

# Compensatory Finance

## Options for tackling the commodity price problem

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This report has been written in a personal capacity. The views and opinions expressed herein do not necessarily reflect the positions of the author's organization.

### **Tackling Commodity Price Volatility**

This paper is published as part of a larger project, sponsored by the Norwegian Government, on policy options to tackle the problem of commodity price volatility. More research and papers can be found at <http://www.iisd.org/markets/policy/price.asp>

## Summary

Compensatory finance schemes were in vogue in the 1970s because this was a (fairly brief) period of commodity power; rather than being a permanent adjustment mechanism in a globally Keynesian economy, they were used by industrialized countries as a calming mechanism and an antidote to a Common Fund which threatened over-regulation of commodity markets: essentially a political response rather than a stabilization fixture.

The paper reviews in detail the IMF's Compensatory Financing Facility and the EU's STABEX scheme, and their variants, highlighting their strengths and weaknesses. Both of the main schemes petered out in the 1990s. By then they were only missed for their aid allocation function, rather than for the producer support or insurance function which had been their claimed purposes. They never shrugged off the tendency to be pro- rather than counter-cyclical.

Various efforts at broadening, globalizing or updating them have not proceeded because the donors who effectively ran the schemes nowadays prefer interventions like direct budget support or the use of modern communications to improve market intelligence. Nevertheless, when the World Bank and the OECD donors pressed ahead with debt relief, it still found that commodity earnings instability was one of the reasons for their HIPC clients missing their targets. Moreover, with a shift back to commodity production in state hands and sovereign wealth funds investing globally in commodities, and given the more recent security and sustainability concerns, this could be the time to make the case for international public funding of a global stabilization-via-compensation mechanism again.

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## Acronyms

ACP	African, Caribbean and Pacific
CFF	Compensatory Financing Facility (of the International Monetary Fund)
EDF	European Development Fund
EEC	European Economic Community
EPA	Economic Partnership Agreement
FLEX	Fluctuations in Export Earnings program
HIPC	Highly Indebted Poor Country
IDA	International Development Association (of the World Bank)
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
PRGF	Poverty Reduction and Growth Facility
STABEX	Stabilisation des recettes d'exportation
TIM	Trade Integration Mechanism
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

## **1. Overview: The theory and structure of compensatory finance mechanisms**

If commodity export earnings revenue instability is deemed to be, and to continue to be, a pressing issue for developing countries, especially the poorest and least developed among them, international compensatory finance could supply a means of addressing their problem. Existing, defunct and potential new innovative mechanisms of compensatory finance could provide a half-way house between direct intervention in commodity markets (no longer overtly politically acceptable) and the more brutal laissez-faire systems of allowing markets to do their work in establishing prices with all the unforeseen fluctuations that that entails, by smoothing out revenue flows over a shorter term, possibly near-instantaneously, and ideally in anticipation of actual fluctuations. This smoothing can be applied at the level of countries' balance-of-payments, through state accounts, or it could, in more sophisticated or interventionist mechanisms, be directed at smoothing out the revenues of producers. In future it might even be directed at new sources of revenue instability, relating to environmental, security-associated or just basic distributional concerns in a post-Millennium Development Goal world after 2015.

But let there be no doubt: the existing systems of compensatory finance at the international or regional level have fallen seriously out of fashion in the twenty-first century. They had their heyday in the 1970s and 1980s—paradoxically in an era when commodity power was concentrated in the hands of a relatively tight group of what were then poor developing countries. By the end of the 1970s, the escalating price of oil triggered by the OPEC oil crisis of the early 1970s had led to a secular shift in incomes, at least for petroleum exporters. Compensatory finance was one of the more prominent responses on the part of the rich countries, as much to wield donor power and defuse the crisis as to establish permanent stabilizers against income fluctuations for poor countries.

Until then, however, commodity dependence by post-colonial developing countries had been deemed a serious impediment to their development, because as price-takers, they could not influence global markets and had to suffer unforeseen fluctuations in revenues with limited means of adjustment at their disposal. Industrialization was then firmly the common aim of development, not only because this was deemed to increase opportunities for incremental growth in both domestic and export markets, but because the more differentiated forms of manufactured products offered the prospect of not only more stable and less fluctuating world prices, but also price increases and better returns in comparison to those of raw commodities (the Prebisch-Singer hypothesis of the long-term decline of commodity prices in relation to manufactures had been advanced as early as 1950, though it was not formally accepted by the International Monetary Fund until the early 1990s).

