

INTERNATIONAL MONETARY FUND

Signaling by the Fund—A Historical Review

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In consultation with other Departments

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I. INTRODUCTION

1. **The issue of “signaling” assessments of members’ policies to outsiders has repeatedly surfaced—directly or indirectly—in the context of recent discussions of Fund policy.**² The Board discussed a staff paper on signaling in early 2003, but signaling has featured also in discussions of surveillance, of a possible successor to the Contingent Credit Lines (CCL), and of the Fund’s involvement in low-income countries, and in the recent interest in “zero-money programs” and in making the Fund the “whistleblower” of the international financial system.

2. **The objective of this paper is to review the Fund’s thinking about signaling since its inception, with a view to drawing lessons for the design of possible signaling mechanisms.** Over the years, the Fund has both reflected on the ways in which its main activities—especially surveillance and use of Fund resources (UFR)—send signals, and has created instruments for the express purpose of signaling. Overall, attempts to “design” signaling mechanisms have been less than fully successful. This paper attempts to elucidate why, drawing primarily on the Fund’s own thinking and assessments. Annex I provides an overview of the various instruments discussed.

3. **The present review uses the term “signal” to refer to the conveying by the Fund of information that influences the financing decisions of outsiders, whether through some form of on/off mechanism or through the rendering of a multidimensional picture.** It thus encompasses the indirect signals sent by use of Fund resources (often referred to as the “catalytic effect” of Fund financing), the various signals that have been designed in an attempt to communicate Fund views about members’ policies, and the signals sent when documents are released to different audiences. The paper thus also considers both *on/off* mechanisms, where the signal is given by the activation of the mechanism (a typical example of which is a Fund arrangement, where the signal is given by approval and continuation of the arrangement), and mechanisms where it is the *multidimensional* analysis and assessment made while using the mechanism that constitutes the signal (a typical example of which can be found in surveillance, where the signal comes from the textured views formulated in the course of surveillance).

4. **The following discussion also encompasses signaling to varied groups, and for varied purposes:**

² “Outsiders” should be thought of as including official donors and creditors, both bilateral and multilateral, private creditors, and more generally the public. They include neither the member under review itself, nor other members in their capacity as its peers: although “signaling” to these is by no means unimportant, it is a different province—that of communication between staff and management, the Board, and the authorities.

- *Private creditors*—including banks, bondholders, and, to the extent that they hold financial assets, the public more generally—look to the Fund primarily for information on repayment prospects. At least nowadays, private creditors also have considerable information bases of their own, or have access to other agents that have such information. Moreover, it is more difficult for the Fund to make information available to private creditors than within official circles, as confidentiality considerations and specific strictures in the Articles of Agreement come into greater play (see paragraph 9).
- *Official donors and creditors*, both bilateral and multilateral, generally look to the Fund for reassurance that the country strategies they are supporting are macroeconomically viable (which may include reassurance on repayment prospects). They typically rely on the Fund’s clear informational advantage in this area, based on the fact that, through their membership and representation on the Fund’s Board, they generally have access to information received and views held by the Fund.

5. **This paper does not examine in detail the value attached by outsiders to the Fund’s signals.** As regards official creditors and donors, the Fund’s signaling role follows from those parties’ reliance on a division of labor with the Fund. There is also little doubt that private creditors looked to the Fund for reassurance in the early years of its existence, when economic information was not widely available. More recently, the literature has generally doubted that the Fund succeeds in catalyzing much financing from private creditors.³ Nonetheless, a recent strand of literature seems to be finding that Fund arrangements or publication of Fund documents do have an effect on interest rate spreads and stock prices, suggesting that some information is being conveyed.⁴

6. **The theoretical literature suggests that the Fund’s signals can convey three different kinds of information:**

- **First, a signal may convey superior information on the part of the Fund about a country’s economy, policies, and prospects.**⁵ The Fund generally has better

³ For a recent review, see Carlo Cottarelli and Curzio Giannini, “Bedfellows, Hostages, or Perfect Strangers? Global Capital Markets and the Catalytic Effect of IMF Crisis Lending,” IMF Working Paper, WP/02/193, 2002.

⁴ See in particular Graciela Kaminsky and Sergio Schmukler (1999), “What Triggers Market Jitters? A Chronicle of the Asian Crisis,” *Journal of International Money and Finance*, 18: 537-560; Ashoka Mody and Diego Saravia, “Catalyzing Private Capital Flows: Do IMF-Supported Programs Work as Commitment Devices?,” IMF Working Paper, WP/03/100, 2003; and Rachel Glennerster and Yongsek Shin, “Is Transparency Good for You, and Can the IMF Help?,” IMF Working Paper, WP/03/132, 2003.

