INTERNATIONAL MONETARY FUND

A New Facility for Market Access Countries—The Short-Term Liquidity Facility

Prepared by the Strategy, Policy, and Review Department, the Legal Department, and the Finance Department

In consultation with other departments

Approved by Reza Moghadam, Sean Hagan, and Andrew Tweedie

October 24, 2008

Contents Page

I. INTRODUCTION

1. **The ongoing financial market turmoil is remarkable for its severity but also for the speed with which shocks have spread across markets and economies.** Disruptions in short-term funding in mature markets, deleveraging and contraction of bank balance sheets, and contagion from a systemic loss of confidence are leading rapidly to sharply reduced financial flows to economies far from the origins of the crisis. Market turbulence in advanced economies has thus led to the emergence of short-term external liquidity needs even in emerging market countries with strong underlying domestic policies.

2. **In these circumstances, the Fund's traditional facilities may not always be the optimal means of addressing short-term balance of payments pressures.** Stand-By Arrangements (SBAs) have been used flexibly to support members' economic programs where both policy adjustment and financing were needed to address underlying vulnerabilities, buttress market confidence, and facilitate a member's early return to market financing. However, countries with strong policies have been reluctant to seek Fund financing when experiencing external liquidity pressures.

3. **There is growing recognition that innovations in the Fund's lending role and instruments may be needed to address the evolving needs of the membership.** In the recent discussion of the Review of the Fund's Financing Role in Member Countries, Directors stated that the present set of lending instruments may need to be adjusted to remain suitable for the needs of the overall membership. The IMFC urged the Executive Board to take the agenda of reviewing the Fund's lending role forward expeditiously, particularly as regards the provision of short-term liquidity assistance.

4. **This paper proposes a special facility to complement existing instruments by filling a gap in the Fund's toolkit.** The proposed new facility is designed for members that are well-integrated into global capital markets and whose strong macroeconomic positions and records of consistent policy implementation do not call for typical Fund-supported adjustment programs. Nevertheless, these members may require large upfront access to Fund resources to help address short-term, self-correcting balance of payments needs.

5. **The paper is structured as follows.** Section II provides an overview of the types of events the proposed facility—the Short-Term Liquidity Facility (SLF)—is meant to address and the rationale for such a facility. Section III presents the main design features, while Section IV presents concluding thoughts. The proposed decision will be circulated to the Board in a supplement—to be issued after this paper—that will also address related consequential changes to existing Fund policies.

II. General Considerations

6. **The SLF is designed to help members who face balance of payments needs arising from external market developments despite strong underlying fundamentals and domestic policies.** The facility is thus intended for countries that are well integrated into global capital markets. Both the sovereign and the private sector would be expected to have sustained market access at relatively favorable terms, and both the public domestic and external debt positions would be sustainable. In general, such countries should be able to access markets to address very short-term liquidity needs that are quickly self-correcting. Recent developments, however, have underscored the risk that even members with fundamentally strong economic policies could experience short-term balance of payments pressures stemming from unanticipated credit market events largely outside their control. If unaddressed, such liquidity pressures could escalate quickly into more prolonged balance of payments and financial system problems.

7. **The SLF would help these members reduce or even reverse the impact of short-term balance of payments pressures.** Some members may find the SLF useful as they seek to bolster their reserves to fortify their defenses against temporary capital account outflows. Other members might find the announcement of Fund support helpful to boost confidence, and reduce incentives for investors to cut their exposures in the face of emerging risks.

III. Design

8. **The design of the SLF is based on three broad principles:**

- *The purpose of the instrument should be clear.* Access should be explicitly limited to those countries facing short-term, self-correcting balance of payments pressures arising from external developments rather than from domestic policy weaknesses, who therefore are in a position to resolve their difficulties with short-term liquidity provided by the Fund.

- *It should be tailored specifically to the needs of the relevant members, even where this requires a departure from traditional Fund practices.* In particular, in light of the rapidity with which market conditions can change, the instrument is designed to put a premium on speed and simplicity. Access should be large and quick disbursing, and requirements—with respect both to procedures and conditions—should be streamlined. Accordingly, expedited procedures would be employed, no mission would be required prior to Board approval, and only ex ante conditionality would be applied to purchases.