For half a century, while OECD industrialized countries with prominent commodity sectors like Canada, Australia and the U.S. enjoyed steady growth, developing countries without an industrial sector suffered from the earnings fluctuations of their commodity export sectors. With the commodification of many basic manufactures on the one hand and developments in branding and product differentiation in tropical beverages and some food commodities on the other, plus the possible crossover from agricultural food crops into biofuels, and the lure of services trade, it may soon be time to revise this theory (see below). But so far, and

certainly in the 1970s and 1980s heyday of compensatory finance, developing countries were felt to suffer from their (largely inherited) dependence on a narrow range of commodities and the income fluctuations which resulted from their exports. Their failure to adjust adequately helped cause the debt crisis of the late 1980s and early 1990s, and led to the recourse to larger international measures than just international compensatory finance, such as the Highly Indebted Poor Country (HIPC) and Enhanced HIPC debt relief programs. However Asian countries that industrialized rapidly, and Latin American countries that strengthened their existing industrial bases, mostly avoided HIPC, though they too confronted financial crises in the 1990s (especially 1997). Whether compensatory finance is still useful in a post-HIPC world is a matter to be addressed at the end of the paper. It cannot be said, however, to be in high demand politically, since it rarely figures prominently in trade or economic cooperation negotiations nowadays even though the donor-supplied facilities to activate it (Aid-for-Trade funding or direct budget support) are much more available than in the past. Nevertheless, dependence on commodity production and exports and uncertainties arising from the fluctuating revenues that occur from these for both governments and producers remain the nub of the problem for many African and Pacific countries and a few other least-developed countries.

We start by considering the theory of international compensatory finance to see whether it remains appropriate to today's circumstances and then examine the structures of the compensatory finance mechanisms which have been put in place and adopted over the years.

### **1.1 The Compensatory Financing Facility of the IMF**

That the first formal system of compensatory finance was established by the International Monetary Fund in 1963 ought to be a strong enough indication that compensatory finance has always been intended as a counter-cyclical, market-friendly stabilizer and, therefore, a means of avoiding interfering in commodity market mechanisms. True, the Compensatory Financing Facility (CFF) was urged onto the IMF by United Nations experts and intergovernmental groups, and it preceded (only by a year) the first UNCTAD conference—as well as the era of brief commodity power by a decade—but the fact that it was lodged within the Bretton Woods system meant that it would remain essentially a financial stabilizer addressed at governments and central banks, and not interfering directly with producers and markets. The IMF had itself noted the adverse effects of the drastic commodity price declines after the Korean War boom which translated into instability in foreign exchange earnings of developing countries. In those days, this was not deemed primarily an African problem—the shortfalls affected a wide range of developing countries and were deemed to be a threat not just to their rapid economic development, but to the strength of world demand and also to the stability of the world financial system. Some of the original motivation for the CFF seems surprisingly modern, including reference to mutual insurance schemes whereby compensatory payments would be made out of an appropriate fund to governments whose countries were experiencing unjust, unfair and inequitable terms of trade.

However, the CFF was not a donor scheme. Borrowing countries were charged interest (although, in its earlier years, they were not subjected to other conditionalities) and had to repay principal, and the aim, as in core Fund programs, was for the scheme to be self-

financing. Above all, it was designed to be counter-cyclical. Member states were allowed to draw on the facility so long as three conditions were met:

- a) an export shortfall had to be short-term in nature and caused by circumstances largely beyond the country's control;
- b) the member had to establish that it had a balance-of-payments need for financial support; and
- c) the Member State had to be willing to cooperate with the Fund in finding, where required, appropriate solutions for its balance-of-payments problems.

It is to be noted that nowhere in the criteria are individual commodity production or export performance mentioned. The CFF remained a purely financial (and balance-of-payments) mechanism even when members were allowed to draw also on the basis of the excess cost of cereals imports (from 1981). In fact as a straightforward financial mechanism the CFF operated well for its first twenty years of existence. Access limits to borrowing member countries were enlarged from an initial 25 per cent of quota progressively to 100 per cent by 1979 (the last increase being partly as a response to the second oil shock).

However, the seeds of its demise are included in condition (c) above. In practice, for 20 years, countries drawing up to 50 per cent of their quota under the CFF were not required to discuss (i.e., agree on a government letter of intent committing themselves to implementing) specific policies remedying their balance-of-payments problem. The requirement “to cooperate” remained a loose gentlemen's agreement. After the cranking-up of all Fund conditionalities in 1983, however, the CFF was not excluded. From then on, all CFF drawings became conditional on the members being ready to receive a Fund mission and adopt the balance-of-payments remedies deemed appropriate.

