International Monetary Fund

IMF Executive Board Discusses Design Issues for a New Liquidity Instrument for Market Access Countries

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On March 7, 2007, the Executive Board of the International Monetary Fund (IMF) continued its discussion on a possible new liquidity instrument for market access countries. The discussion focused on some key design issues, based on a published staff paper.

Background

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 Fund's Executive Board met in a seminar in August 2006 (see Public Information Notice No. 06/104) to discuss the objectives for such an instrument, recognizing the lessons from experience with the Contingent Credit Lines (CCL) which expired in 2003. Specifically, a successful instrument would need to provide an appropriate balance between predictable access to Fund financing and adequate safeguards for Fund resources. Likewise, the design of the instrument would need to manage the tension between the provision of strong positive signals when conditions are good, and the possibility that entry or exist from the instrument could generate negative signals when circumstances deteriorate. Directors considered these issues in the context of an example called the Reserve Augmentation Line (RAL). They considered this framework to be a useful starting point for further discussions, and identified a number of design issues that merited further consideration.

Since the August seminar, Fund management and staff have engaged in outreach with official sector representatives and market participants in order to hear their views on the need for and structure of such a possible new instrument. In light of the points raised at the Board and during the outreach, Executive Directors considered in their March 7 discussion some design issues, including those related to the appropriate qualification criteria for RAL eligibility, the structure of monitoring and reviews, and the size of access.

Executive Board Assessment

Directors welcomed today's discussion of design issues related to a possible new Fund liquidity instrument—tentatively named the Reserve Augmentation Line (RAL)—which builds on the Executive Board Seminar held on August 28, 2006. Directors appreciated the outreach efforts undertaken by management and the staff since the August discussion to gather views from official sector representatives and market participants. Most Directors were of the view that a well-designed instrument could benefit members and the financial system as a whole by reinforcing strong policies and reducing the likelihood of crises. However, some Directors remain skeptical about the need for and the viability of a new liquidity instrument, or feel that the currently proposed formulation of the RAL is unlikely to provide meaningful and reliable support for crisis prevention. These Directors, nonetheless, continue to be willing to discuss possible additional refinements before taking a final position. On balance, Directors considered that the staff has made good progress in addressing the concerns and suggestions made by Directors at the August seminar, but underscored the need to improve and clarify further various design issues of a possible RAL.

Accordingly, today's discussion focused on design issues for the RAL, relating to the qualification framework, monitoring structure, access levels, and financial terms. Directors stressed that such an instrument should be useful for the membership and the system, limit any negative signals, and adequately control risks, including moral hazard. They also emphasized that the RAL should try to strike an appropriate balance between providing effective support to members to avert capital account crises, on the one hand, and ensuring safeguards to the Fund and minimizing moral hazard, on the other.

Qualification Framework

Directors agreed on the importance of a strong qualification framework so that use of the RAL would be limited to member countries with sound fundamentals and policies, and a credible commitment to policies that will reduce remaining vulnerability to capital account crises. In this context, the development of domestic capital markets was seen as one element in a strategy for reducing vulnerability. Directors noted that the frontloaded access under the RAL would be justified by the strength of the member's economic position at the time of approval, and the credibility of its forward-looking commitments. Most Directors broadly supported the four qualification criteria set out in Box 4 of the staff paper, and welcomed their elaboration in the paper. Recognizing the advantages and disadvantages of alternative qualification schemes, most Directors thought that the qualification structure should be based on objective, quantitative indicators—which would strengthen the transparency, predictability, and even-handedness of the selection process—but also saw a role for some degree of judgment, including to take account of country-specific circumstances. Some Directors saw merit in further developing a workable and objective qualification framework, with consideration of the feasibility of presenting case studies also being suggested in order to highlight the boundaries of eligibility. At the same time, many Directors cautioned that qualification criteria should not be so stringent as to have the unintended consequence of limiting recourse for countries that most need the RAL.

While recognizing the difficulty of designing eligibility thresholds, a few Directors considered that some benchmark to guide selection would be important for adequately safeguarding the Fund's resources, especially in the absence of an activation review. Some Directors stressed that measures of exchange rate misalignment should not be a basis for disqualification.

Length of Arrangement and Monitoring Structure

Directors' views on the appropriate length of the arrangement were mixed. A number of Directors agreed that a series of arrangements should not be discouraged so long as the member continues to qualify. A number of Directors favored a one-year arrangement with a mid-year review. They thought a one-year limit would best ensure a fresh look and mitigate negative exit signals. A number of others thought that a longer arrangement, possibly of two years, should be allowed from the outset and that this would provide better signals to the member and markets. Others saw merit in an intermediate approach, with a one-year arrangement but with the possibility of a six-month extension at the time of each semi-annual review, subject to an overall limit of three years.