⁵ The academic literature typically identifies “signaling” with the conveying of superior information in this realm. As noted above, the definition used in this paper is broader than this.

information than other official agents, consistent with the division of labor noted above. It may even have better information than private agents, for two reasons. First, the Fund has special access to policy-makers. Second, the public good characteristics of information may lead to private sector underinvestment—although any informational advantage the Fund may have relative to private creditors has certainly shrunk over time, as economic information has become more widely available (a development to which in recent years the Fund itself has contributed considerably, through its emphasis on data provision to the public and the transparency of members' policies). Any superior information on the Fund's part can be conveyed either directly, through publication, or indirectly, through the granting of a seal of approval, notably by means of the Fund's commitment of financial resources. Indeed, many have argued that in the absence of a commitment of resources the Fund would have inadequate incentives for "truthful reporting."⁶ Interestingly, even donors make this point.⁷

- **Second, a signaling mechanism may give a country the opportunity to demonstrate its commitment to sound policies.** Two possible market failures may be at play here. First, moral hazard arises if a government promises private creditors sound policies but does not have to deliver on them, either because the creditors cannot monitor them or because the policies cannot be contracted upon (for reasons of national sovereignty or because the borrower is not the sovereign).⁸ Second, adverse selection arises if creditors are not able to distinguish between governments that are or are not truly committed to sound policies. Conditionality under Fund-supported programs may thus have, respectively, a "delegated monitoring" role, by raising the cost of renegeing on policy commitments, or a "screening" role, by differentiating between governments who are and are not willing to pay the costs (economic or political) of a Fund-supported program.⁹ A signaling mechanism not involving Fund resources could in principle fulfill similar functions, as long as there were appropriate costs involved at different stages. This function of signaling mechanisms may be of similar importance to private and official providers of finance.

⁶ See, e.g., Dani Rodrik (1995), "Why Is There Multilateral Lending?," in M. Bruno and B. Pleskovic (eds.) (1995), *World Bank Annual Conference on Development Economics* (Washington DC: World Bank).

⁷ See Independent Evaluation Office (2002), "Evaluation of Prolonged Use of Fund Resources," Chapter 6.

⁸ This moral hazard is of course different from the one typically discussed in relation to Fund financing, whereby debtors or creditors may change their behavior in expectation of eventual Fund support.

⁹ See Jean Tirole (2002), "Financial Crises, Liquidity, and the International Monetary System" (Princeton, New Jersey: Princeton University Press) and Sylvia Marchesi and Jonathan P. Thomas (1999), "IMF Conditionality as a Screening Device," *Economic Journal*, 109: 111-125, for an exposition of these two roles.

- **Finally, a signal—at least in the case of a Fund arrangement—may convey information that a country has, or could have, additional resources at its disposal.** In cases of pure liquidity problems and multiple equilibria, it may thereby also allow the maintenance of a “good” equilibrium. This mechanism would likely be of importance for private creditors, though of lesser consequence for official creditors and donors. Moreover, while the mechanism is specific to arrangements, it may also operate to a lesser degree whenever the Fund indicates confidence in a member’s policies, as this could be construed as an indication of potential financial support.

7. **The remainder of this paper is structured as follows:** Section II provides an overview of signaling through the Fund’s history, tracing the recognition and use of signals from the creation of the Fund until now; while section III outlines the main themes emerging from that discussion, and offers a summary and conclusions.

II. HISTORY OF FUND SIGNALING¹⁰

8. **At the time of the birth of the Fund at Bretton Woods, signaling was not a prominent issue.** Central banking—an important inspiration for the Fund’s activities—was generally shrouded in secrecy. Moreover, as international economic relations were controlled to a large extent by states (through pervasive capital controls) and as the notion of foreign aid barely existed (prior to decolonization), the issue of influencing other providers of finance hardly arose. The emphasis was instead on a frank and comprehensive exchange of information between the Fund and its members, and confidentiality was judged to be crucial in this connection.

