Overseas Development Institute *

10-11 Percy Street London W1P OJB
Tel: 01-580 7683

Briefing Paper

No 1 1979
March

COMPENSATORY FINANCE TO STABILISE EXPORT EARNINGS

Introduction

Developing countries (ldcs) vary considerably in the degree to which their economies depend upon international trade and finance, but for very few is it insignificant, and many rely upon external economic transactions to an important extent. Although the same can be said of developed countries (dcs), there are important differences. First, a number of ldcs are very poor, and thus the burden of adjusting to adverse external change is particularly heavy. Second, in many cases their institutions lack the capacity and flexibility to permit a reasonably quick and efficient adjustment process. Third, many ldcs are heavily dependent upon the export of a few primary products, the prices of which may fluctuate and which in some cases may face declining world demand.

This Briefing Paper deals with the two currently operative schemes designed to compensate for export earnings fluctuations: the IMF's Compensatory Financing Facility (CFF) and the European Communities' Export Earnings Stabilisation Scheme (STABEX). Although they vary considerably in their objectives and scope both schemes seek to provide a guarantee mechanism which can also promote the smooth growth of international trade. However, they are not intended for all types of external economic fluctuations, which for practical purposes may be analysed under three headings:

(1) *General balance of payments instability*. Visible and invisible export earnings plus net capital flows may not cover the cost of current imports. An enforced cut-back on imports may prejudice future economic growth and development. The old established international remedy is the International Monetary Fund (IMF) 'standby arrangement', under which loans are provided to IMF members. The drawing country has to undertake to pursue satisfactory corrective measures (usually deflationary) as a condition of receiving the loan. The facility is used by both dcs and ldcs.

(2) *Commodity price instability*. Balance of payments deficits may be due to a fall in world prices for particular exports. Some commodities may be suffering from a continuous and long-term price decline, but often the problem is one of price instability. International price-stabilising commodity agreements which involve both consumers and producers already exist for some individual commodities, and negotiations are at present in progress for the creation of a common fund to finance a number of additional international commodity agreements. ODI Briefing Paper No 4 1978 *Whither the Common Fund?* deals with the relevant issues.

(3) *Export earnings instability*. Stabilising prices does not imply the stabilisation of export earnings. Shortfalls in export earnings may be due to changes in demand in the consuming countries or to supply variations in the producer country, but whichever is the case the threat to the current import capacity of the affected country is the same. Rich consuming nations are more directly responsible for export earnings fluctuations caused by demand changes. They also have an interest in the import capacity of ldcs, not only in cases when the import purchasing power of ldcs falls to a point where their own exports suffer, but also because they have a general interest in stable international trade and in ensuring regular supplies of raw materials, both of which may be threatened by fluctuations in ldc export earnings. International mechanisms can be designed to use resources to benefit producers and consumers alike (and all countries tend to be both, in differing proportions). This is where the CFF and STABEX come in, since they provide an example of one such mechanism. They are guarantee funds which pay out when export earnings decline below a level which is defined by reference either to an average of past years or to what is considered to be a 'normal' trend.

The CFF

A 'mutual insurance scheme' of international compensatory finance was mooted in the UN as early as 1953 for alleviating the temporary export earnings instability of developing countries. The IMF's CFF began in a small way in 1963. During its first three years of operation it made loans worth \$87m. In 1966, the system was liberalised, with the result that total drawings over the period 1966-71 amounted to \$375m. Copper exporting countries availed themselves heavily of the facility, but loans were also made to some developed countries. Later, in 1975, the size and scope of the CFF were extended further, and in one recent year (1976), it lent \$2,700m. Theoretically the CFF could permit annual drawings of up to \$10bn for all countries.

The CFF applies to all countries which are members of the IMF. Use of the facility is now (after the second liberalisation) extended to up to 75% of the member's IMF quota (50% in the first year). Payments are made

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in the form of loans which have to be repaid within five years, but interest and service charges, which total 4.5% in the first year rising to 6% in the fifth (final) year, are far below those prevailing on the commercial money markets.