Even though, in 1988, the CFF was revamped and enlarged in scope into the Compensatory and Contingency Financing Facility, in reality it had become just a lower-order IMF balance-of-payments support program, fully integrated into the Fund's centralized system of conditionality. Because of delays in disbursement which these policies required, it had ceased to operate counter-cyclically (and may on occasion have even operated pro-cyclically). When the interest charged increased in the 1990s, developing countries effectively abandoned the scheme. In recent years, neither they nor the Fund have shown any great interest in reviving it, although the incoming Managing Director, Dominique Strauss-Kahn, in October 2007 offered a new vision for the Fund to “deal with external financial shocks and bring assistance if needed” as well as giving priority to developing countries in its operations (if not on its board).

Thus, the Compensatory Financing Facility, in its original form, scores well in terms of satisfying the theoretical need for a counter-cyclical support mechanism. It retains features of mutual insurance, at an intergovernmental level. While it is probably not entirely self-financing, it does not need the involvement of bilateral donors; at its peak in 1983, it disbursed US\$2.3 billion. It leaves governments to determine—again, at least in its original form—the extent to which they pass on stabilization funds to the producers which—with other agents—suffer the earnings shortfall, just as they remain empowered to collect additional taxes from positive windfalls. It was never explicitly involved in commodity policy, even over petroleum. Its theoretical strengths, however, were undermined when the

developed country members which control the Fund gave priority, in the last decade of the Cold War, to imposing the Washington Consensus over maintaining a modest, fairly autonomous facility, which could mitigate external shocks. It has hardly been used in the twenty-first century, but could be due for a revival unless displaced by a newer Exogenous Shocks Facility or Trade Integration Mechanism (neither of which has the same theoretical elegance).

STABEX was devised a decade later in different circumstances by the EU in the 1973–75 period when the African, Caribbean and Pacific Group came into being and the Lomé Convention was being negotiated between them. With its offshoots, modifications and successors (SYSMIN, COMPEX and FLEX) it has lasted for a quarter of a century, and one of its successors still enjoys a half-life, though far removed from the original model.

## 1.2 The STABEX system

STABEX is not, strictly speaking, an international compensatory finance scheme. However it is, nominally, a scheme for stabilizing export earnings of some countries, and it does embody many of the characteristics of compensatory finance. In fact, it was sold politically to the ACP countries by the then European Commissioner for Development, Claude Cheysson, as an insurance scheme guaranteeing them both against falls in world prices of their commodities and against decreases in local production even if occasioned by the weather and acts of God, for which the EC would pay the premium. It seemed too good to be true (and it was—but the EU got high marks and political kudos for innovation).

The circumstances in which STABEX came into being were the following. 1973–75 were the heady years of commodity power. OPEC exercised its muscle as a commodity cartel for the first time and quadrupled petroleum prices. There was revolution brewing in Iran. There were fears from users of intermediate products that a phosphates cartel might also become effective, to be followed by others—soft as well as hard commodities. Sugar shortages became suddenly so acute that the refined product was not reaching consumers in some key markets, such as the U.K. Prominent non-economists of the “Limits to Growth” school (the so-called Club of Rome) argued that raw materials were being used up faster than they could be exploited or discovered, and predicted an end to economic growth (and a need for radical changes in lifestyles, at least in rich countries). Meanwhile, the European Economic Community (EEC) was embarking for the first time on what was to prove to be its most successful policy—enlargement. The United Kingdom acceded in 1973, together with Denmark and the Republic of Ireland, and the EEC grew from six to nine Member States. (The EEC later became the European Community and then the European Union, and underwent successive enlargements to its present 27 Member States). Such a historic combination of circumstances is unlikely to repeat itself, although there are bound to be other combinations of circumstances which induce and produce major shocks.