9. **The Articles of Agreement contain only one reference to making the Fund’s assessments public, and it is notable mainly for its restrictiveness.** Article XII, Section 8 allows the Fund, by a 70 percent majority of the voting power, to “publish a report made to a member regarding its monetary or economic conditions and developments which tend to produce a serious disequilibrium in the international balance of payments of members.” The founders clearly believed that publicity was potentially a powerful tool and that it had to be handled with great care: the provision both gives the Fund the power to intervene publicly, as a last resort, in case of a threat to the international monetary system (a power that has never been used), but is also interpreted to prevent the Fund (that is, the Executive Board) from

¹⁰ This section draws heavily on J.K. Horsefield (1969), “The International Monetary Fund, 1945-1965—Twenty Years of International Monetary Cooperation” (Washington DC: IMF); M. Garritsen de Vries (1976), “The International Monetary Fund, 1966-1971—The System Under Stress” (Washington DC: IMF); M. Garritsen de Vries (1985), “The International Monetary Fund, 1972-78—Cooperation on Trial” (Washington DC: IMF); and J. Boughton (2001), “Silent Revolution—The International Monetary Fund, 1979-89,” (Washington DC: IMF).

making its views on a member's policies public, absent the consent of the member concerned, unless such a threat exists.¹¹

A. A Simpler World: Surveillance and Use of Fund Resources—1946-1981

10. **While the Fund's instruments had not been designed with signaling in mind, they nevertheless had inevitable signaling effects.** The Fund's consultations with members on exchange arrangements, later to become "surveillance," while confidential, provided information to the Fund's member governments about other members. And use of Fund resources (UFR) sent signals well beyond this restricted circle, as the Board decided very early on that the public was entitled to an accounting of the Fund's resources and their use, and thus that press releases would be issued making the Fund's transactions public.

11. **Official donors and creditors—both bilateral and multilateral—had access to the Fund's information and analyses, and soon came to rely on them.** Both member governments and the World Bank received Fund documents from the outset, and other international organizations, beginning in the early 1950s, received increasing numbers of documents as time went on, subject to less and less restrictive procedures. In addition, to the extent that they were also donors and creditors, governments came increasingly to rely on the provision of additional information and analysis by Fund staff, who attended consultative groups and debt renegotiation meetings as "honest brokers"—particularly as regards the appropriate balance of financing and adjustment—from the late 1950s.

12. **The wider public, however, looked to UFR for signals of the Fund's views, and the signals provided in this context were initially largely negative.** Members came to the Fund in the event of balance of payments problems, and, because rights to draw were quasi-automatic rather than conditional and because there were no fixed periods for repurchase, there was little to offset the negative signal of balance of payments need. Although the member, thanks to its drawings on the Fund, now had more foreign exchange at its disposal, there was no assurance that policies were being adjusted to resolve the external problem. Conversely, because access to Fund resources was easy, the absence of UFR came to signal clearly an absence of need.

13. **It took a series of decisions by the Executive Board, culminating in the invention of the stand-by arrangement, before UFR started (also) signaling strength.** In 1952 the Board clarified the circumstances under which members could draw, mainly by specifying the concept of temporariness of Fund resources and establishing repurchase policies and,

¹¹ "Legal Aspects of the Publication of Staff Reports on Article IV Consultations and Use of Fund Resources," March 29, 1999. The publication of *staff's* views on members' economic policies is not constrained by Article XII, Section 8, but is subject to the principle that views reflecting confidential information from the member can only be published with the member's consent.

with these, safeguards policies and conditionality—paving the way for stand-by arrangements (SBAs).¹² The concept of “upper credit tranche conditionality” was developed to indicate policies of sufficient strength to qualify as safeguards for the use of Fund resources beyond the first 25 percent of quota—specifically, that the member’s program provides a “substantial justification” that its balance of payments problems are being addressed and that the Fund is confident that the improvement will allow it to be repaid. Henceforth, Fund lending implied a vote of confidence, backed by money. In the words of Joseph Gold (1969), referring to the early “impression that members resort to the Fund only in a crisis[.] Now, if one or another member is reluctant to use the Fund’s resources, the reason is less likely to be the fear that the public will be alarmed than the reluctance of the member to measure its program against the Fund’s tranche policies.”¹³ While the Fund would, over the years, develop a number of other financing policies and facilities that members could access even if their policies did not meet the standard of upper credit tranche conditionality, these would play at most a very targeted signaling role (Box 1).¹⁴