Claims for CFF drawings are made on the basis of the total visible export earnings shortfall of the member country. The shortfall is assessed against a five-year earnings series centred on the present (shortfall) year, so that the comparison includes actual earnings for two past years plus projections for two future years.[1] Note, however, that if the IMF considers the results of its computations to be unreasonable, it will use estimates based on a 'judgemental forecast'.[2]

Since 1966, amounts drawn under the CFF are separate from and additional to the member's normal IMF drawing rights. But in order to qualify the country not only has to show that the shortfall is largely attributable to circumstances beyond its control, but must also 'be prepared to co-operate with the Fund in finding appropriate solutions for its balance of payments difficulties'.[3] According to IMF rules the funds loaned may not be used for developmental purposes or for forward transactions. The former restriction reflects the division of responsibilities between the IMF and the World Bank, but since CFF loans are made in foreign exchange the drawing countries do have some latitude in deciding how to use them.

STABEX

The STABEX scheme began in 1975, as part of the Lomé Convention, a five-year co-operation agreement between the European Communities (EC) and 46 (now 56) African, Caribbean, and Pacific (ACP) countries. It is therefore a regional scheme, although the ACP 'region' is somewhat bizarre. In addition, it is limited to fluctuations in the earnings of particular products rather than of exports as a whole. Its total resources are limited to maximum out-payments of $400m over the five-year period 1975-80. An annual ceiling for gross disbursements of $80m is envisaged, though up to $100m may be disbursed under exceptional circumstances. So far, $87m is the highest amount disbursed in any one year. STABEX has been described in some EC publications (notably those in French) as being based on insurance principles. This is misleading. Its resources are part (just over ten per cent) of the European Development Fund (EDF) which has earmarked about $4,000m in aid to the ACP countries for the period to 1980. No developed country can benefit from STABEX payments, but since it covers only the 56 ACP countries several of the poorest countries in the world are excluded – for instance those of South Asia. The 29 'least developed' ACP countries are not obliged to repay STABEX payments, but the others must repay their interest-free loans under certain conditions.

STABEX uses export earnings at current prices as a basis for computing shortfalls, and is purely retrospective, being based on the export earnings of the previous four years. Thus it is possible for real commodity earnings to drop considerably in a time of price inflation, without the country becoming eligible for a STABEX payment. Moreover, payments are made not to compensate for total export shortfalls but relate to a specific group of commodities[4] each taken individually. This limitation made some sense in the scheme originally devised by the EC Commission, which would have channelled resources direct to the producers (growers, estates, forest concessionaries etc) as a means of sustaining production. However, this link was lost during the negotiations at Kingston in 1974, when it was agreed at the request of the ACP representatives that payments would be made to governments without any requirement that they be spent on the product in question. The commodities covered are mainly agricultural, but include one mineral (iron ore) and most refer only to exports in their raw form or in the very first stages of processing.

For an individual commodity of a given ACP country to be covered by STABEX, it must account for 7.5% of all that country's merchandise export earnings (5% in the special case of sisal or 2.5% for the least developed, landlocked, or island ACP states – over half of the total number). Further, there is a minimum level of earnings shortfall below which the STABEX payment will not be made. This is fixed at 7.5% for the larger ACP states with a coastline, and 2.5% for the others. Payments are only made to compensate for earnings shortfalls on supplies to the EC, except for a dozen of the poorest ACP countries, for whom exports to all destinations count. Payments are made to governments, whose only obligation is to inform the EC Commission of how the money has been used and, in the case of the richer countries, to repay the principal if and when their earnings in current prices from the commodity in question rise above the average of the previous four years.

Since STABEX is based on individual commodity earnings from exports predominantly to the EC, it involves, despite its lack of formal obligations, the acceptance of some implicit real or potential limitations on the part of the ACP countries. It contains inbuilt disincentives to diversifying export product structure, diversifying markets, and increasing local processing and value added. Although such disincentives are likely to be small in practice, they are worrying in principle.

