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Friedman UNCTAD Files - New York Meeting on Suppl. Finance Feb. 1966

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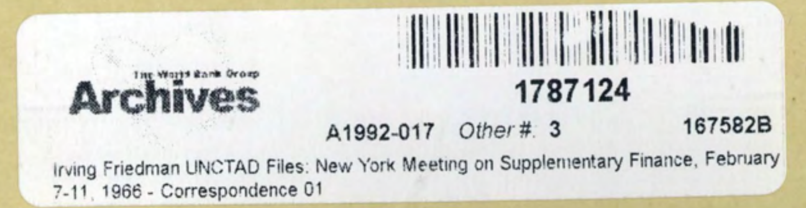

Files                                                                February 15, 1966

Arthur Karasz

UNCTAD BOARD - NEW YORK February 7 - 11 1966

I. The Bank's Study on Supplementary Financing

1. Mr. Friedman's statement was planned for the afternoon of February 7. In the morning of that same day Prebisch talked to me about the Bank Study. He is most satisfied with its contents and will make it the central subject of the second UNCTAD Conference. There is just one detail that worries him a little: does the study not put too much emphasis on the "control aspect" of the scheme? Should not it be a generally accepted fact that the Bank does not give balance of payments assistance, i.e. that all Bank loans are related to projects and the Bank controls *ipso facto*, the development plans of its customers. Therefore, why does the study put so much emphasis on control, as if that were a new idea? (Prebisch was evidently under pressure of some LDC delegates.)

2. However, after having heard Mr. Friedman's statement Prebisch withdrew his criticism. He expects a full study of the Bank paper and reiterates the hope that Supplementary Financing will be the main subject of UNCTAD II.

3. Observations by Delegations.

Some twenty delegations made general observations on the Bank Study. They welcome it and will go into details at a later date.

The following observations were more substantive:

a) Pakistan: It appears from the text of the Bank Study that the terms of the Bank financing would vary according to the financial strength of the individual LDC.

In Pakistan's opinion such terms should always be concessional.

b) Chile: UNCTAD's Resolutions A.IV.17 (on IMF Compensatory Financing) and A IV 18 (U.K's Proposal) should complete each other. This means that the new studies of IMF on compensatory financing should be completed urgently and the new activities of Fund and Bank should be co-ordinated. (In short, Chile would like to establish a link between the two Resolutions and force the IMF to become more flexible.)

Chile/...

Chile has the feeling that the Study puts too much emphasis on the control of development planning. Agreement on global policy will be a pre-requisite to financing and this is a little too strongly underlined in the Study.

Chile agrees with Pakistan on the need for soft terms. According to the text of Resolution A. IV. 18 the scheme should be administered on IDA conditions only.

c) India welcomes the Bank Study. Their only observation is that its field is too narrow. They hope that means will be found to finance all categories of short-falls, not only those discussed in the Bank Study.

d) Ceylon agrees with India on this last point.

e) Philippines and Nigeria: the Study stresses the behaviour of LDC's only; why not that of the donors?

f) France did not speak on the U.K's Proposal. However, it is well known that they continue to be opposed to the Scheme and will submit a counter-proposal, probably at the forthcoming meeting of the Committee on Invisibles ( to start on April 4). The French will propose three ideas:

i) A more co-ordinated sharing of the aid burden (1% of GNP)

ii) Higher prices to primary products and preferences to manufactures (organisation of the market)

iii) Simultaneous measures on all fields (economic, fiscal and monetary policies).

g) The U.S. did not speak on the subject either. I am told that, in the present opinion of the U.S. the replenishment of IDA has priority over the U.K's Proposal.

h) In private conversations, a number of LDC's voiced their feeling that the Scheme contains a too elaborate system of controls and efforts to take care of a relatively limited field. They are wondering whether such effort is worthwhile and will eliminate more than just one part of the uncertainties?

However, all delegations emphasised that their remarks were not meant to be a criticism of the Scheme. All wanted us to know how much they appreciate the work done by the Bank.

i) At a private meeting held in the evening of February 7 Everts discussed some details with Mr. Friedman and myself about the forthcoming meeting of the Committee on Invisibles. Everts is hopeful that the meeting will not discuss politics but will be held on an "expert level" (representatives of the Ministries of Finance).

Sidney Dell will be requested to prepare a substantive questionnaire of subjects that might come up during the April meeting and discuss it with the Bank beforehand.

In Mr. Friedman's opinion the Study is from now on in the hands of the Governments and it will be up to them to take their decisions. The only role the Bank can play is to give technical information.

II. Multilateral Investment Guarantees

The Bank's Study was mentioned by the delegates of Turkey and the Netherlands.

The Board seems to be satisfied with the Bank's Interim Report made last September and circulated last week by the Secretariat of UNCTAD.

III. Horowitz Report

The new Expert Group "on Alternatives and Variants of the Proposal" will soon be appointed. Members will probably be chosen from among bankers and other "practical economists".

I told the Secretariat and the U.S. delegation that we would not be able to assist the Group's meetings on a full time basis. If they need technical information we shall try to give it on an ad hoc basis.

IV. Bank's New Activities

The U.K. and the Netherlands welcomed the Bank's increased activity in Consultative Groups and also in the field of Education.

FORM No. 57 | INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

# OFFICE MEMORANDUM

TO: Mr. Irving S. Friedman  DATE: February 14, 1966

FROM: Paulo H. Pereira Lira ppl

SUBJECT: Remarks on the IBRD Study on Supplementary Financial Measures delivered at UNCTAD - Suggestion for redrafting.

1. Beginning on the 10th line of page 4, one reads: "Less developed countries, however, are usually not greatly endowed with foreign assets or reserves upon which they can draw for such purposes. In any case, such resources are depleted in rather a short time since the external position of such countries does not usually produce enduring surpluses necessary to replenish such resources."

2. These sentences seem to refer to exceptional situations which may contribute to the emergence of balance of payments surpluses, such as impossibility to import during war periods, unexpected rise in prices of export goods or sudden appearance of new sources of foreign exchange.

3. If this is so, and with the purpose of avoiding misunderstandings about the intended role of reserves in the process of development, they might be redrafted as follows: "Less developed countries, however, are usually not greatly endowed with foreign assets or exceptional reserves upon which they can draw for such purposes. In any case, such resources are depleted in rather a short time and the particular circumstances which lead to the accumulation cannot be counted upon to repeat themselves."

Seen - ISF

FORM No. 58 INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

# OFFICE MEMORANDUM

TO: Mr. Owen

DATE: February 14, 1966

FROM: Irving S. Friedman

SUBJECT: Statement to UNCTAD Board

Would you please arrange with the Secretary's Department to circulate copies of my remarks made to the UNCTAD Board on February 7 to the Executive Directors for information.

ISF

N A used

Form No. 89
(9-62)

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL FINANCE CORPORATION

# ROUTING SLIP

Date: Feb. 9, 1966

OFFICE OF THE PRESIDENT

| Name | Room No. |
|---|---|
| Mr. Woods 2/10 | |
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|---|---|---|---|
| | Action | | Note and File |
| | Approval | | Note and Return |
| | Comment | | Prepare Reply |
| | Full Report | | Previous Papers |
| | Information | | Recommendation |
| | Initial | | Signature |

Remarks

Do you think it might be useful to distribute this to the Board for information?

Yes - when it is available as a UNCTAD document.

Irving S. Friedman

From

I am trying to cut down on Bank documents of this type [illegible] 2/10

**HOLD FOR RELEASE**

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

1818 H STREET, N.W., WASHINGTON D. C. 20433 TELEPHONE: EXECUTIVE 3-6360

Bank Press Release No. 65/62
For Release A.M. Newspapers
Thursday, December 9, 1965

Subject: Staff Study on Supplementary Financing requested by UNCTAD

Mr. George D. Woods, President of the International Bank for Reconstruction and Development (IBRD), has transmitted to Secretary-General U Thant of the United Nations a staff Study on supplementary financial measures to prevent the disruption of development programs in less developed countries resulting from unpredictable shortfalls in their export earnings.