14. Although members’ fear that an approach to the Fund for an arrangement would be read as a sign of weakness was mitigated by the safeguards policies, it was not eliminated. As a consequence, to the present day, the Fund would continue to emphasize that members should approach it for an arrangement at an early stage of their difficulties. This objective is reflected, for instance, in the present Conditionality Guidelines as “the Fund encourages members to adopt sound economic and financial policies as a precaution against the emergence of balance of payments difficulties, or to take corrective measures at an early stage of the development of difficulties.”¹⁵ In the late 1970s, the Fund staff would even contemplate the idea of so-called “reverse stand-by arrangements,” under which the Fund would have granted stand-by arrangements to all members whose policies met the standards

¹² The safeguards principles were enshrined in the Articles in the 1968 amendment, which added to the Articles the language to the effect that use of Fund resources should be temporary and in accordance with policies that would assist members to solve their balance of payments problems in a manner consistent with the purposes of the Fund and that would establish adequate safeguards for repayment.

¹³ In J.K. Horsefield (ed.) (1969), “The International Monetary Fund, 1945-1965 – Twenty Years of International Monetary Cooperation,” (Washington DC: IMF), Volume II, p. 535.

¹⁴ Although a stand-by arrangement limited only to the first credit tranche is permitted, upper credit tranche stand-by arrangements have predominated. Their use would eventually spawn other facilities with upper credit tranche conditionality, notably the Extended Fund Facility (EFF) (distinguished by the medium-term nature of the balance of payments need), and the Enhanced Structural Adjustment Facility (ESAF)/Poverty Reduction and Growth Facility (PRGF) (distinguished by the protracted nature of the balance of payments problem, and the greater emphasis on growth and poverty reduction). This paper uses the term “arrangement” to refer to upper credit tranche stand-by, extended, and ESAF/PRGF arrangements.

¹⁵ Decision No. 12864-(02/102), September 25, 2002.

of upper credit tranche conditionality, without members ever requesting them. This proposal would have removed the negative signal from SBAs, but at the cost of transparent negative signaling for all those members that did not meet the criteria for SBAs, and was not pursued.

Box 1. Use of Fund Resources without Upper Credit Tranche Conditionality

Over time, the Fund has created (and in some cases later abolished) a number of policies and facilities under which it approves use of Fund resources without the member's policies meeting the standard of upper credit tranche conditionality. The most notable of these require the member to be “making reasonable efforts to solve its problems” (the first credit tranche, i.e., the first 25 percent of quota access in the General Resources Account), to be “cooperating with the Fund” in resolving its balance of payments problems (emergency assistance for natural disasters; the erstwhile Systemic Transformation Facility (STF), in existence from 1993 to 1995, for countries moving from centrally planned to market-based international trade; and the Compensatory Financing Facility (CFF) until the repeal of this provision in 2000), or to be intending to move to an arrangement (emergency post-conflict assistance, and the STF).

The case for weaker conditionality in these cases rests on a variety of considerations—the wish to build relations with members, humanitarian concerns, and/or on the Fund's desire to assume its role (including its signaling role) as part of an international response to a crisis or at a particular historical juncture, as well as the fact that, in all these cases, the limits to access to Fund resources are lower than under arrangements with upper credit tranche conditionality. The reversibility of the balance of payments problem at issue was the key basis for the CFF's criterion of “cooperation,” but in 2000 the Fund decided that this criterion, which involved making difficult judgments, was not adequate for cases that also featured more basic balance of payments problems and hence a need for adjustment.

Fund resources in these cases are made available without phasing, typically as “outright purchases” (but also through first credit tranche stand-by arrangements). The absence of some of the key trappings of an arrangement (see Box 2), together with relatively low access and relatively rare and targeted use of these instruments, has probably helped prevent misinterpretation of their standards as equivalent to upper credit tranche conditionality.

15. **Alongside safeguards for the Fund, the other basic principle underlying the design of the stand-by arrangement was that it had to give the member assurance as to the availability of resources—and this too had important signaling implications.** The principle of assurance was developed early on and would be codified in 1978 in Article XXX(b), which states that a member with a stand-by arrangement must be “assured that it will be able to make purchases ... in accordance with the terms of the decision...” (Box 2). The significance of this principle in connection with signaling is twofold. First, it maximizes the confidence of other providers of finance in the availability of Fund resources; and second, by curtailing the Fund's discretion to ask for new policy adjustments at a later stage, it ensures the Fund has every incentive to screen the member's program carefully at the outset, and thereby makes the Fund's seal of approval more credible.