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1 The standard IMF procedure for estimating future export earnings is complex. It uses the growth of earnings trend over the past six years, weighted towards the years closest to the shortfall year, by applying the following formula, where E_n = export earnings in year n:

$$\frac{1}{2}\sum_{x=1}^{2} E_{n-x}\left(\frac{\sum_{x=1}^{3} E_{n-x}}{\sum_{x=4}^{6} E_{n-x}}\right)$$

2 L.M. Goreux, *IMF Survey*, March 1977, p.66.

3 Cited by M G de Vries, in *The International Monetary Fund, 1966-1971*, Volume II, p.235.

4 *Products covered by STABEX: The original twelve (from 1975 onwards):* Cocoa beans, paste, and butter; coffee beans and extracts; cotton; coconuts, coprah, coconut oil and oil-cake; groundnuts, oil, and oilcakes; palm nuts and oil; tropical wood, roughly sawn or sawn lengthwise but not further processed; bananas; tea; raw sisal; iron ore, concentrates and pyrites; raw hides, skins, and leather.

Seven additions agreed in 1977: Ylang-ylang; gum arabic; vanilla; cloves; pyrethrum; mohair; wool.

The country groupings, important for concessional treatment, are bizarre: Equatorial Guinea is classed as an island, and Togo (according to the World Bank a middle-income country) for EC purposes benefits from the terms offered to the least developed. Because payments are made for individual commodity shortfalls, a state can receive STABEX compensation on one or several of the eligible products while the rest of its exports are booming and while its balance of payments may be enjoying a healthy surplus. Unless rapid reimbursement is required by the EC, STABEX involves a concessional transfer of resources, and to this extent payments must be regarded as aid. Moreover the fund from which STABEX payments are drawn is not additional to, but part of, an aid fund whose resources are otherwise allocated according to developmental criteria. The payments are made in foreign exchange (and reimbursement, where applicable, must be made in the same currency), but the recipient country is allowed (and actively encouraged by the EC) to put them to developmental use.

Comparison of CFF and STABEX

The relative size of the CFF and STABEX can be seen from the table. The principle advantage of STABEX for ldcs – or those that are eligible for it – is that it usually represents concessional assistance. Thus, ACP countries, such as Niger, classed as 'least developed' have availed themselves of STABEX in grant form without requesting CFF credit. But some of the countries which have required the largest CFF drawings, Mexico and Pakistan, are not eligible for STABEX funds, while some of the ACP countries suffering most from export instability, like Zambia, are excluded from the STABEX scheme because their main exports are not covered. ACP countries can and do draw on both STABEX and the CFF, but clearly only the CFF has the resources to provide bridging finance on a scale commensurate with needs. While STABEX gives cheaper finance to its group of countries, the cost of operation is that it reduces the amounts of EC aid available for projects, technical co-operation etc.

So far, only Fiji and Cameroon have had to reimburse STABEX payments. In both cases, repayment had to be made within a year and in Cameroon's case the STABEX loan consequently had a grant element of less than 12%. CFF credits must always be repaid with interest by the fifth year regardless of the balance of payments position of the country concerned.

Compensatory finance drawings from IMF and STABEX, 1975-7 ($m), gross

	1975		1976		1977	
	IMF	STABEX	IMF	STABEX	IMF	STABEX
World total	286	87	2700	41	288	70[a]
ldcs only	181	87	1754	41	198	70[a]

[a]Of which $33m was advance payments for anticipated earnings shortfalls in 1978.

Neither scheme provides complete compensation for export earnings shortfalls. STABEX compensates partially, and only for shortfalls on selected commodities, and the CFF covers only earnings from merchandise exports, ie it excludes invisibles (tourism, transit traffic, migrants' remittances). It should be noted in this context that in some Caribbean and Indian Ocean countries, tourism is the main source of foreign exchange earnings, and that there are others in which migrants' remittances are of major importance.

Ideally, compensation should not be assessed in relation to current prices alone but should take account of inflation. Neither of the existing schemes fully measures up to this ideal. Compensation under STABEX is assessed only by reference to the earnings of past years. The CFF is better, even though it does not take inflation into account explicitly, since the extent of the shortfall is calculated by reference to both past and estimated future earnings.