The Study was undertaken by the staff of the Bank in response to a resolution adopted by the United Nations Conference on Trade and Development (UNCTAD) which met in Geneva in March-June 1964. The resolution was originally sponsored by the United Kingdom and Sweden; it was adopted by a vote of 106 to none with 10 abstentions. The Study does not purport to reflect the views of the Bank's Executive Directors or of the countries they represent.

Under the resolution the Bank was requested:

1. To study the feasibility of a scheme which might shield the development programs of less developed countries from disruption when their export earnings suffer unexpected shortfalls from reasonable expectations "of a nature or duration which cannot adequately be dealt with by short-term balance of payments support"; and

2. " ... if appropriate, to work out such a scheme."

As a basis for judging the seriousness of the problem as well as for evolving a feasible scheme, it was necessary to have a sound and workable definition of

"reasonable expectations" of export earnings. For this purpose the Study drew on the Bank's own experience in forecasting exports in connection with its regular lending operations. Export projections covering a number of years have proven to be a necessary part of judging what foreign exchange income will be available to finance a country's external financial needs arising out of expected private and public investments. The Study confirms that the problem to which the UNCTAD resolution was addressed is a major one for the less developed countries. Many of them rely principally upon exports of primary agricultural or mineral products for the foreign exchange their development programs require. Prices for such products are subject to wide and sometimes sudden fluctuations or to unpredictable changes in long-term trends that are often beyond the control of individual exporting countries. Adverse movements in export proceeds sufficient to disrupt development programs are at times so severe and protracted that they cannot be dealt with by short-term balance of payments support.

Having determined the potential significance of the problem, the Study deals with ways and means of coping with it. To accomplish the Scheme's objectives, it would be necessary that it operate with certainty and speed when and if an unexpected export shortfall occurred, but also that assistance be given only to countries whose performance with respect to development policies gave assurance that the assistance extended would be used for the intended purposes. Moreover, the Scheme would not be expected to provide financial assistance when domestic adjustment measures could be taken without disrupting the development program or when other financial resources were available as, for instance, foreign exchange reserves or compensatory financing from the International Monetary Fund (IMF). However, the Scheme would give confidence to developing countries pursuing agreed development policies that their progress in increasing output and productivity

would not be halted or significantly retarded by unexpected export shortfalls from an agreed projection of export earnings.

It is envisaged that the Scheme would initially operate on a scale averaging $300 million to $400 million per year and that the administering Agency would receive commitments for a five-year period; a small portion would be in cash and the balance in promissory notes which could be cashed without delay if necessary.

The Scheme provides that any excess in export earnings above the agreed projection would be used as a primary means of offsetting shortfalls during the projection period.

The UNCTAD resolution specified that the Agency would be the International Development Association, but this question was not considered as a part of the Study; the question of administration, it was felt, should be examined after governments had considered the Scheme itself.

The operative key to the Scheme is a provision for the working out of an understanding in advance between the Agency and each developing member country, incorporating a projection of "reasonable expectations" of export earnings over a given period of perhaps five years and a "policy package" which the country would agree to carry out in order to be eligible for assistance in the event of shortfalls below the projected export earnings. The export forecast would be worked out in the context of an understanding on the country's over-all development program, of which it would be considered an integral part. It would be subject to revision only as part of a total recasting of the program. The understanding would include the ways and means by which an unexpected shortfall in export earnings would be met, guided by the principle of avoiding the disruption of progress in development achieved by the pursuit of previously agreed policies.

In arriving at such an understanding, the Agency charged with administration of the Scheme would draw upon the experience of the IBRD and would work in close association with the Bank, the IMF, other development institutions and the various consortia and consultative groups concerned with aid to individual countries.

Implementation of the agreed policies would be kept under constant review by the Agency, both directly through relations with the countries concerned and through the exchange of information with other institutions. In advance of any shortfalls, a member country would be informed if it could no longer be certain of assistance because of failure to adhere to agreed policies. If it had not been so advised, it would be assured of prompt assistance in case of a shortfall from the agreed projection of export earnings. Assistance would be on terms similar to those governing the extension of normal development finance to the country concerned.

If successful, the Study concludes, the proposed Scheme should accomplish two important results: "Countries prepared to meet the Scheme's criteria would have assurance that their development efforts would not be frustrated by unexpected shortfalls due to forces beyond their control. And a new relationship would have been established between individual developing countries and the international community through which the incentives and prospects for effective internal development performance would be greatly strengthened."

DRAFT
June 30, 1966

SHORTFALLS AND "OVERAGES" IN THE SUPPLEMENTARY FINANCE SCHEME

## A. INTRODUCTION

1. An essential feature of the Supplementary Finance Scheme is the understanding between the Agency and the country on an export projection for a period of time which is the same as that of the country's development plan.

2. The export projection indicates the yearly amounts of foreign exchange which the country is expected to earn out of the use of its own production. Together with the expected gross inflow of foreign capital - on short, medium and long-term basis - as well as possible use of reserves (if advisable) they would provide the means to: (a) meet the payment of foreign goods and services (excluding service on capital inflow) which are needed to carry the development program and the projected level of consumption expenditures, and (b) meet the servicing (on capital and income account, both for loan and equity foreign capital), which falls in the current projection period, not only of the foreign capital inflow which occurred prior to it but also of the foreign capital inflow which is expected to finance expenditures during the same projection period.

3. Agreement on above between the country and the Agency would reflect the understanding as to the financial viability of the development plan, both from the point of view of internal and external resources, or in other words, from the point of view of availability of domestic savings and of foreign exchange. The specific objective of the Scheme is 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 export shortfall - actual exports proceeds placing themselves below the projected amounts. The Scheme satisfies a developmental need. It is analogous to an insurance fund for protecting development programs whose financing

is jeopardised by a particular unforeseen and unavoidable circumstance - the lack of expected foreign exchange proceeds.

## B. ADJUSTMENTS IN SHORTFALLS AND "OVERAGES"

4. When an export shortfall takes place, this means that the income of the export sector is correspondingly lower. This will affect its comsumption and investment expenditures. Government receipts will also be reduced. Depending on the kind of compensation policies which the country adopts, there may be room to absorb part of the lack of expected foreign exchange through a reduction in consumption expenditures, without having to interfere with the carrying out of the development program. This permissible reduction in consumption may include deliberate attempts to restrict consumption of "non'essential" items over and above the automatic adjustment which would result from the income adjustments. Besides taking care of the shortfall through this procedure which involves an actual reduction in foreign exchange expenditures - in relation of that which otherwise would take place if the shortfall had not materialized - there are other ways of meeting the shortfall which avoid the need to immediately reduce the planned foreign exchange expenditures: use of the countries own reserves and acquisition of new indebtedness - either from the Supplementary Finance Agency or from other sources such as the IMF or other bilateral sources.Whether the use of the country's reserve or an increase in the indebtedness to "other sources of finance" - besides the Scheme - will be contemplated in the understanding between the country and the Agency depends on the particular situation of the country. For purposes of exposition, it has been assumed in this note that the country would be in a position to make use of the two possibilities mentioned above.

5. The loans that would be received from the Agency during the projection period are subject to partial or total liquidation, during the same period, depending on the behavior of the "overages" - the excess of actual over expected export proceeds - as will be described later. The outstanding amount of loans from the Supplementary Finance Agency at the end of the projection period would then be converted into a final long-term loan.