Moreover, Britain arrived in a Europe (which I shall anachronistically call for shorthand here the EU) with substantial baggage in terms of its links with and obligations towards developing countries, especially those of its former colonies which had recently become independent. Those in Asia were rather unceremoniously dumped on grounds of being too large, too competitive or too poor for France and the other five original Member States to



cope with, given their existing association arrangements in the developing world, essentially with Africa under Part IV of the 1957 Treaty of Rome. These former excluded countries mostly prospered and either avoided or grew out of aid-dependency, establishing good relations with the EU. The rest, in Sub-Saharan Africa, the Caribbean and the Pacific islands were deemed eligible for a regime of special trade preferences with the EU matched by an additional aid program provided by an off-budget vehicle called the European Development Fund. They joined the former African colonies of France and some other Member States to form a new grouping, the ACP group, initially of 46 countries, and were offered a new five-year, renewable, convention with the EU signed in Lomé which no longer imposed a reciprocal trade obligation on them in terms of having to offer tariff preferences back to Europe: this arrangement endured 32 years. Additionally, those countries which from colonial times had remained economically dependent on cane sugar exports under the Commonwealth Sugar Agreement were offered a special continuation arrangement of unlimited duration obliging them to deliver fixed amounts of sugar to Europe, in practice to Tate & Lyle for refining. In exchange for the 1.3 million tonnes in question, they were offered guaranteed quasi-European-level prices regardless of the world market price. This arrangement, the Sugar Protocol, which was separate from, though appended to the Lomé Conventions (and the later Cotonou Agreement) was for its 18 beneficiaries by far the most lucrative element in the entire EU-ACP relationship (although it can also be argued that the subsidies fossilized production and export patterns and hindered development). The Sugar Protocol was unilaterally denounced by the EU in September 2007, and when its forced expiry occurs in 2009 it will have lasted 34 years.

STABEX, the EU's system for stabilizing export earnings for the ACP states, was included in the new package of measures in the Lomé Convention, operated from its very first year of application (1975) and continued, in practice, for a quarter of a century, with modifications and derivatives. The foregoing history serves to explain why a novel compensatory finance and export earnings-smoothing scheme which also gave encouragement to producers to maintain supply might have proved both fashionable and attractive (especially as it appeared to be free, or virtually free, to the ACP users). But it has been set out at length also to explain the politics of the invention of the scheme. On the one hand, it was Europe's early projection of "soft power" to counter the threat of commodity cartels. It was also used within the United Nations and allied fora as an explicit response to, and deflector of, the drive to create a Common Fund to finance market intervention under commodity agreements and for an integrated program of commodity regulation, both of which were then gaining momentum.

Second, internally within the EU, STABEX was regarded by France and the original six EEC Member States with interests in Africa as a *quid pro quo* for conceding the Sugar Protocol to Britain (and so to the Caribbean ACP states, plus Mauritius and Fiji). It was thus designed in such a way as to ensure benefits flowed, at least initially, to francophone non-sugar commodity producers in Africa—necessity being the mother of invention in this case, too. And third, unlike the CFF and unlike any self-financing trade stabilization arrangements or commercial insurance schemes, STABEX was funded out of the EU's aid allocation to the ACP states, the European Development Fund. This meant that whatever the ACP drew down as STABEX compensation, they did not receive as project or program aid (or indeed as other forms of balance-of-payments support) as there was an agreed EDF aid fund renewed every five years, with fixed limits. This became fully the case when, early on in the

history of the scheme, the EU abolished the obligation for the richer STABEX beneficiaries to reimburse if their commodity markets recovered.

STABEX, then, is and has been a system for transferring aid funds to eligible ACP states which can show they have suffered a loss or a shortfall on their normal pattern of exports to the EU. It has a number of distinctive features. Shortfalls are established on the basis of individual commodities, and claims for STABEX payments made on this basis: they are not cumulative (but nor are they offset by a commodity boom elsewhere). Thus, transfers can be deemed gross, whereas the CFF is paid net. Eligible commodities are only agricultural, making the scheme only slightly redolent of the Common Agricultural Policy, although for the first five years iron ore was allowed in as an anomaly, in a concession to the Mauritanian negotiator, and on the strange grounds that the mine was state-owned. The affected commodity export is, or at least was, effectively only the trigger. In the early form of STABEX, it sufficed to establish an arithmetic shortfall in earnings against a previous four-year average, to make the claim. Once approved, the amount of the claim was paid direct from the EU to the government without strings. Because the government did not, in the earliest STABEX guise, have to retain the money in the affected sector or compensate the affected producers or traders, it could logically be used for diversification—including out of commodity trade altogether. However, conditions were increasingly applied by the EU which affected the purity of this approach. This also meant that STABEX payments could no longer be used as balance-of-payments support (as under the IMF scheme) or, eventually (when the use of the funds effectively became projectized) as direct budget support when this became fashionable among donors in the 1990s. Still, the romantic notion of STABEX funds supporting small farmers in distress was an important selling point of the scheme, even if the reality was different.