Box 2. The Design of Arrangements and the Principle of Assurance

The typical design of conditionality, whereby conditions for drawings are identified precisely at the outset of the arrangement, is based on the principle that the member must be assured of the availability of resources—although this assurance has been somewhat qualified in recent decades by the growing role of program reviews. Conditions specified as objectively monitorable performance criteria leave the Fund no room to withhold a drawing if conditions are met, and thus imply a considerable degree of confidence on the Fund’s part in the member’s program, if it is adhered to. Conditions formulated as Board reviews of the program, by contrast, provide an opportunity for an exercise of judgment by the Fund and hence, in practice if not in principle, for a change of heart. In part reflecting the increased understanding of the importance of difficult-to-specify structural policies, program reviews have grown in importance as tools of conditionality since the 1980s, and the credibility of the signal the Fund gives in approving an arrangement may have weakened as a result.

It is to maintain assurance as to the availability of resources that the Fund does not challenge a representation of need by a member drawing resources under an arrangement. While need is a condition for use of Fund resources, it is considered that a Fund right to challenge a representation of need *ex ante* would unduly interfere with the member’s assurance. And although the Fund does have the right to challenge a representation of need *ex post* (i.e., after a drawing has taken place), it has never done so.

The principle of assurance is also the basis for the Fund’s inability to cancel an arrangement, and hence, incidentally, to send a clear signal that a program has gone off track. The Fund holds back its resources with the help of phasing and conditionality, without ever declaring a program beyond repair. While the Fund’s inability to cancel an arrangement reflects the need to give the member the benefit of the doubt as to its ability to bring its program back on track, it also has an effect on the type of signals given: a negative signal is given only through the absence of a positive signal, as a program review is initially delayed and eventually fails to be completed altogether.

Finally, the principle of giving assurance has also informed the proscription of “empty” program approvals and reviews, so that the Fund’s signal in an arrangement is backed up by the immediate availability of its own resources. Arrangements have always included a purchase to be made available on approval, which should be of a meaningful amount. The link between approval of a member’s policies and availability of resources would again be emphasized in a Board decision in 2000. An attempt by a member to request completion of a review under a SBA without requesting waivers that would have been necessary for the availability of the associated purchase, on the grounds that it was not planning to make further purchases, had generated disquiet in the Board, as it might have set a precedent which was not very transparent and which might have sent a wrong signal to the external community. As a result, the Board took a decision to prevent completion of an “empty” review—i.e., one that did not result in the immediate availability of a drawing.¹

¹ DEC/12278 and DEC/12279, August 28, 2000.

16. **Stand-by arrangements would remain a blunt signaling instrument, with little gradation possible.** Although the strength of the member’s program is one of the factors affecting the amount of access, so is balance of payments need, and thus the size of the

arrangement—not unlike its presence—again conveys an ambiguous signal.¹⁶ Nor can the Fund fine-tune its signal by charging riskier borrowers higher interest rates: it is bound by Article V, Section 8(d) to charge all members a uniform rate within each policy or facility in the General Resources Account.

17. **Stand-by arrangements were initially conceived and used in a precautionary manner.**¹⁷ The principle of assurance made it possible to make resources available before they were needed and, to an extent, their availability was expected to make their use unnecessary—implying that a signaling effect was already assumed to be important. While over time the “regular” arrangement became one where the member did draw, precautionary arrangements were always a—popular—vehicle for members seeking external policy discipline, or to signal strong policies, in addition to providing a financial backstop. Such arrangements are no different from non-precautionary arrangements, in the sense that the Fund commits its resources and the member retains the right to draw if a need arises, as long as it has met the conditions of the arrangement. Concomitantly, the signal of a precautionary arrangement may be somewhat more positive than that of an arrangement where the member draws: while the policy standards are the same, the absence of recourse to the Fund’s financial resources signals absence of a balance of payments need.¹⁸ Throughout the Fund’s history, there would be recurrent demand for (typically low-access) precautionary arrangements from members that wanted to demonstrate commitment to strong policies (e.g., recently, countries in central and eastern Europe about to join the European Union) or were exiting from use of Fund resources after an extended time.

18. **In sum, the invention of stand-by arrangements in 1952 opened the door for Fund lending to play a catalytic role.** Very soon, the potential of stand-by arrangements to support members in restoring and maintaining confidence in their currency was recognized. Capital flight featured prominently in a number of crises in the 1950s in which members sought Fund support. The first involved Mexico in 1954 and the most famous the United Kingdom in the Suez crisis of 1956. The Fund’s “psychological assistance” (in the words of an Executive Director at that time) was seen to consist both of the seal of approval conferred by the arrangement on the corrective actions proposed by the authorities, and of the commitment of Fund resources to strengthen reserves.

