International Monetary Fund

IMF Executive Board Holds Board Seminar on Consideration of a New Liquidity Instrument for Market Access Countries

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On August 28, 2006, the Executive Board of the International Monetary Fund (IMF) held an informal seminar to discuss issues relating to a possible new liquidity instrument for market access countries. The staff paper on which the discussions were based is posted on the IMF's website at http://www.imf.org/external/pp/longres.aspx?id=3888.

Background

As part of his report on implementing the Fund's Medium-Term Strategy http://www.imf.org/external/np/pp/eng/2006/040506.pdf, the Managing Director suggested that a new vehicle for the provision of high access financing for crisis prevention be considered.

A number of members, including emerging market countries and others, have called for a Fund-based liquidity instrument specifically designed to support crisis prevention efforts by members active in capital markets. The instrument would aim to reduce the likelihood of crises by providing a way for countries to commit to policies directed at reducing vulnerabilities, sending strong signals to markets regarding policy momentum, and reinforcing confidence that substantial financing is available, if needed.

The seminar focused on options for addressing design challenges inherent in such an instrument, recognizing the lessons from experience with the Contingent Credit Line (CCL), which expired in 2003. Specifically, a successful instrument would need to find an appropriate balance between the desirability of strong predictability of access and the need for adequate safeguards for the Fund's resources. Likewise, a vehicle that provides strong positive signals may also provide negative signals when circumstances deteriorate. Directors considered these issues in the context of key design elements and, recognizing the relationship between these elements, an indicative example, here called the Reserve Augmentation Line (RAL).

Executive Board Assessment

Today's seminar has provided an important opportunity for Directors to discuss key issues associated with a possible new Fund liquidity instrument for market access countries and to begin to consider how such an instrument can best be designed to meet the Fund's objectives. This informal discussion has provided important insights into Directors' preliminary views on key issues outlined in the staff paper.

Directors welcomed the opportunity to consider whether a well-designed liquidity instrument could reinforce the flexibility and predictability of the Fund's lending framework. Most Directors supported the objectives for such an instrument outlined in the staff paper, noting the interest of emerging market members and others in an instrument that could serve as a signaling and commitment device for strong policies, while assuring large scale financing if needed.

While recognizing that demand for a liquidity instrument may be constrained in today's relatively benign market environment, Directors agreed that the Fund needs to ensure that it is well prepared to assist members during less favorable periods. Emphasizing that careful design of any such instrument would be critical, they concurred that a balanced framework would best ensure its effectiveness in supporting the needs of member countries with market access, while protecting against moral hazard concerns as well as reputational and financial risks for the Fund. Most Directors saw merit in further consideration of such an instrument, noting that its design would need to take into account the experience with the CCL. A few Directors, however, expressed reservations about the viability of a liquidity instrument, referring to the tension between automaticity of access and the need for safeguards for the use of Fund resources. Directors also noted that due regard should be given to the interaction of such a new instrument with existing Fund financial facilities.

Design Elements

Directors considered four key design elements—qualification, monitoring, scale and access, and financial terms. They recognized the importance of the relationships among these elements in considering various models for a potential liquidity instrument.

In discussing such models, Directors agreed that there are merits and challenges associated with both "ex ante" models—where access is automatic for members meeting a rigorous qualification standard—and "ex post" models—where access is tied to ongoing performance and implementation of policy commitments through a monitoring structure. While views differed on the need for ex post monitoring, Directors were generally of the view that such monitoring would be important both for ensuring implementation of the policy framework, thereby providing safeguards for the Fund, and for avoiding too heavy a reliance on qualification criteria as a safeguard—which could limit too narrowly the members that could make use of the instrument. This would also serve to avoid unhelpful negative exit signals when a member's circumstances change. On balance, Directors felt that the RAL example, which combines both ex ante and ex post features, provides a good starting point for further consideration of a liquidity instrument.

On qualification, Directors considered that well-defined qualification criteria would be important to ensuring that the instrument would be used selectively. They noted that qualification should give strong weight to the member's current position and the credibility of the member's commitment to implementing strong policies in the context of a forward-looking economic program. In addition, it would be important to verify that economic policies are focused on addressing remaining vulnerabilities, with strong ownership and transparency. Directors also observed that objectively-defined criteria have benefits in terms of transparency, predictability, and even-handedness. At the same time, they saw merit in some degree of discretion, given the difficulty of formulating objective criteria that would be robust in the context of changing markets and diverse country circumstances.