6. The Scheme presupposes that it will be possible for an understanding to be reached between the Agency and the country on the specific ways in which a shortfall would be met. The feasibility of this understanding depends, among other things, on the way "overages" - the excess of actual over expected export proceeds - would be treated in the Scheme. From the amount of eventually recorded overages during the projection period one would subtract, in the indicated order of priority:

(a) the servicing (amortization and interest) of the indebtedness obtained from "the other sources of finance" which was used to finance part of the shortfall during the projection period;

(b) the amount needed to replenish the foreign exchange reserve up to their "agreed" level. This "agreed" level is not necessarily the level which would be regarded as "adequate" for the country; it is the level of research which is considered "feasible" under the circumstances.

(c) an amount corresponding to the reduction in consumption expenditure in foreign exchange which had to be made because of a shortfall. (See paragraph 7, below).

The remainder of total "overages" after deduction of items (a), (b), and (c) would be used to liquidate the eventual outstanding indebtedness due to supplementary finance loans received during the projection period.

7. The meaning of the suggested rules for the meeting of the shortfall and the disposition of "overages" can be best understood by distinguishing three alternative situations for illustrative purposes:

(a) if during the projection period, the country would have only shortfalls, the Scheme would have allowed the country to continue its development program without disruption. The loss of foreign exchange due to unexpected shortfalls in export proceeds would have been substituted by long-term loans. On the other hand the country would have contibuted its share to meet the unexpected situation by reducing to some extent its foreign exchange expenditure for consumption purposes.

(b) if during the projection period the amount of shortfalls would have been equal to the amount of "overages", the country would have been able not only to carry out its development efforts, but also to maintain the expected level of consumption expenditures. Although it would have used the facilities of Supplementary Finance on a contingent basis, it would end the projection period without making a net drain on the resources of the Scheme, because it would have repaid the contingent supplementary finance loans which would have been received during the projection period.

(c) if the amount of overages had not been sufficient to compensate completely for the observed shortfalls, the suggested rule for allocation of overages would have contributed to diminish the balance of payments problems with which the country could have been confronted.

8. The rules indicated above in paragraph 7 have been devised in order that the Scheme may mak it possible for the country to service the indebtedness incurred during the projection period from the "other sources of finance" without having to reduce consumption more than had been initially envisaged. The fact that after the servicing of this indebtedness, the next priority for allocation of overages would be the reconstitution of reserves to their "agreed" level meets the need to preserve an important source of flexibility in the operations of the developing country, which is specially important since the Scheme for Supplementary Finance meets only one among a number of sources of uncertainty associated with the development process. If, however, the amount of overages is such that it could more than take care of the servicing of the indebtedness obtained from other sources of finance and of the replenishment of reserves to their "agreed" level, it seems reasonable that allowance should then be made for an increase in consumption expenditures which would compensate for its reduction in the event of the shortfall. Two considerations are here brought into play. In the same way that shortfalls will cause a decrease in consumption expenditures through the process of income reduction, "overages" will operate in the reverse direction. There will be a tendency to increase the demand for foreign exchange to meet consumption expenditures, which will absorb part of the unexpected receipts. After the two previously mentioned priority allocations of the "overages" have been met, the pressure on the balance of payments would be relieved if some increase in consumption would be allowed to take place. This should go up to the point where there would be a compensation for the decrease in consumption in the occasion of the shortfall. This seems adequate because, when the development plan of the country was found feasible at the beginning of the projection period, one of the important considerations which led to this conclusion was that the savings effort which the country itself was supposed to be able to produce (in other

words, the expected behavior of consumption - with its repercussions on the demand for foreign exchange) had been considered reasonable. Once, however, the accepted level of consumption was achieved, the repayment of indebtedness to the Supplementary Finance Scheme would have first claim on the foreign resources of the country during the projection period.

## C. AN OPERATIVE APPROACH

9. One operative way of running the Scheme according to rules above would be the following: each country which established relationships with the Agency and for which an understanding would be reached on the basis of its development plan, would have two accounts with the Agency, for registration purposes: a "shortfall account" and an "overages account".

10. The registration in these accounts would be made for movements which had occurred for the previous projection years. Given the usual delay for the availability of data on actual exports to be compared with the projection, there would normally be a lag of a few months for the registration to be made and for the eventual loan from the Supplementary Scheme to be made available. It is to be hoped that the existence of the Scheme in operation might contribute to improve the speed with which these data would be prepared. Moreover, it would be possible to operate on the basis of preliminary data, if there would be confidence that they could be considered reliable enough. The yearly operation which would eventually take place between the country or the Scheme (contingent loan or repayment of the contingent loan, as will be explained later) would be made for an initial value, subject to alteration when the final data would be available.

### THE "SHORTFALL ACCOUNT"

11. The "shortfall account" would register, in a cumulative way, the total export shortfall, if any, in each projection year. From the total, three

items, also on a cumulative basis, would be subtracted:

(a) the agreed reduction in consumption expenditures in foreign exchange *

(b) the agreed use of reserves and

(c) the net receipts to be obtained from "other sources of finance".

Information on these items would come from the understanding between the Agency and the country, before the projection period began. (A numerical example of this understanding, as well as the working of the different accounts and operations, is given in Annex I to this note.) The difference between the total shortfall and items (a), (b) and (c) would be the "net shortfall financeable by the Supplementary Finance Scheme", which will be referred to hereafter or the "net financeable shortfall".

THE "OVERAGES ACCOUNT"

12. The "overages account" would register also in a cumulative way the total "overages" which would occur for the country in any year of the projection period. Three items would be deducted from the accumulated value of overages:

(a) the accumulated value of net payments to service, (amortization and interest) the loans from "other sources", obtained during the projection period for purposes of financing of the eventual shortfalls;

(b) an item corresponding to the replenishment of reserves and

(c) item (a) of the "shortfall account". The difference between total overages and items (a), (b) and (c) is called "net overages" for purposes of further reference.

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* The question of the import content of shortfalls and overages is treated in Annex II.

"CONTINGENT LOANS" FROM THE AGENCY

13. The outstanding amount of contingent loans which the country would be entitled to would be determined at the end of each projection year as the difference between the "net financeable shortfall" (if positive) and the "net overages" (if positive).* If this difference would grow from one projection-year end to the other, it would mean that the country would receive additional contingent loans. On the other hand, if it would decrease, the country would have to repay the difference to the Agency. This repayment would, obviously, have to take place, only to the extent that there still existed an outstanding amount of contingent loans. When the difference between the "net financeable shortfall" and the "net overages" at the end of projection year was negative the country would keep the foreign exchange corresponding to the excess of "net overages".

14. This way of running the Scheme would have the advantage of immediately returning to the Agency all the funds which are not needed to serve the purposes of the Scheme. It would insure that utmost liquidity of the Agency compatible with achieving its objectives.

15. The outstanding amount of contingent loans which a country would be allowed to receive from the Agency, given a certain accepted projection of the country's export proceeds, would have to be subject to a certain maximum amount, which should be related to the total value of the export proceeds for the projection period. If the outstanding amount of contingent loans at the end of a projection period would exceed the adopted maximum, a revision of the country's export projection - with the simultaneous revision of its development plan and overall balance of payments projection - may be necessary. It is not conceivable that the Agency could possibly underwrite to finance without limitation the "net financeable shortfall",

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* Whenever that difference is positive.

of each and every country that was a drawing member, because the Agency would always be subject to some limitation as to possible available funds. Obviously, the rule as to the maximum permissible amount of contingent loans which a country would be allowed to owe in relation to the initially projected export proceeds would depend, among other things, on the amount of funds which the Agency would have available for its operation. On the other hand, it seems reasonable that this maximum would have to be of a meaningful size, in order that the attraction of underwriting of export proceeds could achieve its objective. For example, for purposes of further exploration, one could start with the suggestion that this maximum should be one-fifth of the projected export proceeds, over a five-year period (assuming this would be the usual length of the projection periods of the different countries).

TRANSFORMATION OF "CONTINGENT LOAN" INTO LONG-TERM LOAN

16. The amount of contingent loan outstanding at the end of the project on period or after the year in which the Agency would have requested the revision of the export projection would then be transformed into a long-term loan*, with terms, interest rate and conditions as separately discussed in another note. The country would start each projection period (both in the "shortfall account" and the "overage account") with a clean slate.