¹⁶ “The Chairman’s Summing Up at the Conclusion of the Discussion on Criteria for the Amount of Access in Individual Cases, EBM/83/167, December 2, 1983.”

¹⁷ Viewed ex post, precautionary arrangements are arrangements where the member does not draw on the Fund’s resources even when they become available (having declared its intention not to draw either upfront, or—if the arrangement “turns” precautionary—during the period of the arrangement).

¹⁸ Indeed, the different signal conveyed by a precautionary arrangement must have been instrumental in the development of the “precautionary stand-by arrangement” as a separate conceptual category (with its oddly redundant name).

19. **“Confidence restoring” arrangements grew in importance, and a watershed was reached with the 1967 stand-by arrangement with the United Kingdom.** This was not only relatively large, but more significantly departed from normal phasing procedures in that the entire amount of access was made available upon approval—in the words of the Managing Director, “to support a return to confidence with maximum speed, and to maintain confidence in future.”¹⁹ The UK arrangement triggered a general review of the Fund’s policy on the use of its resources, which formalized the possibility of arrangements with no phasing, in exceptional circumstances and where confidence effects were critical.²⁰ The Board was, however, clearly concerned about the possible continuation of the positive signal represented by the arrangement in cases where the member was no longer implementing a satisfactory program: the decision made explicit allowance for a public signal, under Article XII:8, that the member was departing from the agreed adjustment path. The possibility of arrangements with no phasing was relatively short-lived: it was eliminated in the 1979 conditionality guidelines, with the staff arguing that it had been intended only as a “safety valve” and that experience since 1968 had shown that it was not needed.²¹

20. **Arrangements were soon identified by official creditors—the Paris Club in particular—as providing useful signals.** An upper credit tranche arrangement with the Fund rapidly became a condition for the Paris Club to grant a member’s request for a rescheduling.²² The reasons were threefold. First, a Fund arrangement reassured creditors that corrective policies would be implemented. Second, a Fund arrangement also indicated that a rescheduling was needed: without a balance of payments problem, there would be no need for a rescheduling. And third, the Paris Club wished to “share the burden” of exceptional financing with the Fund. (The latter two reasons also underlie a reluctance by the Paris Club to grant rescheduling in the presence of a *precautionary* Fund arrangement.)

¹⁹ Executive Board Minutes, November 29, 1967. The 1967 sterling crisis was peculiar in that much of the risk stemmed from the possibility that official holders of sterling would wish to convert their sterling balances into dollars, but not intrinsically different from other crises of confidence.

²⁰ “In exceptional cases, phasing would not be stipulated if it was essential that the full amount of the stand-by arrangement be available promptly. In such a case, the performance clauses would require the member to consult the Fund about new or amended performance criteria even if there was nothing left to be drawn. This consultation was to include a discussion by the Executive Board that could culminate in a communication of their views to the member under Article XII, Section 8.” Decision No. 2603-(68/132), September 20, 1968, reproduced in M. Garritsen de Vries (1976), “The International Monetary Fund, 1966-1971—The System Under Stress” (Washington DC: IMF).

²¹ “Conditionality in the Upper Credit Tranches—Suggested Guidelines,” December 15, 1978.

²² There have been only a few cases since 1972 where the Paris Club agreed to a rescheduling for a Fund member without requiring a Fund arrangement (or FMP/RAP, see paragraph 34).

21. **Commercial banks, too, began to rely on the signals inherent in the Fund's lending.** A Fund arrangement provided both reassurance that sound policies were in place, and a means for governments to commit themselves to such policies. Accordingly, starting in the late 1950s and increasingly by the 1970s, the banks began sometimes to tie their own lending to the presence of a Fund arrangement, inferring from it that "the Fund [was] sufficiently satisfied with the adjustment measures that it [was] willing to commit its own resources."²³ On occasion banks went further and tied continued disbursements to observance of the Fund's performance clauses.

22. **The Fund looked favorably on banks' "parallel operations," although it was uncomfortable with its own degree of influence in this connection.** Persuaded that it was important for the banks to exercise their own discipline over borrowing countries, the staff emphasized that parallel operations were "of course, totally at [the banks'] discretion" and constituted an (implicitly independent) "private sector endorsement which encourages other forms of capital inflows." To support parallel operations, the staff assisted with the provision of information, and in particular, when requested to do so by the member, disclosed or confirmed to creditors whether the member remained eligible to draw under its arrangement.²⁴ However, the Fund remained firmly opposed to any suggestions to "experiment with certifications [of creditworthiness]," with the emphasis on the fact that parallel operations ensure "that the banks have the objective assurance that the Fund is sufficiently satisfied with the adjustment measures that it is willing to commit its own resources."