Most Directors generally considered that qualification assessments should be made only upon request by the member, at least initially. While recognizing that automatic assessments, including through the Article IV process, could mitigate the potential for negative entry signals associated with a request, they observed that such an approach would risk shifting the Fund's surveillance framework toward a ratings-based structure. Directors acknowledged that a system of graduated ratings (with different access levels provided to members at different ratings tiers) might reduce the bluntness of ratings signals, but cautioned that such a system would present important implementation challenges associated with defining and implementing nuanced graduations across members. As such, Directors generally preferred a voluntary structure, while recognizing the importance of a selective qualification standard to reduce the potential for negative signals associated with a request.

Directors felt that the four qualification criteria outlined in the RAL example provide a good starting point, avoiding the overly narrow limits for qualification under the CCL while still ensuring selective use of the instrument. These criteria focus on the strength of the member's current position and policy stance; the quality of the member's forward-looking commitments to address remaining vulnerabilities; the sustainability of the member's debt position; and the transparency of the member's policies. Some Directors advocated making participation in the Financial Sector Assessment Program-process an additional criterion for entering into such an arrangement. Directors noted that a member requesting access under the instrument would be subject to existing procedures for exceptional access, including a report on the implications of the arrangement for Fund liquidity.

Regarding the monitoring structure, Directors favored targeting it toward ensuring that macroeconomic policies remain appropriate and verifying that the member is making progress in reducing remaining vulnerabilities. They called for further elaboration of the structure outlined for the RAL example, which provides for a semi-annual review of a forward-looking economic plan presented by the authorities. In this context, some Directors suggested that consideration could also be given to alternative review structures. In addition, some Directors emphasized that the monitoring framework should be sufficiently objective to provide strong assurances to the member of the conditions under which drawings could be made, while reinforcing safeguards to the Fund. While a few Directors saw benefit in a review at the time of the member's request for disbursement, other Directors recalled the concerns of many emerging market countries regarding the uncertainty created by an activation review under the CCL. While acknowledging that negative exit signals cannot be eliminated entirely, Directors noted that a monitoring structure similar to that under the RAL would mitigate such signals by allowing for an interruption (rather than a termination) of access to permit the member to make needed adjustments.

On access, most Directors considered that large, upfront access would be necessary to provide adequate resources and send a positive signal to markets, but expressed a range of views on the appropriate scale of access under the instrument. A number of Directors supported the proposal for a 300 percent of quota standard, while a number of others felt that a level between 300 and 500 percent would be more effective given the scale of capital flows.

Most Directors saw merit in limiting the use of a prospective instrument to cases involving a specific balance of payments need, which derives from a sudden and disruptive loss of market confidence reflected in pressures on the capital account and the member's reserves. Directors considered that any drawing should be followed by an early review report to the Board to analyze the member's economic situation, discuss the circumstances leading to the drawing and the authorities' response, and provide a forward-looking assessment.

In terms of the financial structure, Directors generally favored establishing the new instrument as part of the Supplemental Reserve Facility, available for the same type of special balance of payments need, and carrying the same charge and maturity structure, while noting the need to pay due regard to the upcoming review of the charges and maturities of the Fund's financial facilities. They generally thought that limiting the length of the program period to one year would minimize the risk of a material change in policies of fundamentals during the period of any given arrangement, and that a series of several RALs should not be discouraged where the member continues to meet the qualification criteria. However, some Directors felt that the option of a longer program period—say, of 2 to 3 years—should be left open. Directors noted that the new instrument would be subject to commitment fees, as with current policies for the use of Fund resources. Views were also mixed on the issue of a global cap for the instrument, with some Directors favoring consideration of a such a cap, perhaps at SDR 50 billion, at least initially, to ensure that sufficient resources remain available to be provided under traditional arrangements, but some others expressing concern that it might limit the resources necessary for effective crisis prevention for member countries with market access.

Directors will also need to consider the possible merits of a sunset clause. In this context, some Directors noted that a sufficiently long period would be required to assess the new instrument.

Next Steps

Today's discussion has helped to clarify further the broad outlines of a potential new liquidity instrument and provided a good starting point for more formal Board consideration of specific features for such an instrument, drawing from the RAL example. The Annual Meetings in Singapore offer a useful opportunity to engage in an informal exchange of views with members. Staff and management will present a proposal for carrying forward our efforts as part of the Fund's work program following the Annual Meetings with the aim of making concrete progress by the 2007 Spring Meetings.

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