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* It might be simpler from an administrative point of view if the contingent loans which are received during the projection period - and which are eventually transformed into a long-term loan at the end of the projection period - should not be subject to any other repayments during the projection period besides those which might occur as a result of the behavior of "overages". The Agency would only charge a commitment fee (?) related to the outstanding balance which would accrue in the account.

This would mean also that if the country had finished the previous projection period with an "exces of net overages", it would not be transferred to the next project period for the purposes of the operation of the Scheme. Members who succeed in acquiring more foreign exchange than had been reasonably expected during the course of a projection period, would be allowed to consolidate their advantage. However, they would begin the next phase of their development with a strong financial position and this would be taken into account in assessing their need for long-term capital or for the possible extent to which the country would be expected to use its own reserves, before coming to the Scheme for the financing of the eventual shortfalls. By not carrying the "excess of net overages" from one period to the next, the Scheme would provide a measure of incentive for developing countries to try harder to take measures to surpass their export targets.

D. THE TREATMENT OF RESERVES IN THE SCHEME

17. The treatment of changes in the foreign exchange reserves position of the country within the context of the Scheme has to take into account what has been assumed about them for purposes of estimating the basic foreign exchange requirement to support the development program, so as to avoid double counting of their use.

18. For the operation of the Scheme, an understanding would have to be reached between the Agency and the country with regard to a level of reserves which would be used as a reference point for eventually needed replenishment in case of "overages".

19. In the simplest case, this "agreed" level of reserves may be what is regarded as an "adequate" level. In that case, for purposes of the "shortfall account", mentioned previously, the item represented as'drawing down of reserves' is the "agreed" reduction from this level. Similarly, in the "overages account", the amount represented as deductible for the purposes of reserves, is the amount needed to reconstruct reserves back to their "agreed" level. It may be

mentioned that in certain circumstances, the amount of foreign exchange needed to take care of this replenishment might be larger than the previous draw down which was caused by the shortfall in the export proceeds. This is so because other factors - even with the country acting within the agreed specification of the "policy package" - might have needed in previous periods a use of reserves.

20. It may be, however, that the country starts the projection period with a level of reserves which is below that which is regarded as "adequate". But that it is not yet excessively low, so that in case of shortfall it could still withstand some decline. This "agreed" level of reserves - which is below the "adequate level" - would in this case be the reference point for purposes of replenishment of reserves, which is taken into account in the "overages" account.

21. If on the other hand, the country had started the projection period with "excess foreign reserves", that is above what was considered the "adequate" level, the treatment of "excess reserves" under the Scheme would depend on whether their use had been provided for in the basic financing of the development plan. If they had been taken as one of the financing item (that is, the country was being supposed to use its "excess reserves" to finance long-term development), the item in the "shortfall account" and "overages account" should only consider the drawings related to the "adequate" level of reserves. Instead of planning the use of the "excess reserves" to finance the development, it is conceivable that the country might have chosen to use them as an element in the financing of the eventual shortfalls to avoid having to incur short-term indebtedness.* The item related to the drawing down of reserves in the "shortfall account" would then be composed of two parts:

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* This would be reflected in the understanding with the Agency.

(a) the use of the "excess reserves" - which would not have to be subsequently replenished - and which would substitute for, totally or to a large extent, the item related to "other sources of finance";

(b) the use of reserves after they had reached their "adequate" level and which had to be taken into account in the "overages account".

22. It should be emphasised that according to the way the operational rule for treatment of reserves is stipulated, the "overages account" would be deducted only the changes that would bring it to the "agreed" level, which in some cases may be lower than the level which may be regarded as "adequate". This would mean, for example, that if the country had previously received a contingent loan, it would be supposed to use its "overages" to repay the Scheme, even if this would bring the level of reserves below what could be regarded as the "adequate" level. This situation is compatible with the limited objectives of the Scheme. The objective of the Scheme is not to solve directly the problem of bringing reserves to their "adequate level". If this would be included among its objectives, the deduction from the "overages account" would be an item which would bring reserves to their "adequate level". This operative rule would reduce the amount of "overages" available to repay (or offset) contingent loans compared with the rule suggested above. The amount of funds needed to run the Scheme would be correspondingly larger.

THE NEED FOR A FOREIGN RESERVES POLICY

23. It should be stated that nothing in the Scheme would relieve the country from the need of having a very definite foreign reserve policy which is compatible with its short-run objective of stability and long-run objective of development. Much to the contrary, the availability of the Scheme would introduce new elements which have to be taken into account and which would point to the need of trying to identify the foreign reserves policy which the country would find most suitable to meet its goals.

24. It has already been said that the Scheme takes into account only one type of uncertainty which accompanies the process of development. Manipulation of reserves will have to take into consideration not only this uncertainty but also all the others. In addition the suggested operational rules for the Scheme raises the possibility of situations for which reserves would be needed to absorb the impact of differences between actual and expected values. For example, one of the element which is subtracted from the total shortfall to determine the "net financeable shortfall" is the expected reduction in foreign exchange demand associated the fall in consumption expenditures due to the shortfall. For purposes of operating the Scheme the amount deducted is that which corresponds to the best estimate which can be agreed upon between the country and the Agency. What will actually happen is certainly likely to be different from what was estimated. Given the fact that there are so many different factors operating at the same time and that these factors operate with different leads and lags in time, the practical solution to the problem is to operate the Scheme under the rule that what is to be subtracted is the amount initially estimated. The experience in running the Scheme will probably teach lessons which will influence the estimates which will be subsequently made.

25. Another assumption which was made for the purpose of making the Scheme operational was that when the amount of shortfalls during a projection period are matched by an equal amount of overages, the indirect effect on consumption expenditures (and their effect on the demand for foreign exchange) would basically be the same. This will not necessarily be so. It seems, however, that to adopt a more sophisticated approach to this question would be taxing - more than it is already implied in the Scheme - our presumption of knowledge of the workings of the economic system. The blunt hypothesis

adopted seemed a reasonable way out from the point of view of practicability of the Scheme. This, however, points to the need of the country having a policy for foreign reserves which allows it to absorb the difference between what is being assumed for practical operational purposes and what will really happen.

26. The need for a very definite foreign reserves policy becomes apparent in the particular situation in which "overages" would precede shortfall, during a projection period. It has been suggested by some that the country should not keep its unexpected additional foreign reserves in liquid form but should step up the pace of its development program. The stepping up of the pace of the development program is meant here as the initiation of new development projects, above and beyond those which were initially contemplated. It is not meant as measures which would simply anticipate the expenditure of foreign exchange from subsequent periods, in the same projection period. In other words, the stepping up of the pace of the development program would involve an increase in the initially projected and already agreed expenditure of foreign exchange during the projection period. This argument should be considered in the context in which Supplementary Finance Scheme is supposed to work. The Scheme assumes that there is a reasonable development program for which the needed foreign financing is expected to be forthcoming, as a result of the understanding with the capital exporting countries and international financial agencies. Maybe this development program is not as fast as the country could achieve, given its absorptive capacity, defined in terms of the country's actually being able to carry out and run developmental projects. But this is a realistic program for which it was found possible to obtain the necessary external sources for carrying it out and for which the Agency has undertaken the responsibility, subject to a meaningful limitation, of coming forth with the needed foreign exchange in case of a shortfall, so that the projected development would not be disturbed. In other words, this

is a development program for which there is certainty that it will not be impaired because of lack of export proceeds.

27. If the country would use the unexpected foreign exchange available because of the "overages" in its export proceeds to accelerate the pace of its development (assuming it had the absorptive capacity to do so), it would be doing so at the risk of being put in the position of having to disrupt the program subsequently, in case shortfalls would occur in the future years of the projection period. Because, having spent the unexpected foreign exchange and not being entitled to receive the contingent loan from the Agency (according to the described operation of the Scheme the previous "net overages" would compensate partially or totally the "net financeable shortfall") there would be a lack of foreign exchange to carry the "expanded program", which would then be disrupted.

