International Monetary Fund

IMF Executive Board Discusses Precautionary Arrangements

Public Information Notice (PIN) No. 06/94
August 10, 2006

On May 17, 2005, the Executive Board of the International Monetary Fund (IMF) discussed the purposes and outcomes of precautionary arrangements.

Background

When a member seeks a Fund-supported program, but does not face a pressing balance of payments need, it may treat a Fund arrangement as precautionary—an arrangement which provides the right, conditional on implementation of specific policies, to make drawings should the need arise. Directors have often emphasized the value of precautionary arrangements in supporting sound policies, but have also, on occasion, stressed that the standards and requirements for precautionary programs should not fall short of those for drawing programs. During their discussion of the Design of Fund-Supported Programs, Directors remarked upon the apparent differences in macroeconomic outcomes—especially as regards output growth—under precautionary programs, and requested further analytical work and more in-depth study of such programs.

Responding to this request, a comparison was made between experience under precautionary programs and non-precautionary programs with a view to answering two questions: Are there systematic differences between precautionary and non-precautionary programs in terms of program policies, conditionality, or macroeconomic outcomes? And, if so, are these attributable to the nature of the program or to economic problems facing the member and the circumstances that led it to seek the Fund's support?

Executive Board Assessment

Executive Directors welcomed this opportunity to discuss the purposes and performance of precautionary arrangements—that is, programs supported by a Fund arrangement that the authorities decide to treat as precautionary—based on a review of experience under these programs over the period 1992-2005, as part of the follow-up to their discussion of the design of Fund-supported programs in December 2004. This review provides a useful analytical backdrop to help clarify the framework for Fund financial support, in particular for serving better the evolving financial needs of its middle-income and emerging market members, as identified in the Fund's Medium-Term Strategy. Directors looked forward to the upcoming discussions on a companion paper on crisis prevention, which examines how program design and Fund financing can contribute to reducing the likelihood of a crisis, and to further discussions of possible new instruments ahead of the Annual Meetings.

Turning to the present review, Directors observed that one-third of all General Resources Account arrangements during the period 1992-2005 were treated as precautionary by the member. Such arrangements were generally of slightly shorter duration and had lower access (relative to quota) than drawing arrangements, and most often remained undrawn. Directors felt that these patterns were consistent with the distinct purposes served by Fund arrangements for members facing different situations. At the same time, Directors recognized that some drawings under precautionary arrangements were to be expected, especially when members faced turbulent conditions in international capital markets.

Directors concurred with the view that members with weaker initial macroeconomic performance—lower economic growth, higher inflation, and reduced private capital flows—were more likely to request drawing programs, whereas those members with stronger macroeconomic fundamentals, but facing various uncertainties—including political economy considerations—opted for precautionary programs. It was also recognized that members used precautionary programs to signal policies to markets, especially where these arrangements were sufficiently ambitious in addressing vulnerabilities. Some Directors expected that, with greater integration of global capital markets and heightened exposure to capital market crises, members may need to rely on precautionary arrangements as an instrument for crisis prevention, and in this context called for further reflection on the reasons for the recent decline in precautionary arrangements and GRA-supported arrangements more generally.

Directors noted that, in the first program year, output growth was significantly higher, and inflation significantly lower, for members with precautionary programs compared with drawing programs. However, these differences could largely be explained by the different initial conditions that led authorities to choose one type of program over the other. Indeed, a number of Directors observed that, by the end of the program period, growth rates in member countries with non-precautionary programs had caught up with growth rates in members with precautionary programs, notwithstanding weaker initial conditions. They further noted that inflation rates in members with drawing arrangements declined more rapidly over the program period, largely converging with inflation rates of members with precautionary programs. A number of Directors saw these outcomes as supportive of the view that Fund programs were generally well-tailored to country-specific needs.

Directors noted that members undertook significant current account adjustment prior to the onset of both precautionary and non-precautionary programs, but also pointed to the reversal of this action during the program period through a widening of the current account deficit. While this development represented a welcome return of confidence and resumption of capital inflows, Directors cautioned against the risk of an excessive build up of external debt. In this regard, Directors were generally reassured by the finding that these wider current account deficits were often accompanied by stable or declining external debt ratios for members with debt ratios in a vulnerable range, and thus did not compromise debt sustainability.

Directors welcomed the analysis of market reactions to Fund-supported programs embodied in interest rate spreads. In particular, Directors noted that spreads were no higher for members with precautionary programs than at other times, suggesting that the market does not stigmatize members for adopting precautionary programs. Going further, a number of Directors observed that spreads might even have widened if the members had not requested precautionary arrangements—suggesting a more positive assessment of their signaling effects—while some other Directors questioned whether the market adequately rewarded countries for adopting precautionary programs. Directors further noted that spreads were lower for members with precautionary programs than under drawing programs, suggesting a differentiated response according to whether the member had a balance of payments need and expected to draw Fund resources. Some Directors felt that, within drawing arrangements, the behavior of market spreads suggested a degree of ambiguity in market signaling, possibly pointing to some stigma that might have been associated with these programs. Some Directors cautioned against drawing strong conclusions regarding the signaling effects of precautionary programs or borrowing programs, and considered that further analysis of this issue would be useful. More generally, Directors noted that spreads fundamentally reflect a country's pursuit of sound policies and benefit from full transparency of economic data.

Directors stressed that conditionality for all Fund arrangements should be tailored to the member's circumstances while safeguarding Fund resources. They welcomed the empirical finding that monetary and fiscal targets were generally geared toward the economic circumstances facing the member and that, controlling for initial conditions, targets under precautionary programs were no less ambitious—and for inflation, slightly more ambitious—than under non-precautionary programs. Directors also observed that precautionary and non-precautionary programs had similar records of achieving program targets. Observing that precautionary arrangements were drawn by members facing capital account turbulence, a few Directors suggested that the ex ante conditionality of such arrangements did not appear to have prevented crisis, but rather that the arrangements served as contingent finance.

Directors noted that the number of quantitative conditions typically employed to monitor fiscal and monetary policies were similar across both types of Fund-supported programs. As regards the number of structural conditions, precautionary programs tended to have fewer conditions than drawing programs. Most Directors concurred, however, that this difference appeared to reflect an appropriate tailoring of structural conditionality to the economic challenges facing the member. They also were reassured that comparing both types of Fund-supported programs for the same member did not yield a significant difference in the number of structural conditions.

Directors expressed a variety of views on the role of precautionary arrangements in supporting a successful exit for members from Fund-supported programs. Directors considered that all Fund-supported programs should be sufficiently ambitious to achieve an exit from Fund financing. In this vein, all members with Fund-supported programs should aim to return to a surveillance-only relationship with the Fund. Precautionary arrangements may have an important role to play as an intermediate stage in this process, although some Directors noted that precautionary arrangements should not become a routine exit instrument, as extending a program relationship with the Fund unduly could undermine the credibility of a member's policies as well as the benefits of Fund financial support.

Conclusions

Overall, Directors agreed that precautionary programs are a most useful instrument in the Fund's tool-kit, lending the Fund's credibility in support of the authorities' policies and enhancing policy discipline. Many Directors also considered that these programs send a well-calibrated signal to markets of the authorities' commitment. Comparisons of policy objectives and conditionality between precautionary and non-precautionary programs suggested to most Directors that Fund policies are being applied consistently. A number of Directors noted that, given the focus in this review on regular access programs, its analytical results cannot necessarily be extrapolated to the effectiveness of high access precautionary arrangements in deterring capital account crises. Some other Directors noted that the Fund's commitment to provide a significant amount of resources in case of need does matter, and looked forward to the forthcoming discussions on this issue.

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