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COMPENSATORY FINANCING

Inadequacy of Present Arrangements and
New Proposals

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I propose to raise here some questions relating to the role of compensatory financing in the establishment of an international economic order that is more equitable than the one that now pervades the world. As far as is possible, I have kept deliberately away from technical questions and concentrated on issues of policy.

Wide Fluctuations

That commodity export earnings are subject to wide fluctuations very largely in the wake of fluctuations in economic activity in the industrialized world has been generally established in econometric studies. Also, since these fluctuations take place largely for reasons outside the control of the commodity producing countries and since the incidence of these fluctuations on the developing countries would be rather harsh because of their large dependence on these exports, the need for international action with respect to commodities of export interest to the developing countries has, by now, come to be generally accepted. What is not quite agreed upon is the set of

measures that should be taken at the international level with a view to helping the developing countries to establish their export earnings.

Measures Proposed

The developing countries have argued strongly for the establishment of (a) international commodity agreements, supported by buffer stocks and (b) a common fund to finance such buffer stocks. On the other hand, the developed countries have underlined the importance of improving and enlarging a compensatory financing arrangement to finance shortfalls in the commodity export earnings of the developing countries. While buffer stocking arrangements should help promote stable prices of commodities, compensatory financing arrangements seek to stabilize export earnings, over time. It is necessary to emphasize here that both the sets of measures, the set advocated by the developing countries, as well as the set advocated by the developed countries are extremely complementary. One does not really do away with the need for the other, though the impression has unfortunately been created that these two sets of measures are somehow exclusive.

Their Complementarity

To the extent that commodity prices are stabilized through the instrumentality of international stocking arrangements, it is bound to reduce fluctuations in commodity export earnings.

But one cannot rely on stocking arrangements alone for stabilizing earnings because (a) earnings may be affected by non-price factors beyond the control of the producing countries (e.g. when a natural calamity like drought or flood wipes off a major part of a country's crop) and (b) not all commodities may be amenable to stocking arrangements either because they are not quite stockable or because international agreement is hard to reach thereon. Nor can one rely on compensatory financing alone, if it is also the objective to stabilize commodity prices, an objective which has much to be said in its favour. No less important is it to point out that if and when a compensatory financing arrangement is not adequate, for whatever reasons including that of limited resources, to compensate fully for the shortfalls experienced in export earnings, it becomes even more necessary to complement such an arrangement with appropriate international stocking arrangements, wherever, feasible, to stabilize earnings.

Misplaced Controversy

The point which needs very much to be emphasized is that the debate on the relative virtues of compensatory financing as against international stocking arrangements is rather academic, if not altogether misplaced, in the context of the present situation in which whatever compensatory financing arrangements exist already are either

grossly inadequate or very much restricted in coverage and whatever proposals have been floated to improve these existing arrangements come no where near to ensuring an adequate coverage of shortfalls in the export earnings of the developing countries. For a meaningful discussion of the role of compensatory financing, it is necessary that one should have in mind a scheme that seeks to provide a reasonable cover, given its objective of compensating producing countries for the shortfalls in their commodity export earnings. Fortunately, there are afloat a few serious proposals which seek to establish an entirely new comprehensive compensatory financing arrangement. These proposals are addressed directly to the problems of the non-oil developing countries. The important question to ask in appraising these proposals is whether or not they are backed with adequate funds because only then will they create a viable complement to appropriate international stocking arrangements for stockable commodities.

We shall first outline the two existing arrangements with respect to compensatory financing (1) IMF's Compensatory Financing Facility (CFF) and (2) European Economic Community's Scheme for Stabilizing Export Earnings (STABEX), to indicate how inadequate they are in meeting the needs of the non-oil developing countries and also to what extent some recent suggestions to improve these existing arrangements go in

meeting their inadequacies. Later, we shall go on to examine the principal proposals for additional compensatory arrangements and the major departures those proposals seek to make.

IMF Facility

CFF has been in existence for 15 years now. The gross amount given away by the IMF in compensation for export shortfalls added up to a little over SDR 4 billion by April 1978.

All member countries of the IMF, developed as well as developing, are entitled to avail themselves of this facility, when their visible export earnings show a shortfall, in nominal terms, but the developed industrialized countries have refrained from drawing on it, even with respect to their commodity export earnings. However, some of the developed commodity exporting countries like Australia, New Zealand, South Africa and Israel have drawn on it. So also have several non-oil developing countries.

Of the amount of SDR 2.8 billion drawn from this facility during a period of 28 months since January 1976, some 30 per cent is accounted for by the developed countries and the balance by non-oil developing countries.