Another distinctive feature was that STABEX was a purely regional scheme, operating for the ACP states alone and on their exports to the EU only (except for a few exceptional least developed countries which were permitted to count export earnings fluctuations to “all destinations”). When pressed on this, the EU challenged other donors and major traders to set up and fund their own schemes, and UNCTAD conducted numerous studies, some with this author, on how to globalize STABEX, without any firm result. The EU did briefly offer a non-ACP scheme, called COMPEX, to a few residual least-developed countries (e.g., Haiti before ACP accession, Nepal and Bangladesh), but this was not a success, was not analogous with STABEX and was quickly discontinued. Similarly, the EU initiated a scheme for ACP mineral exporters called SYSMIN after the 1978 Shaba invasion when the then Zaire’s (now the Democratic Republic of Congo) copper province again threatened to secede. This, too, was posited on the circumstances of the mining industries of ACP states being state-owned (the logic of the EU funding Rio Tinto’s or BHP’s occasional losses not bearing scrutiny) but SYSMIN too collapsed early on under the weight of its own contradictions, and can never really be said to have operated successfully: either as a form of balance-of-payments compensation or as an export earnings stabilization scheme.

Lastly, apart from the anomalous period at the beginning of the STABEX when a few of the richer ACP countries were eligible to repay their STABEX transfers if the market recovered (they were very rarely forced to do so even when the conditions were met and when the requirement was cancelled their loans outstanding were cancelled too), STABEX has operated throughout as a grant-based aid allocation scheme (not as a revolving fund). It must

be said that, as a system of rapid aid allocation and disbursement with, initially, low conditionality (rather than a scheme of counter-cyclical export earnings smoothing), it was the jewel in the EU's crown, disbursing aid much faster than any of the other Lomé/Cotonou aid instruments, and the one, with the Sugar Protocol, most valued and sought-after by the ACP states themselves (not all were eligible, though the EU strove to broaden the list of eligible commodities and the number of claiming ACP countries, so as to be politically inclusive). STABEX was also faster-disbursing than many of the aid schemes and programs of other donors, including bilateral donors who were also EU Member States, though this engendered less envy than suspicion at the rapid but sometimes purposeless disbursements in question and finally hastened the scheme's demise—for even a fairly rapidly disbursing system with fast moving mixed commodity markets could still prove unfortunately pro-cyclical. STABEX was succeeded under Cotonou (from 2000) with a system called FLEX, the Fluctuations in Export Earnings program, similarly funded, but this no longer had individual commodities nor commodities as a whole at its heart, and so appeared more as a minor latter-day CFF on easy terms to give balance-of-payments support using, as ever, grant aid. It has basic eligibility criteria related to demonstrated export earnings shortfalls *or* public spending deficits, but is not taken seriously as a compensatory finance scheme and may not be continued under the Economic Partnership Agreements which will succeed the Cotonou Agreement.

## **2. Strengths and Weaknesses of Compensatory Finance Mechanisms**

The most obvious weakness of the IMF's CFF scheme and the EU's STABEX is that neither operates nor has any effect on commodity markets nowadays.

They both had quite a long innings, however. STABEX lasted for a quarter of a century: it was the EU's 1996 Green Paper on reforming the relationship of special, unreciprocated preferences for the ACP, including the commodity protocols on bananas, sugar, etc., and the political will of its Member States towards the World Trade Organization (WTO) which pulled the rug from under compensatory finance of the STABEX form, not the availability of funds nor the effectiveness of the mechanisms itself (which lived on in shadowy form with FLEX). The IMF CFF scheme lasted longer, in practice over thirty years until the 1990s, until its attractions were for developing countries sidelined by conditionality and alternative sources of relief for debts, often built up during commodity shortfalls and booms. These are durable achievements for mechanisms which started merely as theoretical constructs backed by public funding, but in comparison with donor funds such as the International Development Association (IDA) and the European Development Fund (EDF), they died as mere striplings: 2007 is the 50<sup>th</sup> anniversary of the EDF (itself slightly older than the World Bank's IDA). Thus, we can conclude early that formula changes (which were tried) were not as important as the aid-conditionality which determined the freedom of operation of compensatory finance schemes, and eventually hastened their demise. In a better international development climate, new versions of the schemes could still be devised and funded with the newly abundant Aid-for-Trade allocations from donors which, as leading trade partners, feel guilty about the lack of progress of the WTO Doha "Development" Round.

