the short run to an improvement in the terms of export credits extended to developing countries.

Robert S. McNamara

DRAFT

February 13, 1970

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Pearson Commission Recommendation No. 8 Concerning Bank Assistance in Appraising the Terms of Export Credits

Recommendation

"The Commission . . . urges international institutions such as the World Bank to give suitable technical assistance to developing countries in appraising the terms of export credits offered to them."^{1/}

Background

In its discussion of export credits as one form of private foreign investment, the Commission points out the dangers stemming from their imprudent use, and addresses its principal recommendation in this context to the balance of payments problems created by the excessive accumulation of short-term credits.^{2/} The recommendation quoted above is ~~put forward~~ ^{made} in the context of critical reference to the high cost often associated with export credit financing (high equipment prices or high interest rates) and to the doubtful economic justification of some of the projects undertaken with the help of such financing.

The Commission enumerates various factors which have led to imprudent use of export credits: pressure to invest despite insufficient local savings; investment decisions taken in the misleading context of distorted tariffs or exchange rates; reluctance of aid-givers, bilateral

^{1/} Report, page 121.

^{2/} See the memorandum analyzing Recommendation No. 11, concerning an "early warning" system.

3/49
Dick
Hunt!
discusses
with me
R.H.P.
I have been
there.

March 26, 1970

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concerned with immediate political advantage than with potential future economic problems, and by unscrupulous salesmen for the manufacturers of capital equipment in developed countries". ^{1/} At the same time, the Commission recognizes that export credits "have a part to play in development" and that the dangers come from excessive or inappropriate use. The Commission has recommended the institution of an "early warning" system, based on the external debt reporting system being evolved by the ^{World} Bank and the Organisation for Economic Co-operation and Development, as a means of helping to discourage the further extension of credits to countries in a difficult debt position. ^(Reiterated in another memorandum, 2/) But *Dick, Shih, we can do as a matter of fact, bring something, Zero. Please mention.*

rewrite

~~I see little opportunity for a useful Bank contribution in the suggestion which is the subject of this memorandum, that we should help developing countries to appraise the terms of export credits offered to them. At this stage, when the prospective buyer must decide whether or not to accept a credit, alternative choices of projects, suppliers and financing are usually not available, and political pressures preclude opportunity or time to reconsider the proposal. In these circumstances, the Bank would have little scope for advice and little leverage.~~

This is not at all to say that we can do nothing to help developing countries make better use of the export credit facilities available to them. It ^(2. addition) is rather that I believe we can make a much more effective contribution by attacking the problem at the real point of difficulty, the project selection and preparation stage, and in ways which, because they are more closely related to our own lending operations, would make better use of Bank staff.

1/ Report, page 120.

2/ See the memorandum analyzing Pearson Commission Recommendation No. 11, (See Annex - dated April 1970).

March 2, 1970

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We are now emphasizing assistance to the developing countries in the formulation of sectoral investment strategies and on project identification and preparation work, in all of which we have the cooperation of the United Nations Development Programme and of ^{the} other specialized agencies. This kind of assistance will increase significantly as our lending rises and broadens its scope, particularly in the fields of industry and tourism. These efforts should lead to more and better projects, including projects to be financed from sources other than the Bank Group. They should also help to build up or to strengthen, particularly in the less experienced countries, project-oriented planning units capable of screening commercially sponsored projects more effectively and of ensuring procurement and financing arrangements along the lines endorsed by the Commission. The project evaluation courses of our Economic Development Institute are also helping to produce the relevant expertise in developing countries.

Similarly, the technical assistance we provide in the form of advice on the structure and capability of organizations such as power, telecommunications and railway authorities and development finance companies will help to develop a capacity within the developing countries for making better use of export credits. Some of the beneficiaries of our financing have, with our encouragement, obtained export credit financing on satisfactory terms for items of equipment particularly suitable for such financing, for example, power-generating plants or rolling stock, after seeking offers on both a cash and credit basis from a number of manufacturers. And in the joint and parallel financing operations in which the Bank has participated involving export credits, the recipient countries have benefitted from the advantages of wide international competitive

March 2, 1970

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bidding. As noted in my memorandum analyzing the Commission's recommendation on joint and parallel financing, the staff has been instructed to examine every project with a heavy external financing requirement to see whether it has possibilities for joint financing.^{1/} Aid coordinating groups provide another channel through which progress may be made in improving the terms on which external finance, including export credits, is made available to the developing countries.