The point to note about this facility, in our context, is that though it is very broad in coverage (it covers all commodities and all countries are eligible for drawings against it), the relief it has been able to provide is extremely limited, particularly to the non-oil developing countries. According to recent calculations put out by UNCTAD secretariat, drawings against this facility have not, on average, exceeded 12.5 per cent of the shortfalls in visible export earnings of the concerned non-oil developing countries. In fact, in 1976, the year of maximum drawings when as much as SDR 2.3 billion was paid out of this facility the proportion of shortfalls covered with respect to these countries was only 12.7 per cent. Compensation payment to these countries amounted to SDR 1.6 billion as against the total, formula based, shortfall of SDR 12.5 billion experienced by them in 1976.

(See accompanying table). This limited coverage of the shortfalls of the non-oil developing countries by the IMF facility has been due very largely, if not entirely, to restricting the drawings by a country in any one year, and outstandings, to limits based on the country's quota with the Fund. Currently, drawings in any 12 month period must not exceed 50% of a country's quota and its outstandings must not exceeds 75% of the quota.

It is well known how regressively the IMF quotas are distributed among its member countries. The non-oil developing countries accounting for 70% the population of the IMF members hold 22% of the quotas. Much more significantly from the point of view of compensatory financing, these countries account for 70% the total commodity exports of the IMF members countries other than industrialised countries. It should be a matter of no surprise therefore if the average coverage of shortfalls is found to be very much smaller for the non-oil developing member countries of the Fund than the developed countries.

Also, since the quotas had not been raised adequately from time to time to keep pace with the growth of world trade, the inflation and the volatility of the prices, limits on compensatory drawings based on quotas were bound to become more and more inadequate, unless, of course, the limits themselves were being raised. Actually, however, the limits on compensatory drawings were changed only once in 15 years and that was done exactly three years ago, in December 1975.

However the inadequacy of this facility with respect to the non-oil developing countries is sought to be understated by frequent resort to judgemental, in place of formula, determination of shortfalls in a manner that the shortfalls

themselves are grossly under-estimated. In recent days, i.e. from January 1976 to April 1978, the under-estimation in the above manner of the shortfalls in the export earnings of the non-oil developing countries has been of the order of 66.67 percent. (See Note 2 to the accompanying table.)

Further, the terms of repayment (they call it re-purchase) of drawing from this facility are such that every country is obliged to repay, with interest, within a period of three to five years regardless of whether or not the export earnings of a country have recovered or its balance of payments position has improved. There is a glaring asymmetry here. While (a) the IMF determines a country's entitlement to drawing on the basis of short fall in export earnings and (b) it expects a country to start repaying earlier if its export earnings recover, no allowance is made if the earnings of the country do not recover enough, or at all, during the short period of five years fixed for repayment to be completed.

To the argument that since a monetary institution like the IMF, whose principal task is to help countries even out their temporary ups and downs in the balance of payments, cannot undertake to extend loans of longer maturities, the most effective answer would be that therefore

the world community should think in terms of an altogether different institutional arrangement which can perform this special type of business of stabilizing export earnings of primary producers much more adequately without importing considerations that are not quite applicable.

In any case, the gross inadequacies of this facility in terms not only of the proportion of coverage it is currently able to provide against shortfalls in export earnings, but also of the conditions of repayment, can clearly be seen.

Does the IMF have any ideas of improving its facility, particularly in so far as the developing countries are concerned? It is relevant to refer in this connection to some of the major ideas recently emerging from within the IMF for a so-called liberalization of its facility. These are:

- (1) changing the quota based limits on drawings and outstanding from 50 percent and 75 percent to 50 percent and 100 per cent respectively;
- (2) inclusion of earnings from invisibles for purposes of determining shortfalls; and
- (3) inclusion of excesses in the cost of cereal imports for calculating shortfalls.

To start with the proposed relaxation of the quota-based limit on outstanding drawings from this facility, it will be

interesting to know that 34 out of the 47 countries which used this facility in 1976, drew full 50 per cent of their quotas, and six reached the 75 per cent quota ceiling on outstandings. This meant that if the former group of countries experienced a shortfall again before the earlier drawing had been repaid, they would be entitled to draw only between 25 to 50 per cent of their quota, the actual percentage depending on the proportion of the earlier drawing already repaid. The countries in the latter group would be entitled to draw even less.

According to our rough calculations, the suggested relaxation of the limit on outstanding drawings would have increased the coverage of shortfalls in 1976 for the non-oil developing countries from 12.7 per cent to only 13.5 per cent. It must be added, however, that in the next round of large scale drawings, following another depression in the industrialized world, the proportion of shortfalls of the non-oil developing countries which will be covered by drawings is unlikely to be even as high as 12.7 percent unless the limit on outstandings is relaxed, as proposed. The most important point here is that the suggested liberalization hardly takes things further; it only seeks to restore the old position which too seems to be slipping away.