- *Fund resources should be safeguarded.* Participation should be restricted to countries that not only have very strong policies and fundamentals and sustainable public and external debt, but who also have a history of implementing sound policies. Moreover, the period over which resources can remain outstanding should be strictly limited.

A. Balance of Payments Problem and Eligibility

The specification of the balance of payments problem and related qualification framework should ensure that the facility is restricted to countries whose sound domestic policy frameworks and economic conditions provide confidence that liquidity problems will be resolved relatively quickly with continued strong policies and temporary support from the Fund.

9. **The SLF would be established pursuant to Article V, Section 3(a), which authorizes the Fund to adopt special policies on the use of its general resources that will help members to solve special balance of payments problems.** Given the considerations noted above, the new facility would be intended to address exceptional balance of payments difficulties reflected in pressure on the capital account and the member's reserves, which—taking into account the strength of the member's policies and its underlying fundamentals—are judged to be quickly self-correcting.

10. **Consistent with the special balance of payments problem covered, access to the new facility would be dependent on an assessment by the Fund that the member's economic policies and underlying fundamentals were both very strong.** This would be based on the following criteria, assessed through an analysis of information obtained, inter alia, in bilateral and multilateral surveillance.

- ***Very strong policies and underlying fundamentals.*** The member has a solid initial position and a sustained track record of pursuing very strong policies, and remains committed to maintaining such policies in the future. This would give confidence that the member will overcome its short-term external liquidity problems without the need for policy adjustment. Policies should have been assessed very positively by the Board in the context of the most recent Article IV consultations.

- ***Sustainable debt.*** The standard Fund debt sustainability analysis of both public domestic and external debt should indicate a high probability that both will remain sustainable. This analysis would cover both the evolution of the level of debt and the rollover and financing requirements under various scenarios and stress tests.

11. **Assessments of the strength of macroeconomic policies will inevitably involve a degree of judgment, but it is possible to identify some indicators that strong performers would be expected to share.** Such countries would typically have sound structural fiscal positions, low and relatively stable rates of inflation resulting from solid monetary policy implementation, and effective financial sector supervision. They would also be expected to

have sustainable current account positions, capital accounts that are dominated by private flows, and a history of steady access to capital markets at favorable terms. Finally, while the growing balance of payments pressures may require the country to augment its reserves with Fund financing, its reserve position should be relatively comfortable by standard measures.

B. Access and Safeguards

Under the facility members would be granted substantial access available upfront that would reinforce confidence in the member's capacity to meet short-term liquidity requirements. It would also add force to the Fund's signal of support. Safeguards would be ensured by the quickly self-correcting nature of the balance of payments problem, by the very short repurchase period, and by the related strict qualification criteria that focus on strong policy frameworks and track records.

12. **Access under the facility would be up to 500 percent of quota, available in the form of outright purchases.** This level of access would make the SLF relevant to members' needs. It would also equal the cumulative access limits that have been proposed for the credit tranches/EFF and for "global" access to Fund resources in the GRA.

13. **Consistent with existing requirements, the full amount of any purchase would need to be justified by the member's actual balance of payments needs.** It is envisaged, however, that the maximum 500 percent of quota would typically be needed, considering the high degree of capital market integration of the members eligible for the facility, and the nature of the balance of payments problem the facility is designed to address.

14. **The nature of the balance of the payments problem and the related qualification framework, including the debt sustainability analysis, would constitute the key safeguard for the Fund.** As the member's problem is self-correcting, the provision of high-access financing in the absence of an arrangement with standard features such as reviews and program targets would not result in any reduction in safeguards for the Fund. Rather, the Fund would have assurances that, in light of the member's fundamentals and policies, Fund financing would help the member resolve its difficulties quickly, and within the repurchase period under the facility. The outright purchases approach requires the Executive Board to conduct its assessment of policies and needs at the time each purchase is to be made.[1] Moreover, even if there were unexpected developments and additional measures are needed, the Fund would be confident, based on the member's very strong track record, that the member would take additional measures appropriate for these developments. The debt

[1] This is in contrast to a precautionary arrangement, for example, where the member has the right to make purchases until the next set of performance clauses become applicable, even if the outlook has changed drastically since completion of the last review.

sustainability analysis would provide further confidence regarding the member's capacity to repay the Fund.

C. Terms and Modalities

The terms proposed for the new facility reflect the premise that a quick restoration of global confidence should allow for a rapid recovery in the balance of payments of the relevant members and repayment to the Fund.