→ Conclusion

The Commission has identified the serious consequences for developing countries of an injudicious and excessive reliance on export credits. I believe that the Bank's efforts to deal with the problem should be addressed to a stage of the investment process earlier than the point of appraisal of credit terms which the Commission has suggested: they should be directed principally to helping the developing countries to improve the quality of projects which ~~may~~^{might} be financed with export credits and to adopt appropriate procurement practices in connection with such projects. This will be one of the consequences of our stepped-up lending, the increased emphasis on assistance in project identification and preparation, and the institution-building aspects of our preinvestment assistance. While these activities relate to what the Commission has described as "fundamental solutions," they should also contribute significantly in the short run to an improvement in the terms of export credits extended to developing countries.

Robert S. McNamara

^{1/} R69-232, dated December 11, 1969.

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Recommendation No. 11 Concerning an "Early Warning System"

Recommendation

"In regard to the possible excessive use of export credits, a strong 'early warning system' based on external debt reporting should be evolved by the OECD and the World Bank."1/

Background

The Commission reviewed the problems arising from the growing volume of export credits extended to developing countries. It noted that these credits are often easy to negotiate and that commitments are frequently entered into without adequate scrutiny by any responsible agency in either the borrowing or the lending country of the price of the goods financed or of the purposes for which the goods are to be used. The Commission recognized that short and medium-term export credits have a part to play in meeting the needs of developing countries for external finance. It concluded, however, that imprudent use of such credits is a present danger.2/

The report suggests that the World Bank fix ceilings on export credits to countries which are "in the danger zone from the standpoint of debt liabilities and interest burden", and that credits beyond the ceilings should be given "significantly less favorable treatment than other claims" in any debt rescheduling.3/

1/ Report, page 123.

2/ Report, page 16.

3/ Report, pages 121-2.

This suggestion was not incorporated in the formal recommendation quoted above. We are informed by members of the Commission's staff that this is because the Commission recognized that it would be unrealistic to expect that the World Bank could establish a ceiling, determine precisely which credits exceeded the ceiling, and arrange that these credits be given relatively unfavorable treatment in any debt reschedulings. The Commission clearly hoped, however, that the World Bank would formulate and, where appropriate, express views, on the volume and terms of financial flows to countries that have a serious debt problem. The report also proposes that the World Bank be given responsibility for "issuing definitive recommendations against further encouragement of export credits to countries which are in the danger zone."^{1/}

The Commission was aware that the International Monetary Fund already performs some of the proposed functions - for example, it frequently recommends ceilings on certain types of credit for countries seeking IMF stand-by arrangements. We have been informed that there had been a reference to the IMF, as well as to the Bank, in an earlier text of the recommendation, but that it had been inadvertently omitted from the final version.

Analysis

I welcome the Commission's warning against excessive reliance on export credits. I agree that the World Bank can, and should, play a role in helping to avert debt crises.

^{1/} Report, page 121.

As the Commission notes, "Fundamentally, the task of preventing the excessive use of export credits for projects of low priority must be that of the individual developing country."^{1/} There are, however, a number of things which the Bank can and, I believe, should do to assist those developing countries determined to prevent their debt problems from reaching an acute stage:

First, we can help member governments to improve their debt management and reporting systems; we are in fact ^{beginning to do} ~~doing~~ this through special missions in some cases and through country economic missions in others.

Second, we can continue our efforts to improve the scope and quality of our information on long-term debt, from both the creditor and debtor sides. Missions, both the special missions referred to above and country economic missions, are one vehicle for improving the collection and quality of data from the debtor countries. We also exchange information with the regional banks. The joint system for collecting data on long-term loans from the creditor governments, agreed a few years ago between the Bank and the OECD, is beginning to be productive. And we are working with the IMF in trying to obtain better statistics on short-term debt.