As for the other two suggestions, which propose the liberalization of the formula calculation of shortfalls, suffice it to say that, while they will certainly benefit some individual countries who do not now become entitled to drawings against this facility, the overall position of the developing countries is unlikely to improve as a result of the implementation of these suggestions. Firstly, to the extent that there is a net increase in the overall shortfall of a country as a result of the implementation of these two suggestions, its coverage is bound to come down if the country's quota limit remains unchanged. Of course, quotas themselves are being raised. But the increase in quotas so far has been rather so miserly that, as a proportion of world trade, quotas today are only half of what they were in the mid 50's. Secondly, given the prevailing practice of determining shortfalls on the basis of judgement ultimately rather than formula, all these suggestions for liberalising the formula calculation may mean no more than white wash.

On the whole, therefore, the IMF does not seem to be seriously concerned about playing a major role in stabilizing the export earnings of the non-oil developing countries. Given the weightage enjoyed by the new developed countries in its decision making, this lack of adequate concern in the IMF with one of the most serious problems of the developing

world is not difficult to understand.

STABEX

This arrangement, which has now been in operation for almost three years, was set up by the European Economic Community (EEC) to help a group of 53 countries from Africa, the Caribbean and the Pacific (ACP) stabilize their earnings from the exports of certain listed commodities and bi-products which they sell to the Community. A sum of ECU 380 million (\$420 million approximately) was earmarked for the purpose to be used over a period of five years, 1976-1980, spread out equally, but with some scope allowed for flexibility. During the first two years, something like ECU 110 million has been paid, under this arrangement, as compensation for shortfalls in commodity export earnings.

While the above arrangement addresses itself to quite a large number of developing countries, its coverage is still extremely limited. The value of commodity exports whose earnings this arrangement seeks to stabilize, accounts for less than 20 per cent of the total export earnings of the ACP countries and less than 3.5 per cent of the export earnings of the non-oil developing countries from commodities.

The inadequacy of this scheme even for ACP countries is compounded by the manner of determining compensation. All its shortfalls are calculated in nominal terms and compensated

separately for each of the listed commodities and bi-products only when (a) the concerned commodity or bi-product accounts individually for at least 7.5 per cent of a country's total merchandise exports to all destinations and (b) the shortfall itself, again individually, is at least of the order of 7.5 per cent with reference to the average earnings from exports to EEC over the past four years. For the least developed, land-locked or island member countries of the ACP, the proportion in both the cases is set at 2.5 per cent. As a result of these restrictive provisions, not only do several of the commodities exported by ACP countries, but not included in the list, get excluded from the benefit of this arrangement, but also the entitlement of a country to compensation payment is not always certain with respect to commodities which are on the list. A country may be dependent on three or four of the listed commodities for its export earnings, but its shortfalls will not qualify for compensation if each of these commodities does not pass the 7.5 per cent test of dependence, or if each of the shortfalls does not pass the other 7.5 per cent test. The fact that the least developed, land locked or island countries have to pass these two tests at the level of only 2.5 per cent, will certainly have given them a decided advantage, compared to

the other ACP countries.

Once, however, the tests mentioned above are passed, compensation is more or less assured, though the EEC still wants to be satisfied that (a) the shortfall did not occur because of any policy action by the countries concerned and (b) it did not amount to a significant change. Of course, there is also the overall constraint of the annual allocation though the arrangement does not quite spell out how the claims for compensation will be affected should this constraint become operative. Still it would be reasonably valid to say that once the above thresholds are crossed, a given formula shortfall has greater chances of being covered adequately under this arrangement than it would have under the CFF type arrangement. Under the latter, as has been stated above, the formula shortfall is subjected to a drastic scaling down in the process of judgemental determination where the non-oil developing countries are concerned, and then, assuming various conditions are satisfied, the watered down shortfalls are set against the quota based limits on yearly drawings and outstandings before the actual amount of compensation is determined.

The terms of repayment are also very much more liberal under STABEX than under the IMF facility. Compensation payments to the least developed countries are made in the form

of grants. For the other ACF countries, compensation loans are repayable as and when their export earnings recover, as a result of improvement in prices, but they carry no interest. Outstandings after 1980 may be considered for conversion into grants or long term loans.

Thus though extremely restricted in its scope because of (a) limited country and commodity coverage and (b) application of tests to individual earnings and shortfalls, two positive aspects of the STABEX arrangements outlined above are still worth-while highlighting. Firstly, the less advantaged countries are given preferential treatment in considering their claims to compensation by prescribing lower thresholds for them. Secondly, the least developed countries are offered compensation on distinctly generous terms.