15. **As noted above, resources under the SLF would be made available in the form of outright purchases rather than under an arrangement.** This approach is appropriate, as a key purpose of Fund arrangements is to provide a framework for policy monitoring, which would not be applicable to SLF financing. It should be emphasized, however, that reliance on outright purchases would employ a modality particularly used in the early history of the Fund, when conditionality on policies was applied exclusively on an ex ante basis (see Box.)

16. **Given the facility's objective of addressing short-term self-correcting liquidity needs, a member's extended need for resources under the facility could signal a different kind of balance of payments problem.** Accordingly, access to the SLF would be limited to three outright purchases per 12-month period. All purchases under the SLF would be subject to the same terms and conditions.

17. **Once the three purchase limit was exhausted, any further Fund financial support would have to be requested under another Fund facility**. For example, a successor arrangement could be financed through the SRF or in the credit tranches (depending on the member's balance of payments need) with phased drawings and a standard structure of conditionality, since the member's need would be different in nature from that addressed by the SLF.

18. **Purchases under the SLF would be subject to short maturities, which would be consistent with the nature of the problem addressed by the facility.** Specifically, members would be obligated to repurchase the Fund's holdings of their currencies resulting from purchases under the facility in a single repurchase three months after the date of the relevant purchase.

Box. Background and Evolution of Conditionality in the Use of Fund Resources

The legal basis for Fund conditionality is Article V, Section 3(a), which requires the Fund to adopt policies that (i) will assist members to resolve their balance of payments problems in a manner consistent with the provisions of the Articles, and (ii) will establish adequate safeguards for the temporary use of the Fund's general resources. Conditionality is designed to meet both of these objectives. Specifically, by supporting policies that help the member resolve its balance of payments problem, conditionality also ensures that the member will be in a position to repay the Fund. And while the specific modalities of conditionality have evolved over time, the basic conceptual framework—an assessment that the member's policies are adequate to resolve its balance of payments problem—has not changed.

While Stand-By Arrangements have been an important feature of the Fund's policy framework since the 1950s, the Fund has in some periods also made very active use of outright purchases and the ex ante conditionality associated with this financing modality:

- **Era of Outright Purchases.** During the early years of the Fund, outright purchases were the primary modality through which members made use of the Fund's resources. They continued to be used frequently into the late 1960s. These requests for outright purchases were approved based on an assessment that the member's current and future policies would be sufficient to deal with its BOP problems. Adequate safeguards were thus ensured through an ex ante assessment of the member's policies. There was no framework for performance, monitoring or consultation. 1/

- **Emergence of the Stand-By Arrangement.** The first stand-by arrangement was approved in June 1952. Originally, stand-by arrangements were normally to be approved for periods not exceeding six months, and the early arrangements contained no performance clauses. The Fund over time became more willing to provide stand-by arrangements for longer periods of time, and performance, monitoring and consultation clauses were developed in this context. A robust framework of ex-post conditionality consisting of multiple reviews and other performance clauses has now become standard under Fund arrangements, including extended arrangements.

1/ While the original Articles did not provide an entirely explicit basis for policy conditionality, this basis was provided through a March 1948 interpretation. See Decision No. 287-3 (March 17, 1948).

19. **The SLF would be subject to charges and surcharges in line with the current schedule in the credit tranches.** SLF purchases would be subject to the general service charge that applies to all GRA purchases, and to the same level of periodic charges/surcharges as purchases in the credit tranches (the latter of which are equal to the adjusted rate of charge plus surcharge of (i) 100 bps for outstanding credit in excess of 200 percent of quota and (ii) 200 bps for outstanding credit in excess of 300 percent of quota.) The upcoming review of charges and maturities will consider surcharges under all facilities, including the SLF.