Both schemes, then, had strengths in delivering aid, especially in their earlier incarnations before they were hedged around with increased conditionalities. The CFF functioned as a form of balance-of-payments support, while STABEX acted more as budget support. Both acted directly on governments and on public finances, without intervening in commodity market trade or directly influencing producers. But can they be said to have helped manage volatile commodity revenues? And were they taken seriously as trade policy?

The benchmarks here might be, say, on the one hand the EU's Sugar Protocol itself, which intervened directly in the world sugar market, and gave a few of the dozen targeted cane-dependent economies enough of a breathing space to develop out of their commodity dependence, with Mauritius, Barbados, and Trinidad and Tobago being the most striking examples; or the diamond cartel run for 30 years by de Beers so effectively that it was deemed to be an outlaw trust in the U.S., yet it helped Botswana to graduate from a basket case on independence to one of Africa's best managed countries today. In fact, if assistance to small farmers producing *inter alia* export crops were the main target of schemes managing volatile commodity revenues, one might make the Grameen Bank the benchmark for delivering support to producers, in its case through microcredit.

There was no pretence that the CFF was a trade-smoothing scheme; in practice it supplied financial support, at cost, to the balance-of-payments by targeting movements from a trend in merchandise exports. Later on this was extended to food imports (excess cereal import costs) and, in 1981, to cover fluctuations in tourism and migrant remittances, both well beyond merchandise exports for some countries and, nowadays, more important flows than development aid itself. The scheme was revised in 2000 but by then had become overtly adjustment-related (and expensive for developing countries). Its trade and commodity elements were taken over in minor ways by the IMF's Exogenous Shocks Facility to deal with such contingencies, and then even more recently by its Trade Integration Mechanism (TIM), a policy-lending facility targeting overall revenue losses, on which Bangladesh, the Dominican Republic and Madagascar have drawn in recent years.

Experience with STABEX is more mixed. In its first five years of operation it paid out directly to claiming governments, imposing few obligations on how they used their funds. That it tended to go to West African francophone countries in the CFA Franc zone which needed to bolster their under-performing groundnut sectors (such as Senegal) was a way of buying time—but it did little for groundnut farmers in the longer term. Later on, small countries with a range of STABEX-eligible products like the Comoro Islands were able to play the system (especially with bush crops giving variable yields) so that they attracted STABEX payments every year, even as their overall economy declined, without any incentive towards restructuring and diversification. The government of Solomon Islands even became dependent on STABEX inflows to fund its budget deficits—and the problems became serious when the EU built up a backlog of undisbursed STABEX payments when new conditions on use were imposed. There was however never an agreed EU-ACP policy on what STABEX transfers were targeting. ACP governments preferred to maintain their freedom to use public funds to finance diversification; even when they conceded, under pressure, to reinvest the revenues in the affected sector, they would usually remain at the level of national stabilization funds (and sometimes never leave the Central Bank) rather than being spent additionally on farmers to upgrade productivity. As we have already cited, the instances where SYSMIN funds could only be used by the mining sector if it were still in

state hands. The figures cited on actual STABEX use are not very reliable, but they may be indicative of orders of magnitude. About one-quarter of transfers was said to be channelled to producers of the raw commodity (more so in the later years of STABEX when it became heavily conditioned on being a further form of project aid) and rather less than that for diversification. On the other hand, well over one-third was channelled through (and often to) national commodity boards and *Caisses de Stabilisation*—bodies which have mostly nowadays been abolished owing to their inefficiency or past history of venality.

So long as the sector is in long-term decline and confronting permanent changes of income rather than just fluctuations it would seem unwise to argue against diversification as the main use of the funds after the balance-of-payments effect has been met. This is especially the case if the country's economy is heavily dependent, as was often the case in Sub-Saharan Africa's commodity trade with Europe. But because STABEX failed to distinguish between forms of market intelligence failure—short-term fluctuations in earnings—and fundamental, even secular, decline, the scheme fudged the issue and proceeded (in an often very inefficient way) to subsidize or reward failure. It hardly ever achieved the romantic notion of putting resources in the hands of farmers when they were suffering from bad weather or unfavourable world prices. Modern forms of communication such as cell phones supplying market intelligence do that much more effectively nowadays.

Lastly, STABEX never became a self-financing scheme. In fact it went in the other direction, eliminating its loan element and wiping clean the debt of the few eligible ACP countries early on. This condemned it to being essentially an aid allocation mechanism with a trade-based trigger. It also meant that when Member State governments turned against it, as they did in the 1990s, they would simply turn off the tap. STABEX and its successor no longer feature in the EPA negotiations which conclude in December 2007, even though the trade reciprocity element will leave many ACP countries fiscally vulnerable. For instance, tariff income is 75 per cent of government revenue in the case of Guinea; for Lesotho tariff revenues (notably under the SACU arrangements) represent 33 per cent of GDP. This is in strong contrast to the OECD countries which have eliminated their reliance on trade taxes which constitute an average 0.37 per cent share of GDP.