It should therefore be regarded a welcome development that the two principal proposals, one from Sweden and the other from West Germany, currently afloat for the establishment of an additional compensatory financing arrangement, addressed only to the needs of the non-oil developing countries, incorporate the above-mentioned positive features of STABEX. We shall turn now to the discussion of these very proposals.

The Swedish Proposal

At the Seventh Special Session of the United Nations' General Assembly in September 1975, two proposals were put forth, one by the U.S.A. and the other by Sweden. Both were aimed at helping non-oil developing countries stabilize their export earnings. The U.S. proposal was to establish a \$10 billion Development Security Facility. The Swedish proposal refrained from naming any figure. What is now significant, in our context, is that while the U.S.A. has seldom tried to revive its proposal, Sweden has constantly been updating its proposal in international fora. It is quite likely that the U.S.A. has had second thoughts and is no longer wedded to the idea it once seriously championed. In the circumstances, we shall discuss only the Swedish proposal. Chronologically, the German proposal, which too we discuss here, is of later origin.

In its latest version, the Swedish proposal suggests that:

- (1) a separate fund should be set up, financed out of contributions from countries and borrowings from the capital market in the ratio of 1 to 3;
- (2) such a fund should finance compensation payments against net shortfalls in the total export earnings of all commodities other than fuels (SITC 0-2, 4 and 68) of only the non-oil developing countries.

- (3) shortfalls should be measured from the trend value of commodity export earnings in real terms, based on the five years immediately preceding the shortfall year;
- (4) no conditionality should be attached to compensation other than that the country has tried first to obtain a drawing from the IMF facility;
- (5) compensation against shortfalls should be paid in the form of loans carrying differential interest rates, with the poorest countries paying no interest and the rest paying interest at the rate of 5 per cent;
- (6) compensation loans should be repayable in the years when a country's commodity export earnings exceed the trend value; and
- (7) for the poorest countries, any loan outstanding after five years should be converted into grants but for others it should run on until it is fully repaid.

In the proposal originally put forth by Sweden, it was stated, quite explicitly, that the extent to which shortfalls will actually be compensated by the proposed fund will depend on the ceiling for available financial resources in any given year. However, unlike the U.S. proposal, no figure was given for the ceiling. In the latest version, this aspect is kept more vague and there is no indication at all to what extent the proposed fund would aim at covering the shortfalls in

commodity export earnings.

With respect to the administrative arrangements for the proposed fund, Sweden's original suggestion was to establish the fund within the framework of the UN system so that all member countries have equal possibility of participating in the decision making processes. Now, however, possibly as a concession to opinion in other developed countries, Sweden is inclined to consider the fund being administered as an IMF trust fund, even though the decision making in the IMF, as we all know, is strongly dominated by a few developed industrial countries.

The German Proposal

The proposal by the Government of the Federal Republic of Germany, advanced somewhat vigorously in the past one year or so, is also addressed to shortfalls in commodity export earnings of non-oil exporting developing countries. However, it is a far more cautious proposal and differs from the Swedish proposal in the following principal respects:

- (1) while the Swedish proposal seeks to cover all primary commodities other than fuels, the German proposal draws up a list of 25 commodities which includes 17 out of 18 commodities in the UNCTAD list, but excludes a number of commodities in the STABEX list;

- (2) while both the proposals seek the calculation of a net shortfall in commodity export earnings on the basis of a formula, and do not envisage resort to judgemental determination, the German proposal is content with a calculation in nominal terms, on the basis of the present IMF formula of the average of five years, centering on the shortfall year;
- (3) the German proposal attempts to restrain compensation claims by requiring that a net shortfall of a country must exceed 7.5 per cent of its average export earnings (2.5 per cent for the poorest countries) to qualify for compensation; thus only shortfalls above the threshold level will be compensated;
- (4) at the same time, the German proposal speaks in terms of a ceiling of \$5 billion over a ten-year period, though it is not quite clear whether the proposed ceiling applies to the gross amount payable over a 10 year period or the fund is conceived as revolving in nature so that the gross amount payable over a 10 year period could be much larger;
- (5) while the German proposal also speaks in terms of compensation loans of longer maturities and of interest rates significantly below the market rates with special treatment of the poorest countries, the Swedish proposal is more explicit in this regard; and

- (6) like the Swedish proposal, the German proposal also relies on both contributions and borrowing from the capital market, but without laying down the proportions in which funds from these two sources may be raised.