23. **While there was also interest outside the Fund in getting direct access to the Fund's information and analyses, the Board was keenly protective of the confidentiality of the relationship between the Fund and its members.** Commercial banks began to seek, and obtain, staff reports from country authorities, in violation of the Fund's rules prohibiting outside circulation of Fund documents. In 1977, in a discussion that foreshadowed the "transparency" debates of the 1990s, the Board considered, but rejected, the option of allowing members to release "their" Recent Economic Developments (RED) reports.²⁵ Its principal concern was that the confidentiality of the relationship between the Fund and its

²³ "Fund Relations with Commercial Banks," June 7, 1977. Quotations in the following paragraph are from the same source.

²⁴ While drawings were public knowledge and confirmed that a member had observed performance clauses, sometimes they were not necessary because of an absence of balance of payments need.

²⁵ REDs were (meant to be) factual reports, complementing the staff's analysis in staff reports. They were abolished as no longer useful in 2002, in the wake of explosive growth in the availability of economic information.

members—in particular, the manner in which Article IV consultations were conducted—was basic to the Fund’s work and effectiveness:

- The value of the Fund’s judgments, and hence the power of its signal, would be jeopardized if documents were released, because members would be tempted to exert pressure on the staff for a positive assessment. Accordingly, as noted by one Director, “the banks would never know whether the Fund’s view was in consequence of economic analysis or political pressures.”²⁶
- Conversely, release of documents would force the Fund into over-cautious assessments, as it would try to avoid blame for assessments that might lead private creditors to make loans that might subsequently prove imprudent.
- Finally, there was a risk of a “domino” effect: the option to publish REDs would exert irresistible pressure on all countries to publish their REDs. If a country did not publish, this would be interpreted as an admission of lack of creditworthiness.

B. Designing Signals—The Debt Crisis and Beyond

24. **The Mexican standstill of 1982 and the debt crisis that followed marked the beginning of a new relationship between the Fund and private creditors.**²⁷ The success of Fund-supported programs now depended, more than ever before, on the reactions of the banks. While the banks needed the Fund’s expertise and its ability to obtain credible policy commitments from the member, the Fund needed the banks to contribute resources to cover financing gaps, and assurance that potential Fund lending would not just lead to a commensurate reduction in bank exposures. The Fund’s three successive strategies during the debt crisis can be seen as different attempts to manage this mutual dependence, paralleling the shifting balance of power during this period as bank balance sheets strengthened. Under concerted lending, the Fund initially refused to lend without formal assurances from the banks that they would lend, too. Under the Baker Plan of 1985, the Fund returned to its traditional catalytic role. Finally, under the Brady Plan of 1987, the Fund developed its policy of lending into arrears, which allowed it to support a member’s program with financing from banks in the form of toleration of arrears, without clear assurances (as yet) that a comprehensive agreement that would provide adequate financing and restore sustainability would be forthcoming. Thus the Fund always played a key role in signaling the

²⁶ Executive Board Minutes, June 20, 1977.

²⁷ In July 1982, the Mexican authorities had approached the Fund to explore the possibility of a form of public endorsement by the Fund, without actually negotiating an upper credit tranche arrangement. The Fund agreed to explore this option, but events soon made it obsolete.

appropriate balance between debtor countries' adjustment efforts and financing, but its actions became progressively less dependent on those of the recipients of the signal.

25. **The dangers involved in moving beyond signaling to explicit coordination with banks were thrown into sharp relief by the Fund's first strategy to deal with the debt crisis, concerted lending.** The Fund initially refused to lend without formal assurances from commercial banks that they would lend, too. Concerted lending turned the Fund and the banks to an important degree into mutual hostages:

- Banks obtained a virtual veto over the design and approval of adjustment programs, especially but not exclusively in smaller countries where their exposure did not threaten their solvency, and increasingly over time as their balance sheets strengthened. In the case of Chile's 1984 stand-by arrangement, for instance, the Fund agreed to government subsidies for the servicing of private sector debt, even though this implied a multiple-currency practice and weakened the adjustment.
- Concerted lending implied significant interference by the Fund with the normal functioning of markets. The Fund became concerned, in the words of Jacques Polak, then Executive Director for the Netherlands, that "urging banks to extend credit... could not be a long-term activity of the Fund" and that banks were using concerted lending as a "security blanket" and a substitute for their own business judgment.²⁸