On account of the severely limited size of its resources, STABEX is more prone than the CFF to the requirement to ration its payments, and so has operated rather arbitrarily on several occasions.

Future prospects

While the CFF scheme operates smoothly on a substantial scale, the much smaller STABEX scheme has stolen much of the limelight at the current renegotiations of the Lomé Convention, because:

(1) STABEX has been portrayed as an important innovation in the Lomé Convention compared with its Yaoundé predecessors.

(2) ACP countries expect the EC to agree to few major concessions in the successor to Lomé in the fields of aid and trade preferences. They would like to restore the real value per head of Community aid to 1975 levels and at least to maintain the terms of their access to Community markets. But on STABEX they expect to advance.

(3) STABEX was declared by the EC to be an experimental scheme. It has had teething troubles and provoked disputes. Experiments provide an opportunity for practical improvement, one suggestion for which is that STABEX might become a world-wide scheme. This would imply either the EC or rich countries as a whole offering concessionary but commodity-linked compensatory finance to cover the export risks of all developing countries.

(4) One European head of government, Chancellor Schmidt, has proposed that minerals – copper specifically – ought to be included in a new STABEX, but this is not the view of the EC Commission, nor of some of the other Member States.

The ACP countries are now campaigning for a 'globalised' STABEX, meaning that it should encompass all their export products (ideally invisible exports too) to all destinations, not just the EC. If a revised STABEX scheme conformed to these conditions, there would no longer be any sense in having payments linked to earnings shortfalls on individual commodities rather than on exports as a whole. But such a scheme already exists: the CFF. Moreover it covers not only exports to all destinations, but offers finance to all countries in the IMF, not merely the ACP countries. If the ACP countries want to develop STABEX therefore (eg because of its higher element of concessionality) will they campaign for its 'globalisation' in the fullest sense – that of covering exports from all ldcs, ACP, and non-associates alike? The average annual cost of such a scheme has been estimated at up to $2bn[5]. It is highly unlikely that the EC would be ready to provide this over and above its normal development assistance programmes. The implementation of a fully global scheme, therefore, would imply a complete policy reversal with respect to the EC's aid instruments, which are currently and traditionally heavily focused on project aid. Moreover, a defining characteristic of the Lomé Convention is precisely that it is limited to a specific number of ldcs.

A fully global STABEX is therefore most unlikely to be implemented by the EC in the foreseeable future. It is probable, however, that it will continue to operate in the ACP countries in a modified form.[6] Some products may be added. In particular copper (the inclusion of which in 1975 would have exhausted STABEX resources very rapidly) may be grouped with iron ore and some other minerals in a separate STABEX scheme which gives the EC more discretion over allowing a payment and determining the use to which it is put. More processed products may be allowed, and some invisibles, such as tourism (but not migrants' remittances), may be included. More of the poorer countries may be allowed to count their exports to all destinations. But the EC would be loth to compensate on a large scale in respect of other countries' export earnings shortfalls on other markets, and it has already declared its unwillingness to index payments.

The STABEX fund will probably be larger in real terms and its finance may be separate from the fund for development assistance. But there seems little doubt that more for STABEX will mean less for mainstream development assistance for projects and technical co-operation in the ACP countries. Unless the latter participate financially in a revised scheme after 1980 (other than by their loan repayments) it will continue to be a hybrid, using an aid resource for trade needs. A concessionally financed export earnings compensation scheme will remain an arguable way of allocating aid funds, and while it remains region- and product-based, it will continue to offer incentives (albeit mild) which may distort rather than stimulate world production and trade.

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[5] Estimate (at 1974 prices) of the annual average net cost of currently operating a STABEX-type grant/conditional loan scheme, bereft of the dependence and trigger thresholds, covering all the commodities and semi-processed products of interest to ldcs, with shortfalls calculated in terms of real purchasing power and with transfers available to all ldcs. See J D A Cuddy: 'Compensatory Finance in the North-South Dialogue', *Journal of World Trade Law*, Volume 13, No.1, Jan/Feb 1979, p.76.

[6] One other possibility is that Japan may initiate a STABEX-type scheme to cover its regional import trade from the ASEAN developing countries of the Far East.

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