Third, because lack of information and divided counsel can contribute to delay in a debtor country's decision to deal with an impending debt crisis, we can, in cooperation with the IMF, help to assure that appropriate officials in borrowing countries are informed, fully and in good time, when a debt crisis appears

^{1/} Report, page 121.

April 1, 1970

to be looming. Finally, at the invitation of the borrowing country and its creditors, the Bank and the IMF can help to formulate a corrective program.

The last two steps would respond directly to the Commission's recommendation. The first two are necessary pre-conditions. The annex to this memorandum describes the analytical work on debt being ^{initiated} ~~undertaken~~ by the Bank in cooperation with the IMF. It should be increasingly possible for the two institutions to identify debt problems before the dangerous surges in export credits take place, and before service payments are delayed, and to warn the debtor. Such warnings must, of course, be given in strict confidence. A public warning of impending debt difficulty can become a self-fulfilling prophecy.

Creditor countries, on the other hand, do not appear to expect or to need warnings of impending debt crises from the World Bank to supplement those which they receive from other sources. The Berne Union of export credit insurance agencies already provides a kind of early warning through its work in identifying sharp increases, or "surges", in the use of export credits. Members of the Union exchange information on outstanding credits at regular meetings. They also compare information on terms and conditions for different borrowers and evaluate other economic variables in countries which have greatly increased their use of export credits.

There are good reasons why a surge in the flow of export credits is a useful (although not a certain) indicator of debt difficulties. The pressures of sales competition often assure the continued availability of export credits, even at times of obvious financial crisis in borrowing countries. Governments of countries which are the principal sources of export credits often have little control over the more or less autonomous institutions which actually grant or guarantee export credits. Export credits can thus usually be obtained more quickly and more easily than loans by government agencies concerned with foreign aid, which are

normally extended only after a careful look at the prospective borrower's ability to repay. Commercial bank credit is also very sensitive to changes in the market evaluation of a country's creditworthiness. Thus, with other sources of credit unavailable, a country whose shortage of foreign exchange is becoming acute is likely to resort to export credit financing for imports of equipment and other goods, especially for projects under way; a surge of export credits to that country is often the result, and it may occur before delays in service payments give a more definite sign of financial difficulty. This whole range of problems is ^{being} ~~regularly~~ reviewed by the Development Assistance Committee of the OECD. This ~~regular~~ exchange of information and views among governments of countries which provide export credits to developing countries can help them to identify difficult debt situations and plan timely remedial action.

There have been several attempts to bring about organized international cooperation by creditor countries to establish mechanisms or agreements on principles for dealing with problem debt cases.^{1/} These efforts have been largely unsuccessful. Instead of undertaking joint efforts, individual Berne Union members have generally adopted their own restrictive measures, e.g., raising premium rates and reducing the proportion of insurance coverage on export credit transactions with the debtor country concerned. The normal "float" of short-term bank credit is likely to be reduced at the same time. But while these measures help to limit the exposure of the financing and insuring agencies, they do not prevent the occurrence of a debt crisis and indeed may even provoke one.

^{1/} See a recent IMF study, prepared at the request of the U.N. Conference on Trade and Development (UNCTAD), "The Use of Commercial Credits by Developing Countries for Financing Imports of Capital Goods," SM/69/203, December 31, 1969, page 57 et seq. See also a study by the staff of the Bank, also prepared at the request of UNCTAD, "Suppliers' Credits from Industrialized to Developing Countries," Revised edition, April 3, 1967, pp. 8-10.

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I welcome the Commission's warning against excessive reliance on export credits. And I agree that the World Bank can, and should, play a role in helping to avert debt crises.

Once a debt problem is identified, the Bank and the IMF, if the interested parties so desire, could assist in working out a corrective program, indicating both the financial measures to be taken by the debtor and targets for the mix of financial flows to be sought from creditors (e.g., a recommended upper limit to flows on conventional terms and a recommended minimum for flows on concessional terms). The Bank and the IMF are in fact already separately engaged in helping to formulate elements of corrective programs. Under its standby arrangements the IMF has frequently worked out with a prospective borrower a plan to limit external borrowings to a level consistent with progress toward a solution of that country's debt problem. Similarly, the Bank has on occasion, usually in the framework of a consortium or consultative group, suggested the amount and the terms of external financial flows which would be appropriate to the recipient country's financial situation. I believe that the two institutions could usefully combine their efforts, where appropriate, to deal with developing debt crises. The Managing Director of the IMF shares this view.