There could still be scope for smoothing measures to facilitate the transition to lower dependence on trade taxes. The Ivory Coast could be a warning beacon, for it was rapid fiscal restructuring which helped promote the collapse of the country into northern and southern factions. However, the direction of travel is clear. Both European Commissioners (Peter Mandelson and Louis Michel) signed an open letters at the end of the EPAs negotiations asserting that their objective for the ACP was to “break their dependence on trade preferences and basic commodity trade.” “The Economic Partnership Agreements.....are designed... (to) take a trading relationship based on dependency and turn it into one based on economic diversification and growing economies.” There is no obvious opening for commodity revenue management schemes under this scenario, so politically, too, STABEX and its successors seem to have served their time and perhaps their purpose. Even in UNCTAD's own 2007 Trade and Development Report, high commodity prices are given as the main reason for developing countries' growth last year, and their differential growth with respect to developed countries, so that they now account for 37 per cent of global trade (with some becoming net exporters of capital as a result).

However, pride comes before a fall, especially in commodity market trades, and in the next sector we attempt to determine whether both the high levels of current commodity prices and the high pledges of aid (including aid-for-trade) from some donors, now focused on growth and stability as well as achieving the Millennium Development Goals, will create an enabling environment where innovative compensatory finance mechanisms might be revived or devised.

### **3. New and Innovative Thinking on Compensatory Finance**

A time when many commodity market prices are at all-time peaks (even for foodgrains as well as minerals and metals) ought to be a suitable moment to concentrate the mind of consumers and intermediaries on devising stabilization schemes appropriate for the twenty-first century, given also the funding availabilities arising from increased aid and debt relief, especially that directed towards Africa.

However, the pegs for compensatory finance schemes are no longer present. The international commodity agreements which operated through buffer stocks and other direct forms of market intervention, in tropical beverages and in metals like tin, are now all defunct. Within the donor perspective, direct budget support for reforming governments whose overall policies are trusted to be market-friendly has overtaken the desire to institute schemes paying out according to arithmetic or geometric formulae to all eligible governments. If stability in the incomes of poor farmers, let alone of poor miners, remains the problem, this can be better addressed by indirect methods such as better communications providing reliable forecasts and market intelligence, better access to credit, forms of social protection and—though this is also costly—farmers' insurance schemes.

Moreover, the institutions which backed and invented the schemes are themselves undergoing major change. The IMF's own business model is being questioned, currently by the G20. In future it may find itself dealing more with small developing countries and Sub-Saharan Africa, as the debts of Latin America, Turkey and the Philippines are paid off in advance and as rapidly growing countries in Asia and the Middle East develop sovereign wealth funds which far outstrip the IMF's own availabilities and power to influence financial markets.

Its newest scheme, the Trade Integration Mechanism (TIM), is a lending facility with few of the characteristics of compensatory finance of the past, though in providing funding at a time of overall shortfalls it is a useful underpinning of the Fund's own Poverty Reduction and Growth Facility (PRGF). The vision of the new Managing Director of the Fund, Dominique Strauss-Kahn, is to concentrate on dealing with external financial shocks and bringing to bear the assistance needed, and he anticipates a bigger role (and voice) for Africa in the Fund in future. However, there is also a sense that western countries' need for regular supplies of many commodities is less pressing now and China has yet to take up its position in the international institutions to make the interventionist case, even though before it became the main user of commodities, China used to side religiously with the G77.

The World Bank is also inclined to steer clear of dirigiste schemes and seek out market-friendly alternatives when dealing with commodity price and earnings risk management. The Bank has set up a task force and developed a pilot of a market-based international commodity price insurance mechanism, with price floor guarantees for producers and exporters and price ceiling guarantees for buyers. It has been tried in West African agriculture but the dilemma remains how to fund the costly insurance premiums, especially for poor producers. But if it were easy to do, then like crop insurance in developed countries, it would be done already. Yet it remains the case that in developing countries, the private sector cannot cope on its own. On the other hand, the Bank recognized recently that many of its HIPC and Enhanced HIPC debt relief targets were being missed because of the failure of commodity markets to guarantee revenues of many of its African target countries, so the Bank remains within the frame for new thinking. Its biggest effort for the least developed countries in this area has been in refining (with the UN and the WTO) the Integrated Framework through trade diagnostic studies which identify the bottlenecks preventing the full growth potential of trade from being realized. These are then addressed largely through trade facilitation measures, though with some targeted budget support which could be more closely attuned to compensatory finance, though more obviously for countries whose export economy needs restructuring than for those encountering temporary shortfalls.