Regarding the monitoring structure, many Directors favored an approach based on semi-annual reviews, with a number of them expressing interest in complementing such reviews with ad hoc reviews to allow for the suspension of access rights in case of a clearly-defined flagrant departure from the policy framework. A number of Directors suggested an approach under which, in lieu of a fixed semi-annual review for a one-year arrangement, there would be ad hoc reviews, triggered by objective, verifiable criteria as specified in the authorities' policy documents. Those Directors noted that the trigger for an ad hoc review should include only actions that are under the control of the authorities. A number of Directors favored a longer period between reviews, noting that this would afford users greater certainty. In any event, Directors stressed the importance of keeping the Board regularly informed of country developments. They generally agreed that the content of the review should be clearly laid out in the authorities' policy intentions documents, and should focus on verifying that macroeconomic policies remain appropriate and that the member is making progress in reducing vulnerabilities. In cases in which a drawing does take place, Directors generally supported establishing a procedure for ex-post Board discussion of the circumstances of the drawing and the authorities' policies. Some Directors considered that such due diligence could be done in a way that is less formal than a program review.

Access

Directors generally agreed that large, automatic, and upfront access would be needed for the RAL, but views differed on the appropriate level of access. A number of Directors favored a range for access of 300 to 500 percent of quota, depending on the circumstances of the member requesting financing under the RAL. Such a range would provide flexibility and be consistent with linking access to the specific circumstances of members. A number of other Directors, however, felt that it would be hard to justify different access levels within such a range on the basis of potential balance of payments need. They also worried about the signal implied by different access levels, and preferred a uniform level of access of 300 percent of quota. Some other Directors preferred a higher access of 500 percent of quota.

Furthermore, a number of Directors considered that the RAL should provide financing with one purchase, and that any financing beyond the first drawing should be provided in the context of a new arrangement when the nature and extent of any additional balance of payments need are better known. Some Directors thought arrangements under the RAL could include a second purchase of 100 to 200 percent of quota. In this context, Directors advised that careful thought should also be given to exit issues. They generally recommended that, were the member to face the need for a drawing, additional access could be made available under an appropriate Fund facility. It was stressed, however, that there should be no expectation that drawing under the RAL would be followed by purchases under another facility.

Terms

Many Directors reconfirmed their preference expressed during the August 2006 seminar that the RAL should be established as part of the Supplemental Reserve Facility (SRF), since the new instrument would commit resources on a precautionary basis for the same type of special balance of payments need as the SRF. Directors recognized that any changes to SRF terms emanating from the review of charges and maturities would apply to the RAL as well. Some other Directors were of the view that the circumstances for use of the RAL were different enough from the SRF that a new instrument should be established, with different charges and maturities. These Directors considered that delinking the RAL from the SRF framework would also enhance the former's appeal to potential users by allowing greater flexibility in the design of the instrument and by sharpening its signaling features.

Directors considered the design and level of the commitment fees very important for an instrument such as the RAL where the member is not expected to draw. Many Directors agreed that the commitment fees should be left at current levels for the time being but could be reviewed as experience is gained. Some Directors considered the current charges and fees too high, while yet others saw a need to discuss the charge structure more carefully.

Other Issues

Most Directors agreed that there should not be a global cap on commitments under the RAL. They preferred to conduct a review of the instrument if commitments reached a pre-specified amount of perhaps SDR 30 billion. It was suggested that the adequacy of the Fund's liquidity position should also be considered if commitments under the RAL reached such a threshold.

Many Directors did not support the inclusion of a sunset clause in the RAL, with some noting that the Fund can decide at any time to eliminate instruments. Recognizing that demand for a liquidity instrument may be constrained in today's market environment, they felt that a scheduled termination before the potential merits of the new instrument have been tested could unnecessarily be seen as a failure. A number of other Directors felt that a sunset clause would help ensure that the Fund does not maintain instruments that are not used.

Directors considered the relationship between a new liquidity instrument and precautionary Stand-By Arrangements in the credit tranches. It was noted that the overlap should be limited, considering that the RAL would address a very specific capital account-related balance of payments need and could be approved only for members meeting strong qualification criteria. Nonetheless, a few Directors were concerned that precautionary Stand-By Arrangements in the credit tranches would be undermined by the RAL, as it was unavoidable that, if the RAL were successful, some members might see it as providing a more positive signal. Some other Directors noted, however, that many members may prefer the monitoring structure and lower commitment fees associated with lower access under Stand-By Arrangements in the credit tranches. It was agreed that the qualification framework is crucial to ensure that the RAL is not used where it is not the appropriate instrument. In this context, a few Directors continued to believe that the objectives of the RAL can be accomplished through the use of slightly modified precautionary Stand-By Arrangements, without the establishment of a new instrument.

Next Steps

We have had a useful and constructive discussion. In light of the progress made in elaborating the objectives and design of the RAL, some Directors were of the view that the Board could next consider a concrete proposal to establish a new instrument. While also welcoming the progress made, many others considered, however, that the staff should continue to refine the proposal further in light of the various suggestions and comments made by Directors today before the Board is asked to make a final decision. A number of Directors favored waiting to consider establishing a new instrument until there is demonstrated demand, while a number of others were of the view that only by establishing the instrument as part of the Fund's toolkit would potential users be in a position to assess its benefits and costs based on its concrete features. The importance of continuing to seek the views of the emerging market countries—as potential users of this instrument—was also noted by several Directors. In light of today's discussion, the staff will prepare a follow-up paper that will set out areas where there seems to be emerging common ground and address other areas where more progress needs to be made.

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