28. The fact that the country refrains from spending the unexpected foreign exchange (and accumulates it in some liquid form) is a price which it pays to avoid the risk of eventually having to disrupt the program later on. It is the apparent short-run cost of having an orderly development. Countries, like individuals, may have different preferences as to the bearing of risks. The Supplementary Finance Scheme assumes that the prospective pace of development which the capital-exporting countries and international financial institutions are willing to support is attractive enough to the country for it to want to protect the program from disruption.

29. There is, indeed, a very important practical problem of how the authorities can resist the mounting pressures to spend the accumulating foreign resources in the reserves of the country, when the advocates of a larger program point the innumerable problems which remain to be solved in the country. The logical argument of insuring an "orderly development" tends to weaken as the reserves pile up. One expedient which may help to alleviate

this type of pressure is to allow countries - if they so desire - to make term deposits with the Agency, which would not be included in the definition of the country's reserves. The Agency could use such deposits to make investments in the international capital markets.

30. If, however, there is a tendency for an accumulation of unexpected earnings above certain limits, (say "net overages" being equal to one or two average years of projected export proceeds) the country could initiate measures to revise its development program, taking the proper initiative with the suppliers of foreign financing.

ANNEX I

SHORTFALLS, "OVERAGES" AND CONTINGENT LOANS - A NUMERICAL EXAMPLE

1. Given the magnitudes of the development plan and the export projection, the available knowledge as to workings of the economy and the policy intentions of the Government, the following understanding is reached between the Agency and the country:

on meeting the shortfall:

a) reduction of consumption expenditures in foreign exchange - for each possible level of shortfall which could be observed in any year, the corresponding amount of reduction in foreign exchange consumption expenditures would be determined; for purposes of the numerical example, it will be assumed that the reduction would be equal to 10% of the shortfall of the particular year.

b) use of the country's own reserves -

the "agreed" level of foreign reserves is 100; the country is supposed to use its foreign reserves to finance the shortfall, in each year, to the extent of bringing them down to the level of 80. The country is supposed to make the same use of reserves whenever they could have been replenished to the "agreed" level in subsequent periods by "overages".

c) use of loans from "other sources of finance" -

the country is supposed to obtain from them, for the financing of shortfall of the current projection period, net funds (principal minus servicing - amortization and interest) up to the level of 30. The shortfall account will register the net funds actually received during the year from "other sources of finance". For example, if during a year the country received a certain amount of loans and at the same time made payments for servicing its debt of a corresponding amount, item c in the "shortfall account" would show no alteration. Nor, for that matter would the "overages account" (see below).

Before going to the Scheme for funds, the country should obtain from the

"other sources of finance" the maximum agreed net contribution of funds (net receipt minus net repayments). However, when in a position to liquidate indebtedness because of subsequent overages, the country can give preference to the settlement of indebtedness due to those "other sources".

2. The "shortfall account" registers, for each year of the projection period and in a cumulative way, the observed shortfalls and the deducting items a, b, and c above. The difference is called "net financeable shortfall".

3. On the disposition of the "overages", the following priority is to be observed:

(a) actual net funds paid by the country during a year for the servicing of the loans received from the "other sources of finance". For example, if in the year in which the country makes the payment for servicing of the previous loans, it also received a new loan, the value of the latter would be deducted from the servicing payment to obtain a net figure. (There would be an entry in item a of the "overages account" if the new loan would be smaller than the servicing payment. Otherwise the entry would be in the "shortfall account".)

(b) replenishment of reserves - measured as the difference between the level of reserves in the end previous year and the "agreed" level of reserves.

(c) compensation for the reduction in consumption expenditure - equal to item a which has been entered in the "shortfall account".

4. The "overage account" registers, for each year of the projection period and in a cumulative way, the observed "overages" and the deducting items a, b and c above. The difference is called "net overages".

5. The outstanding amount at the end of each year of the contingent loan which the country is entitled to receive from the Agency during the projection period is equal to the "net financeable shortfall" (if it is positive) minus the "net overages" (if it is positive).* The outstanding amount of the contingent loan at the end of the projection period would be transformed into a long-term loan.**

6. For purposes of the numerica example, the behavior of the "shortfall account", the "overages account" and the contingent loan will be observed in each projection year, subject to certain postualted events and the rules described above. The projection period is supposed to be 5 years.

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* The contingent loan is subject to a ceiling - a meaningful limitation - above which the Agency can request the country to revise its plans. The country itself would have the right to do it if the excess of net overages would surpass certain limit. No numerical example is given for these cases.

**For purposes of simplification, the numerical example does not consider the fee which the Agency would charge (see paragraph 16 of text).

Year 1

EVENTS - a) shortfall of 60

b) level of reserves at beginning of year 1 - 100

c) loan from "other sources of finance" of 30 to be repaid in 3 yearly installments of 12

| Shortfall Account | | | | | Overages Account | |
|---|---|---|---|---|---|---|
| a) reduction in consumption - | 6 | | shortfall - | 60 | | |
| b) use of reserves - | 20 | | | | | |
| c) net receipts from loans "other sources" - | 30 | 56 | | | | |
| net financeable shortfall | | 4 | | | | |
| | | 60 | | | | |

outstanding contingent loan at end of first year = 4 ("net financeable shortfall" - positive; "net overages" - nihil)

Year 2

Events - a) shortfall of 50

b) level of reserves at end of year 1 - 80

c) loan of "other sources of finance" of 12 to be repaid in 3 yearly installments of 5.

Shortfall Account | | | | | | Overages Account

| | | | | Shortfall | |
|---|---|---|---|---|---|---|
| a) reduction in consumption | - | 6 | | | Shortfall - | 60 |
| | | 5 | 11 | | | 50 |
| | | | | | | 110 |
| b) use of reserves | - | 20 | | | | |
| | | - | 20 | | | |
| c) net receipts from loans - "other sources" | - | 30 | | | | |
| | | - | 30 | 61 | | |
| net financeable shortfall | | | | 49 | | |
| | | | | 110 | | |

Outstanding contingent loan at end of second year - 49 ("net financeable shortfall" positive; "net overages" - nihil) (an increase of 45 in relation to the first year)

Observations:

1 - The reduction of reserves for purposes of financing the shortfall in the year 2 was zero, because of the level of reserves had already reached to the "floor" of 80 in the end of the previous year.

2 - As the country is running into shortfalls, it is assumed that it will obtain from the "other sources of finance" net funds of 30 as agreed; the repayment of the 12 has to be financed by a new loan from the same sources; the net receipts from "other sources of finance" remains the same as in the previous period. (If the country would not be successful in obtaining this additional loan it would have to use its own reserves for the repayment).

Year 3

Events - a) an "overage" of 55

b) level of reserves at the end of year 2 - 70, (other "acceptable" pressures on the balance of payments - delay in the disbursement of public funds or in negotiations with private sources - resulted in the further lowering down of reserves).

Shortfall Account *

| | | | | | | |
|---|---|---|---|---|---|---|
| a) reduction in consumption | 6<br>5 | 11 | | Shortfall | - | 60<br>50<br>110 |
| b) use of reserves | 20<br>- | 20 | | | | |
| c) net receipts from loans - "other issues" | 30<br>- | 30 | 61 | | | |
| net financeable shortfall | | | 49<br>110 | | | |

Overages Account

| | | | | | | |
|---|---|---|---|---|---|---|
| a) net payments on loans - "other sources" | | 17 | | overage | - | 55 |
| b) replenishment of reserves | | 30 | | | | |
| c) compensation in consumption | 6<br>5 | 11 | 58 | | | |
| net overages | | | -3<br>55 | | | |

outstanding contingent loan at the end of third year - 49 ("net financeable shortfall" - positive; "net overages" - negative).