For the EU, compensatory finance has not featured in the long-running negotiations with the ACP on Economic Partnership Agreements. This is partly because the EU's perception of WTO rules prevents the ACP being treated as a bloc anymore. Instead, the ACP has been broken into six negotiating regions. For trade purposes a distinction is being drawn between least developed countries and other low or lower-middle income countries; there will even be an EU-African summit just weeks before the deadline in December where the Caribbean and the Pacific will be dropped entirely. As a result, a revival of STABEX/SYSMIN has not even featured in the alternative proposals from the ACP to counter the EU's insistence on (phased, asymmetrical) trade reciprocity, even though EDF monies are assumed to be available independently of the final outcome of the trade negotiations. Within the EU, the U.K., Germany and many of the recently joined Member States in central and eastern Europe are opposed to compensatory finance schemes for poor countries, although France in particular continues to be favourable, and may succeed in engineering a change in donor attitudes.

The most useful ongoing work on innovative compensatory finance scheme continues to be done by UNCTAD. In 2003 their eminent persons reported recommending an international scheme which now seems quite idealistic, as it embodied:

- 1) automatic payouts according to specific triggers;
- 2) ease of access regarding technical requirements (to avoid the delays which caused most schemes in the past to become pro-cyclical despite best intentions);
- 3) no conditionality; and
- 4) a pass-through mechanism to benefit producers directly.

A refinement of the eminent persons group's scheme is now going before the Committee on Trade and Commodities, with even more ambitious aims, for it is to include food import stresses (as was the case with the CFF) as well as export earnings (as was the case with

STABEX), will retain the desired automaticity and pass-through mechanisms, yet aims to be entirely self-financed, by loan finance rather than grants. It may allow targeting of the balance-of-payments as well as vulnerable producers, and as such would be a hybrid of the two original schemes.

It is however doubtful that there is enough political will at the moment for such a scheme, even from Europe, from where aid-for-trade monies could be diverted to provide the initial loans. If there were, it remains likely that the U.S. would block it at the international level. However, a subsidiary point is that, whereas at the end of the century, commodity production was predominantly in private hands, recent years have seen a return of state corporations reasserting control over national and even international assets, particularly in the case of Russia, Venezuela and some Gulf States. Compensatory finance might be seen by some as a means of stemming this tide by offering guarantees of stability to private producers.

It is true to say that compensatory finance has never properly worked because it has never been properly tried. The original schemes were either regional, or, if international, hedged around with too many conditionalities which were not relevant to commodity market earnings vulnerability. They never operated as a revolving fund, and it became easier for donors to take them over and impose their will as aid, especially when trade liberalization was simultaneously on the agenda. Moreover, there is far less third world solidarity to provide backing for such an international scheme now: consider how even poor ACP countries have been targeted for their special preferences; and how long it would take for China to prefer to fund an international scheme rather than secure its raw material supplies by bilateral action.

Moreover, of the remaining problems caused by commodity price volatility—planning uncertainty, dependency, inequality and weak or distorted environmental management—the systems of compensatory finance available hardly address any other than the first, and of all the EU schemes, it was only the Commodity Protocols (especially sugar) which offered long-term international price guarantees to eliminate the planning uncertainties, not STABEX itself. In today's political climate, however, that would be ruled out and, to garner international support, compensatory finance itself would need a new rationale, perhaps anchored in environmental rather than economic or financial stability. It is therefore not easy to endorse recommendations coming from a small part of the UN for a revival of compensatory finance. International and regional schemes have fallen seriously out of political fashion, and the existing mechanisms have fallen into disuse. Despite best intentions they almost invariably proved not to be counter-cyclical and they were appreciated by beneficiary governments because they were a free good, or less politely, a boondoggle. In their time, they were a guarded donor/creditor response to the calls for a more dirigiste Common Fund and the integrated program for commodities, though they could also be claimed to have their origin in Keynesian deficit financing. Perhaps they served their former purpose; yet, while there remains plenty of scope for rent-seekers keen to access public funds, there is surprisingly little demand for the revival of such schemes.



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