20. **Depending on demand, the SLF could have a significant impact on the Fund's liquidity position.** Fund liquidity is currently at historically high levels, with the Forward Commitment Capacity (FCC) at SDR 127.6 billion as of end-September 2008. However, this is expected to decline with new lending operations under existing facilities, including on exceptional access terms, and would fall further if there is wide demand for the SLF. By way of illustration, for an average-sized emerging market country, SLF access at 500 percent of quota would be on the order of SDR 4.3 billion while for some countries access could be of the order of SDR 15 billion or larger. Given the importance of ensuring that the Fund has sufficient resources for its traditional lending operations, it is proposed that the SLF be reviewed if outstanding purchases under the facility reach about SDR 60 billion, or half of the current Forward Commitment Capacity.[2]

D. Approval

21. **The process for the approval of a purchase under the SLF would be designed to give comfort to members that requests will be considered promptly, while reducing the risk of negative signals.** Following an expression of interest from the member, staff would make a preliminary assessment of eligibility. If Management decides there is a basis for moving forward, it would consult promptly with Executive Directors in an informal meeting. Staff would provide Directors with a short note setting out the case for approving the request. Board consideration of the member's request would take place quickly thereafter and be based on a short policy statement from the authorities and a staff report that assesses the member's qualification and the nature of the member's balance of payments problem. An assessment of the impact of the proposed purchase on the Fund's finances and liquidity position would also be part of the report.

[2] In order to ensure that the FCC appropriately captures purchases under the SLF, it will be necessary to redefine the measure by excluding repurchases falling due under the new facility.

E. Other Design Issues

22. **Establishment of the SLF would require an Executive Board decision adopted by an 85 percent majority of the total voting power.** Inter alia, Article V, Section 7(d) requires this qualified majority in cases (as proposed for the SLF) where a special repurchase period would apply to holdings of currency acquired under a special policy.[3]

23. **The SLF would incorporate a sunset clause providing for the expiration of the facility two years after its establishment.** At that time, the Board could review experience with the facility and determine whether it should continue to exist and whether any design changes are warranted. The effects of the SLF on the Fund's liquidity position could also be examined. A decision to extend the SLS beyond the initial sunset date would, like the original decision establishing the facility, require a Board decision adopted by an 85 percent majority of the total voting power.

24. **While the Fund has authority to require collateral when it provides high-access financing of the kind proposed for the SLF, it has generally not done so.**[4] The Fund has considered that the most effective safeguard for the use of its resources has been members' implementation of sound policies in the context of Fund-supported programs that enable them to overcome their balance of payments difficulties. And while the SLF involves no formal ex post conditionality, the facility's ex ante requirements place significant emphasis on policies, as discussed earlier. Even if additional policy measures were to be needed, the member's strong track record would provide assurances that appropriate measures would be taken. A collateral requirement in this context would thus seem necessarily to signal doubt by the Fund about either the nature of the balance of payments problem and/or the credibility of the member's policies and track record. Moreover, the Fund's emphasis on policies is a generally recognized public good that provides an important basis for the Fund's preferred creditor status. Finally, taking a pledge of collateral would raise important implementation issues, including the need to review the negative pledge clauses in the member's existing debt contracts to determine if any waiver or modification is needed.

---

[3] As is normal for special facilities, it is also proposed that purchases under the new facility would "float" against the reserve tranche (i.e., members would be able to maintain a reserve tranche position in the Fund despite making purchases under the facility); a decision providing for such floating also requires an 85 percent majority of the total voting power under Article XXX(c)(iii).

[4] Under Article V, Section 4, the Fund may require a member to pledge collateral security, inter alia, as a condition for the waiver required under the Articles where access exceeds 200 percent of quota. Such collateral is to be in the form of "acceptable assets" having a value sufficient in the opinion of the Fund to protect its interests. This authority has been used extremely rarely in the history of the Fund, and was last used over 45 years ago.

IV. Concluding Comments

25. **The SLF would fill an important gap in the Fund's toolkit at a critical time in global financial markets.** The high degree of integration of some emerging market countries into global capital markets has led to significant short-term external liquidity difficulties even in countries with sound macroeconomic frameworks and sustained histories of market access. While existing Fund facilities offer substantial flexibility, they are fundamentally designed for countries that require both financing and policy adjustment, and not for countries facing liquidity pressures that are external in origin and are expected to be self-correcting without the need for changes to an already sound policy framework. A number of features of the proposed new facility would address the needs of these members more directly than would an arrangement under existing facilities:

- Approval of a request for support under the SLF would represent a very strong endorsement from the Fund of the member's policies. A qualifying member would have passed a selective qualification framework.

- The design of the SLF is unique in that it provides substantial financing, all available upfront, without the standard phasing and conditionality of a Fund arrangement.

- The SLF would support the authorities' own efforts to reduce the impact of a crisis, providing substantial policy space to members.