Observations:

* same as in the end of the previous year:

1 - the replenishment of reserves is determined by the difference between the actual level of reserves at the end of the previous year (70) and the "agreed" level of reserves (100). It should be observed that it takes into account not only the replenishment of reserves used for financing the export shortfall but also that used because of other pressures.

2. The fact that country has an overage allows it to make a net repayment of funds to the "other sources of finance". The 17 is sum of the second installment on the loan of 30 and the first installment in the loan of 12.

Year 4

Events - a) an overage of 70

b) level of reserve at the end of year 3 - 100

Shortfall Account

| | | | | | |
|---|---|---|---|---|---|
| a) reduction in consumption | 6 | | | Shortfall | 60 |
| | 5 | 11 | | | 50 |
| | | | | | 110 |
| b) use of reserves | 20 | | | | |
| | - | 20 | | | |
| c) net receipts loans "other sources" | 30 | | | | |
| | - | 30 | 61 | | |
| net financeable shortfall | | | 49 | | |
| | | | 110 | | |

Overages Account

| | | | | | |
|---|---|---|---|---|---|
| a) net payments on loans - "other sources" | 17 | | | overages | 55 |
| | 17 | 34 | | | 70 |
| | | | | | 125 |
| b) replenishment of reserves | 30 | | | | |
| | - | 30 | | | |
| c) compensation on consumption | 6 | | | | |
| | 5 | 11 | 75 | | |
| net overages | | | 50 | | |
| | | | 125 | | |

outstanding contingent loan at the end of the fourth year - nihil ("net financeable shortfall" (positive) smaller than "net overages" (positive)); the country repays after the calculations related to the fourth year, the debt to the Scheme which was outstanding at the end of the third year.

Observation:

1. The deducting item for replenishment of reserves in this year is zero, because the level of reserves at the end of year 3 (100) was equal to the "agreed" level of reserves (100).

Year 5

Events - a) a shortfall of 80

b) level of reserves at the end of Year 4 - 95 (in Year 4 the country had had an overage of 70 which had been used partly to service the loans from "other sources of finance" (17) and partly to repay the Scheme (49). This should have left an increase in reserves of 4 over the position in the end of year 3 (100); the expansion of income in the period, plus other factors, led to an increase in the expenditure of foreign exchange which brought it below the level which had been reached in the end of year 3, that is 95)

Shortfall Account

| | | | | | |
|---|---|---|---|---|---|
| a) reduction in consumption | 6 | | | Shortfall | 60 |
| | 5 | | | | 50 |
| | 8 | 17 | | | 80 |
| | | | | | 190 |
| b) use of reserves | 20 | | | | |
| | - | | | | |
| | 20 | 40 | | | |
| c) net receipts loans - other sources | 30 | | | | |
| | - | | | | |
| | 30 | 60 | 117 | | |
| net financeable shortfall | | | 73 | | |
| | | | 190 | | |

Overages Account

| | | | | | |
|---|---|---|---|---|---|
| a) net payments, on loans "other sources" | 17 | | | Overages | 55 |
| | 17 | 34 | | | 70 |
| | | | | | 125 |
| b) replenishment of reserves | 30 | | | | |
| | - | 30 | | | |
| c) compensation on consumption | 6 | | | | |
| | 5 | 11 | 75 | | |
| net overages | | | 50 | | |
| | | | 125 | | |

continued

<u>outstanding contingent loan</u> at the end of fifth year -
23 ("net financeable shortfall" - positive; minus "net overages" - positive) - this would be transformed into a long-term loan.

<u>Observations:</u>

1. The use of reserves which is entered in year 5 is the full amount between the level of "agreed" reserves and the "floor" of 80; it does not take into account the fact that the country really was not able - or did not want to - keep reserves at the "adequate" level by the end of year 4; the difference is absorbed by the country through a change in its reserves.

2. The net receipts of loans from "other sources of finance" takes into account that the outstanding debt to these sources of 5 - at the end of year 4 - would be liquidated in the fifth year, bringing this type of debt of the country to zero; according to the understanding with the country, in the event of a shortfall, before using the funds of the Scheme, the country should have 30 of net receipts from the "other sources of finance". To achieve this result the country would have to receive a gross loan of 35 out of which it would repay 5. The servicing of this loan would fall in the next planning period, and would be considered when drawing the foreign exchange accounts associated with the financing of the next development plan.

## ANNEX II

### Import content of "overages and shortfalls

1. Let us suppose that the exports of a country were 100, out of which 20 percent (20) were imported from abroad, leaving a value added by exports of 80. If the volume of exports of the country unexpectedly increased by 30 percent, with no change in prices, the additional needed imports would be 6 and the unexpected foreign exchange proceeds available to the country would be 24. On the other hand, if the same unforeseen change had taken place in the opposite direction (30 percent decline in the volume of exports, with no change in price) the export proceeds would decline by 30. But as there would be a corresponding decline in the require imports, the actual unexpected shortfall in terms of foreign exchange available to the country (in terms of value added of exports) would be 24.

2. If the contingent loan made by the Supplementary Finance Scheme would be measured in terms of the gross export proceeds, when the shortfall took place the country would be entitled to a loan of 30, whereas its shortage of foreign exchange would be only 24. The country would be receiving an "excess" loan of 6, beyond its need of foreign exchange to carry out its development program. When overages of the same extent would subsequently take place, although the unexpectedly available foreign exchange would be only 24, the country would be obliged to repay the full 30. If during a certain projection period, the "overages" and shortfalls are measured in gross terms, (instead of a valued added basis) there would be a compensation within the period between the "excess" loan received at one stage and its repayment. The country operating with the agency would have to be aware of this so as to take it into account in the administration of its foreign exchange reserves.

3. If, in relation to the projection period, the "overages" more than compensated for the shortfalls, the "excess loans" would all have been repaid. There would be no question of the country having to repay more than it should, becuase of the ways the rules regulating the disposition of "overages" operate.

4. However, if, in relation to the projection period, the shortfalls were larger than the observed "overages", the country could have outstanding a certain amount of "excess loans".

5. The rule of computation of "overages" and shortfalls on the basis of gross foreign exchange proceeds instead of "value added" foreign exchange proceeds does not penalize the borrowing country. In any case, it is not obliged to take the full amount of the contingent loan to which it is entitled, so that the country can avoid having "excess loans" if it so desires.

6. The rule poses a probelm from the point of view of the application of funds by the Agency. Being subject to a limitation on the availability of funds, it could be put in the position of having to make more loans to a country than would be strictly necessary from the point of view of fulfilling its stated objectives.

7. From the point of view of operationality, however, it was considered that, as a general rule, the magnitude of the problem was not important and that the adoption of the rule, on a "value added basis" would add to the complications of implementing them on a practical basis. It should be left open to the Agency, however, the power to request that, in relation to particular countries in which the problem might prove to be significant, the rule for computation of shortfalls and "overages" be made on a "value added" basis.

DRAFT
June 28, 1966

The Role of the Agency as a Residual Lender

1. The objective of the scheme is to provide long-term financing for that part of an export shortfall which cannot be absorbed from "other" sources without disrupting the country's development program. Thus, in its discussion with a member country the Agency would agree, among other things, on how much of other sources of finance could reasonably be mobilized in the event of an export shortfall. These other sources would include the IMF compensatory tranche and other IMF help, if available and other appropriate credit sources such as the "emergency foreign trade loans" advanced by Export - Import Bank or program loans as well as the "Food for Peace Program" of the United States A.I.D. In addition to the possibility of financing part of the shortfall from other sources of finance, the Agency would also agree, to the extent feasible, on what adjustment measures the member country could take. This understanding need not be fixed through time, since the Agency would remain in contact with the member country, enabling, among other matters, an adaptation of these adjustment measures, from time to time, to changing circumstances. The scheme's resources would be used only if further resources were needed to prevent disruption of development.