As can be seen, the German proposal anticipates that the compensatory financing arrangements envisaged therein will be met by a fund of \$5 billion, over a period of next ten years. This estimate has to be viewed, however, in the light of the fact that though compensation payments in 1976 out of CFF and STABEX, together, added up to some SDR 2.5 billion, they did not provide to the non oil developing countries a total cover of more than 13 against their shortfalls. According to the UNCTAD secretariat's calculations, shortfalls in just two years, 1975 and 1976, added up to over \$45 billion for 74 non-oil developing countries. (The shortfall estimate for 1976, referred to earlier in this paper, related only to countries which actually drew on the CFF in one or the other of the years of the existence of the facility.) Nevertheless, since these calculations relate to total export earnings, it is certainly possible to argue that shortfalls with respect to primary commodity exports may be significantly lower than \$45 billion. The point still remains that given the financial ceiling of the German proposal, its benefits may

turn out to be extremely limited and therefore inadequate, even to cover all such claims to compensation as pass threshold tests suggested on the ST-BEX pattern.

The Swedish proposal, by comparison, has certainly much more to be said in its favour because (a) it concedes the case for measuring shortfalls in real terms, though only the basis of a moving average, so that at least payment of compensation is better timed than in the past, (b) it seeks to compensate shortfalls without any conditionality and without any thresholds to cross and (c) its terms of payments are more liberal. But with the sums left unstated, the uncertainty as to the proportion of shortfalls which will be covered under this proposal, remains.

Concluding Observations

The great drawback of the present IMF and EEC facilities resides, in my opinion, in their gross inadequacy in relation to the shortfalls the non-oil developing countries experience in their export earnings. If the new schemes also suffer from that very major drawback, the choice between the old and the new virtually boils down to one between tweedledum and tweedledee. Even if a new scheme is intended to supplement the existing facilities like CFF and ST-BEX, the total cover the non oil developing countries may thus secure against their

shortfalls may still not add up to more than 25% on an average. The compensation coverage of their export shortfalls will thus remain unsatisfactory. In the circumstances, the issues such as whether the shortfall thus covered is measured in real or nominal terms, whether the trend for determining the reference value is measured on the basis of an adequate number of observations, whether the compensation against shortfall becomes payable more readily than before or whether repayments are more closely related to the repaying capacity of the concerned countries are, in my judgement, of a lower order of importance. First and foremost, the task of the international community should be to provide for funds that can ensure a reasonably adequate cover against export shortfalls of the non-oil developing countries.

In the light of foregoing assessment, will it not be a bold man who asserts that compensatory financing arrangements, existing already and additional ones, are anywhere close to the point where they would make a major impact in stabilizing commodity export earnings of the non-oil developing countries and thereby play a significant role in ushering in a new international economic order?

Table Export Shortfalls and Compensatory Drawings allowed
by IMF, 1966-1976

	SDR Million					
	1966 to 1975			1976		
	Estimated shortfall	Drawings permitted	Percent cover provided %	Estimated shortfall	Drawings permitted	Percent cover Provided %
All countries	12,312	1,140	9.3	25,990	2,399	9.3
Developed countries	213	125	58.7	81	824	1017.0
Developing countries	10,099	1,015	10.1	25,909	1,575	6.1
Non-Oil Developing countries	8,264	998	12.1	12,438	1,575	12.7

Notes: 1. Information given here relates to only those member countries of the IMF which actually drew on the CFF. Thus while the shortfall experienced by the non-oil developing countries according to this table, works out to \$12.4 billion in 1976, the total shortfall in export earnings by 74 non-oil developing countries is estimated by UNCTAD to be almost twice as high.

2. The shortfall estimates shown here have been worked out by UNCTAD Secretariat according to the formula used by IMF for the purpose since the beginning of 1976. It must be added however that, in actual practice, the IMF has resorted much more often to a judgemental estimate, to determine the entitlement of countries to CFF drawings and this has almost always gone against the developing countries. Interestingly, the developed primary producers could, in 1976, have drawn 10 times more than their formula shortfall precisely because of the resort to judgemental determination, which went in their favour. Of course, since entitlement to a CFF drawing depended not only on the estimated shortfall but also on the country's quota and its outstanding CFF drawings, the IMF possibly used judgemental determination mainly to bring the estimate of shortfall closer to what a country could have drawn from this facility. This presumption is born out by the fact that as a proportion of their judgemental shortfalls, drawings of the non-oil developing countries are reported by the IMF to work out to about 40%. But this only goes to show that for the non-oil developing countries, judgemental shortfalls have tended to be around one third of the formula shortfalls.

SOURCE: UNCTAD Document no TD/B/C.3/152 of October 4, 1978.