Conclusion

I welcome the Commission's warning against excessive reliance on short credits. And agree that the World Bank can, and
 I believe ~~that~~ ^{ADT} the Bank can play a useful role in providing information, with due regard to confidentiality, to individual developing country members in the early stages of an impending debt crisis. We shall, accordingly, ~~continue to~~ work with the IMF to improve the timeliness of warning signals which can be given to those members with respect to the accumulation of external debt, particularly in the form of export credits. Our projections of the debt service ratio and use of other analytical techniques, together with the steadily improving financial information available to us and to the IMF, should provide a basis for estimating the likelihood that a debt crisis will develop. *Further working together,* Together, the two institutions should be able, ~~when invited to do so,~~ to help in the formulation of the two principal components of a corrective program: financial plans for the debtor and aid plans for the creditors. *It* We shall ~~also continue to~~ keep in close touch with the Development Assistance Committee of the OECD, which is very much concerned with the problems discussed in this memorandum. *Should play a role in helping to avert debt crises.*

ANNEX

The analytical work done by the Bank staff suggests that one of the most significant indicators of the growth of a debt problem at an early stage is the debt service ratio of the country concerned. Attached is a table which gives summary information on 24 debt reschedulings arranged for 11 developing countries between 1965 and 1969; it compares the debt service ratios of the latter with those of 35 other developing countries for which data are readily available.

The debt service ratios in the year in which a rescheduling occurred and in the following year presumably reflect approximately the consensus among creditors as to what the debtor could reasonably be expected to pay. The ratios in those years averaged about 17 percent, ranging from around 24 percent in the upper quartile to about 9 percent in the lower.* The average of 17 percent for cases of rescheduling may be compared with a 7 percent average for countries which did not reschedule in the period. Out of ten countries with an average debt service ratio higher than 15 percent during the period, eight had reschedulings. While the data are not conclusive, they suggest that the risk of debt crisis is relatively high for a country with an average debt service ratio in the general range of 15 percent and above.

It should be noted, on the other hand, that much lower debt service ratios have been associated with several reschedulings. It may be concluded that there are limitations on the usefulness of the data on debt service ratios as indicators of the burden of debt. One of the limitations is that the debt

* These statistics do not take into account the rescheduling in Ghana in 1966; see footnote f/to the table.

service ratio is normally defined to exclude short-term debt of maturity below one year as well as unguaranteed private debt; these types of debt can contribute significantly to a crisis. A second limitation is that it may not be the most appropriate index for countries which are members of a larger currency area; in such cases the pressure of debt service on the government budget alone may be the critical problem, rather than any shortage of foreign exchange for the economy as a whole. A third limitation is that a number of circumstances may affect the ability of a country to service its debt, e.g., the level of its reserves (including access to IMF resources), the availability of new capital, the rate of growth of GNP, the degree of fluctuation of exports, and the ability to restrict imports. Different combinations of such factors have been and are being tested for their predictive value by Bank staff, by the Development Assistance Committee of the ^{OECD} ~~Organisation for Economic Co-operation and Development~~, and by other bodies. Variants of the debt service ratio are also being tested, taking account, for example, of the level of debt outstanding and of the proportion of debt attributable to export credits.

The quality and completeness of the debt statistics affect our ability to analyze debt situations. We are working closely with OECD in an attempt to improve statistics on medium and long-term debt. Extension of our information on the short-term end of the maturity spectrum could be particularly valuable. Through various channels we have already received some information on this, and we are now consulting with the IMF on ways of amplifying and systematizing it.

In addition to examining the historical record of debt service ratios, the staff is undertaking long-range forecasts of these ratios and other

economic variables, as an aspect of our regular creditworthiness analyses. This forecasting, like the warnings to debtor countries, must of course be conducted in confidence. The earlier years of the long-range projections can be particularly useful for the purposes of "early warning". After these projections are considered in conjunction with the country-by-country analyses which the Bank and the IMF prepare, it should be possible to arrive at a reasonable estimate of the likelihood of a debt crisis for each developing member country.