2. The above condition that "other sources of finance be utilized first before recourse is made to the Scheme was thought necessary for two reasons: (i) the necessity of economizing in the need for "new" funds for the Scheme by making the maximum use of all other existing sources of finance and (ii) to permit the IMF compensatory

financing facility to play a role in cases where shortfalls subsequently prove to be temporary or when a country's export and indebtedness position is such as to make short-term borrowing sensible. However, it should be emphasized that in thinking of the Agency as a residual lender, we do not envisage a time-consuming sequence in the utilization of other sources of finance. The Agency is meant to be a residual lender in the accounting sense only, and not in the chronological sense, that is, it is not envisaged that the country would go to all these sources of finance after a shortfall has occurred and if turned down or left with a deficit would come to the Agency for assistance. The understanding as to the use of other sources of finance would be formulated at the beginning of the projection period, as a part of the broader understanding on development policies etc., rather than left to be arrived at at the time of the shortfall. In acting as the residual lender, the Agency would still have the essential objective of the Scheme in mind, i.e. "to provide needed finance with certainty and speed on appropriate terms in order to avoid disruption of development programs, so long as members act in accordance with agreed development policies."

3. As has been mentioned earlier, the amount of resources that the Agency may be expected to provide in the event of a shortfall would be determined not only by the availability of "other" sources of finance but also the extent of domestic adjustment that is feasible by the country itself. The purpose of the Scheme is thus to facilitate the continuation of the growth process by protecting a development

program from disruption due to unexpected factors rather than to relieve the country of all burdens of adjustment. In countries where the income-effect of a shortfall in exports is significant(the income-elasticity of imports being positive) part of this adjustment may be automatic. Moreover, to the extent that the adverse export movement reflects a shortfall in volume rather than simply a price phenomenon, there is likely to be some saving of foreign exchange that otherwise would have been spent on direct and indirect imported inputs (in countries where some exports are those of finished manufacturing or semi-manufacturing articles based on imported raw materials). 1/ In addition to some of these adjustments, which are more or less automatic, in certain cases, there may be room for desirable adjustments of a more final character through deliberate public policy. For example, by restricting the import of "superfluous" or luxury consumption foods which are not quite indispensable for economic development. The domestic adjustment that a country can take would, however, differ from case to case, but it should be emphasized that these adjustments would not involve a disruption of the investment and development program (or other harmful short-term measures designed only to meet the consequences of an export shortfall) except in cases where the whole world picture has changed so drastically that it makes a total recasting of the development strategy desirable. The latter cases are likely to be extremely infrequent, and in all but the very few, the presumption would be that an export shortfall should not invalidate the plan priorities or planned pattern of resource allocation. Nor should it involve a cut back in the level of planned expenditure, which is otherwise considered desirable.

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1/ On 'import content of shortfalls and overages', see Annex II of Note on "Overages".

4. The "other" sources of finance that a country would be expected to use (if these are available) before drawing upon the Agency are: (a) its own reserves (b) IMF compensatory financing facility (c) drawing under the ordinary tranche policy of the Fund and (d) bi-lateral loans and grants of a suitable character.

5. Whether a country can and should use its resources in the event of an export shortfall would depend on whether the country and the Agency consider it advisable to use them. 1/ For quite a large number of developing countries, reserves are already at a dangerously low level, and it may be undesirable for them to run these down any further. Yet there are a number of countries (the oil-producing countries come immediately to mind) which may have a sufficient cushion in their exchange reserves to absorb the consequences of an export shortfall. The countries which have been accummulating reserves and are in quite a comfortable reserve position are obviously those where part or whole of the export shortfalls would be expected to be covered by drawing down reserves. There may be some others for which reserves are not excessive but which may still be in a position to use some of their reserves to finance the shortfall. In all cases the extent and the manner in which reserves are expected to be used would be made a part of the initial understanding between the Agency and the country. Active cooperation of the IMF would be sought for guidance as to the advisability of using reserves to meet a shortfall in particular cases.

6. The use of IMF resources both under the compensatory financing facility and the ordinary tranche policy of the Fund for the purposes of meeting an export shortfall would depend on the existing external debt of

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1/ See note on "Overages".

the country. The IMF assistance is strictly short to medium and is provided to enable a country to tide over a difficult balance of payments situation. 1/ In cases where the external debt of a country is already uncomfortable, the use of IMF resources for development purposes even if available may be undesirable, and if the Scheme comes into existence no use need be made of IMF resources in such cases to meet the adverse effects of an export shortfall. The efficient working of this mechanism would call for close collaboration between the Agency and the other international financial agencies, and the Scheme is predicated on the assumption that such collaboration would be forthcoming.

7. Having agreed with the country that it would, to a certain extent, use short or medium-term financing to offset the shortfall, the question arises whether the Agency would refinance these debts at the time of repayment, if exports of the country have not recovered and not other possibilities of refinancing exist. It seems to us that the Scheme should be prepared to do so, since otherwise the country at the time of repayment would have to resort to commercial borrowing of an undesirable character or else cut-back its own development program, precisely the results that the Scheme is meant to avoid. The use of IMF and other short and medium-term resources is justifiable only in cases where shortfalls prove (after the events) to be temporary; it proves to be persistent, the Scheme should in effect, finance such a shortfall by repaying the earlier debt with the IMF. If the Scheme were to undertake refinancing, it is quite likely that larger resources than initially estimated in the Study may be required.

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1/ The IMF is reconsidering its compensatory financing facility. It is quite likely that proposed changes may in effect lengthen the repayment period for countries which are not in a position to make repayments within the normal period.

8. The possibility of using other sources of finance (e.g. 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. AID, the World Food Program, etc.) would also have to be made a part of the initial understanding between the country and the Agency rather than left to be explored after the shortfall has taken place. This would, of course, call for coordination with other bilateral agencies but this should not be difficult if the provision of such assistance under the Scheme is made contingent on agreed plans and policies. In cases where bilateral agencies can not provide the necessary assurance or fail to provide the agreed assistance, the Agency would be responsible for providing adequate financing in the event of an export shortfall. Only with this guarantee on the part of the Agency can the need for maximizing the use of existing financial sources be combined with the need for timely and sufficient action.

DRAFT
June 29, 1966

"Form and Terms of Assistance"

Form of Assistance

1. The criterion which should obviously determine the form in which supplementary finance is provided is that of "timeliness", that is, such assistance should be forthcoming immediately after a shortfall has been identified. At the same time, there is also the need for the international agency disbursing such assistance to be satisfied that the resources thus transferred are used effectively and for purposes which are clearly identifiable. Part of this guarantee - that resources transferred under the scheme are used effectively and for development purposes only - comes from the fact that the satisfactory performance of members, under the scheme, is a prerequisite for assistance and that access to the scheme depends on the implementation of development programs and related policies previously agreed with the Agency. Once, however, the eligibility of a country for assistance, subsequent to a shortfall, has been determined on the basis of a country adhering to agreed plans and policies, there still remains the problem of ensuring that resources transferred under the scheme are in fact spent, in the "post-shortfall" period, for purposes agreed to with the Agency.

2. In the field of basic development finance, tying aid to specific projects is often considered one way in which this can be done effectively. This is one reason why the World Bank group has found it necessary to adhere to the project approach, quite apart from certain other advantages attached to channelling aid through projects (such as, the greater effectiveness with which technical assistance can be provided at a basic operational level).

Administration of aid through projects is, however, a time-consuming process, and would be patently unsuitable for supplementary finance, where speed with which external resources are transferred is of crucial importance in protecting a development program from disruption due to an unexpected shortfall.

3. It is, of course, always possible to combine the need for "speed" with some notion of project approach by channelling assistance to already existing projects rather than new projects; for example, by agreeing with the country on a number of well-defined projects which are being domestically financed but could be taken over by the Agency in the event of an unexpected export shortfall, or alternatively the Agency could channel its assistance through projects which are being financed from external sources, but only partially - thus in effect increasing the total share of foreign financing in the cost of these projects.

4. However, this does not meet the need to have control over the disbursement of foreign resources for specific purposes. Financing of projects to an extent more than their foreign exchange cost provides extra foreign exchange for the country which is equivalent to cash receipts. It is felt that the best way in which supplementary assistance can be provided with speed and yet be used directly only for purposes for which it is given is to provide such assistance by opening lines of credit with the Agency rather than trasferring "cash". The country could draw upon this credit to make payments abroad, and the Agency would thus always be able to determine whether its resources are being used for agreed purposes. This procedure need not cause any delays in disbursement (it is like drawing a check on a foreign Bank), and at the same time quarantees the use of external resources

for agreed purposes. These purposes would include the imports not only of capital goods but also raw materials and intermediate goods.

Terms of Assistance

5. Here, as elsewhere, the approach of the study has been pragmatic and flexible. The principal idea underlying the attitutde of the study on the question of terms is to emphasize the need for tailoring these terms to individual country situations which differ markedly in export outlook, debt structure, savings potentiality etc.

6. Admittedly the present terms on which most developing countries receive development finance not only vary considerably according to source and purposes but are clearly unsatisfactory on the average. This is the reason why the World Bank for one (DAC is another) has been arguing for softer terms on development assistance. At the same time there is no reason why developing countries which differ so much in their debt servicing capacity (and in the genesis of their debt problems) should receive development assistance on the same terms. The terms on which a developing country receives development finance should be determined on the basis of an examination of the over-all financial and economic position of a country - not only the present but the future outlook as well. (See Avramovic, et al. on "Debt-Servicing Capacity".)

7. The view expressed in the study on the subject of terms of financing is a natural by-product of the view that supplementary finance should be treated on the same basis as basic development fiance. Since we have argued that terms of basic fiance should be determined by the economic outlook in that country (which unfortunately is not the case now), we also feel that the same considerations should apply in determining the terms on supplementary assistance. Given the present indebtedness problems of

developing countries (see the World Bank Annual Report 1964-1965), and the fact that in many countries the debt servicing ratio has already reached dangerous proportions, which severely limits the capacity of these countries to undertake further debt on any but the "softest" terms, it is clear that terms on supplementary finance (as also on basic development finance) for these countries, on something like IDA terms. Though the precise terms on which a country receives supplementary finance would be decided individually, for administrative convenience it may be possible to decide broad categories of terms within which different developing countries would fall. In this way it may be possible to indicate in advance to the member countries the particular group which they belong without having to specify the precise terms of a loan, which can then be left to be determined at the time of the shortfall.

8. The experience of the World Bank group may be a case in point. The rate at which the Bank lends is determined by the rate at which it can borrow (even here there are two rates - one for the richer and the other for the poorer countries among its borrowers), while the IDA credits are interest-free (with only a service charge of 3/4 of 1 percent) and maturity of 50 years (including the grace period of 10 years). By varying the Bank-IDA mix in the total volume of lending to countries, it has been possible for the Bank, in effect, to have different average terms for different countries depending on the economic outlook. The flexibility that the Bank has been able to exercise in determining average terms of lending to member countries has, of course, been limited by the availability of IDA funds. Nevertheless within these limits, it has been possible to achieve marked variety of terms on development assistance from the Bank group. There are now broadly four categories of countries:

(i) entirely "Bank countries",

(ii) entirely "IDA countries",

(iii) "hard-blend" countries, which receive assistance mainly from the Bank but also some IDA finance, and

(iv) "soft-blend" countries which receive assistance mainly from the IDA, but also some Bank finance.

9. Granting the need for flexibility in the terms of supplementary and development finance, there is an interesting question which is sometimes raised: shouldn't the terms of supplementary finance be more lenient than those of basic finance (even in the ideal case) because of the fact that (a) following a contraction in exports, the savings and debt servicing capacity of the country would have diminished and (b) the bridging of the exchange gap through the Scheme can only insure a continuation of development according to the plan but does not generate extra foreign currency earnings in the future. The idea behind the former argument is that the terms of basic finance, even in the ideal case, would be determined at the beginning of the plan period or in yearly aid negotiations on the basis of the expected outlook. However, an unexpected shortfall might affect the debt servicing capacity and saving potentiality in the mid-period, and it would, therefore, be unsatisfactory to provide supplementary finance on terms on which the country had received basic finance initially. If such is the case, our view would be that terms of supplementary finance should in fact be more lenient than the terms on which the country had received past assistance since the outlook has changed because of the unexpected factors. There is no contradiction in this and the view that the factors which determine the terms of basic finance should also determine the terms

of supplementary finance since if "new" development finance were to be negotiated after a significant change in the outlook for debt servicing capacity of the country, it would be appropriate for terms of such finance also to be made more lenient to take cognizance of the changed situation.

10. The other idea - that the scheme can only insure a continuation of development according to the plan but does not generate extra foreign currency earnings in the future - is only partially true. It would depend on what the expected exports were meant to finance. If there are export (or re-export) industries, by making possible the implementation of original investment or production targets, the scheme does contribute to an expansion in exports (now or in future) than would have been otherwise possible. The real question, however, is that since supplementary finance is a loan, an export shortfall covered in this manner would increase the total indebtedness of the country than would have been the case otherwise (had this shortfall never occurred); and therefore the terms of these loans should be as soft as possible unrelated to the terms on which the country receives basic finance. The validity of this point of view depends on how one looks at supplementary finance. If one thinks of it in terms of "compensation", that is compensating the developing countries in some sense for their unexpected export shortfalls, then, of course, supplementary assistance should be grants (to equate it to export earnings). If, however, supplementary assistance is supposed to be emergency development loan to augment the long-term flow of capital to the extent of an export shortfall, then there is no reason why it should be treated any differently from basic finance so far as terms are concerned. This, of course, increases the indebtedness of the

country; but if the terms of additional indebtedness are tailored to the country's debt servicing capacity, this is no more than what a country would have been willing to undertake, in the form of basic finance, had the "unexpected" shortfall been in fact "expected" at the beginning of the planning period. In the event of an export shortfall, the availability of supplementary finance is tantamount to an increase in the flow of basic development finance in mid-period in order to support an agreed plan.

11. Some have suggested the idea of "rotation of funds" for the scheme by making such assistance short term, or at least medium-term (10 to 15 years). Our view on this is that quick repayments of supplementary finance by countries which are likely to be dependent on foreign capital and are already in critical indebtedness position "would usually mean that they would have to borrow elsewhere in order to repay the amounts due to the Agency; the alternative of retarding the development process runs counter to the very purpose of supplementary finance" (p. 60, Study). As we see it, supplementary finance is not balance of payments support - to tide over year to year imbalances - or a "bailing out" operation, but a species of development finance, extended on the same basis and for the same purposes as basic development finance - to promote long-term growth of the country. Only in the case of those few developing countries where there are good reasons to expect the resource gap to close in the near future while maintaining an adequate rate of economic growth and where the present indebtedness position is comfortable, would it make economic sense to prescribe relatively short repayment periods.

12. The concluding paragraph in the chapter on the form and terms of assistance in the Study had pointed to the possibility that there may be

circumstances under which the Agency could request advance repayment of its loans to a country. It has been suggested that this idea would be self-defeating since it would run counter to the basic rationale behind foreign assistance. As it is clearly stated in the Study, the circumstances which would make advance repayment possible are probably infrequent, and it is not envisaged that developing countries which still have a "resource gap" may be asked for advance repayment. It is only in cases where the resource and foreign exchange position of the country improves so substantially over time that it could afford to repay its debt to the Agency before maturity (e.g. due to the discovery of oil or the emergency of a new export factor) without affecting its attainable rate of growth that the Agency may retain the right to request repayment earlier than originally stipulated.