26. **A less fundamental problem with explicit coordination of lending decisions was the "chicken-and-egg" problem**—whereby the Fund arrangement was dependent on financing assurances but also often a condition for these assurances. Although this problem featured more prominently in the Fund's relations with the Paris Club than with commercial banks, it came to a head at the time of the widespread debt-servicing difficulties of the 1980s. In response, the Fund developed the "approval-in-principle" (AIP) procedure, under which the Fund stated its intention to approve an arrangement based on the member's program subject to adequate financing assurances, but the arrangement became effective only once the financing assurances had been obtained. AIP became popular for a time, and was even on a few occasions extended to arrangements where all the policy measures required had not yet been taken. Soon, however, the Fund became uncomfortable with the fact that AIP undermined the principle that a Fund arrangement constitutes a seal of approval for viability, and hence risked undermining the Fund's credibility. The practice was reined in, in favor of

²⁸ Executive Board Minutes of April 6, 1983 and April 22, 1983.

less formal coordination with the Paris Club in particular, and disappeared by the late 1980s.²⁹

27. **As the need for the Fund’s own financing in the debt crisis receded, the banks’ need for signals from the Fund led, for the first time, to interest in signaling outside the context of an arrangement.** In 1984, as the focus shifted to a medium-term approach, debtors and banks began to discuss Multi-Year Rescheduling Agreements (MYRAs) which would stretch into a time when Fund financial involvement would no longer be strictly required. The Fund was keen to avoid being drawn into prolonged use of Fund resources in cases without a manifest balance of payments need, and was therefore receptive to finding nonfinancial ways of supporting MYRAs. Moreover, it recognized that some members would prefer not to be subject to the conditionality associated with a Fund arrangement—“either or both as it is perceived as a formal recognition of a failure of past policies or as an imposition from outside of often difficult adjustment measures.”³⁰ Monitoring outside the context of an arrangement was appealing also from this point of view.

28. **These considerations led to the development of the first instrument designed explicitly for signaling purposes, “enhanced surveillance.”** The first commitment to some kind of post-arrangement Fund monitoring was given to Mexico in 1984, and procedures for such monitoring were established in September 1985. It was to be conducted at the request of the member; to involve semiannual consultations with the member, based on a quantified program and resulting in staff reports; and to permit the member to release “its” staff report to its creditors. Enhanced surveillance acquired its name because its procedures mimicked to a large extent those of Article IV surveillance; in fact, it was not part of surveillance, but rather a service to members under Article V, Section 2(b).³¹

29. **The Fund had reservations about enhanced surveillance from the outset, and the design of the procedure reflected a number of tensions:**

- As it had under concerted lending, the Fund feared that the banks would become too reliant on its judgment and that market discipline would thereby be weakened, in that creditors would no longer be “full and active participants in the process of monitoring

²⁹ In recent years, AIP has returned in a very restricted set of circumstances, with arrangements under the Poverty Reduction and Growth Facility (PRGF) being approved in principle when the World Bank has not yet approved the corresponding Poverty Reduction Strategy Paper (PRSP).

³⁰ “The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors,” July 23, 1985.

³¹ Article V, Section 2(b) states that “If requested, the Fund may decide to perform financial and technical services...that are consistent with the purposes of the Fund.”

and assessing the policies of debtor countries.”³² Moreover, such reliance could lead to the Fund taking responsibility for actions over which it had no control. Thus the notion that the Fund might “act as a rating agency” elicited universal disapproval. Accordingly, care was taken to avoid any on/off signals for bank lending decisions, including any *endorsement* of the member’s program. Enhanced surveillance was instead to provide a multidimensional, “textured” assessment on which banks would base their own decisions. In this context, considerable importance was also attached to the fact that only *staff* views were released to banks, and not the summing up of the Board discussion.³³ Later, the staff would also emphasize that the absence of performance criteria allowed opinions to differ on the significance of departures from desired performance.³⁴

- At the same time, the Fund was concerned that enhanced surveillance might provide a temporary palliative for members that really needed a Fund arrangement: “enhanced surveillance by providing a first and looser form of Fund involvement could delay rather than promote the adoption of actions which are sufficiently strong and comprehensive in the member’s circumstances.” As a result, and thus to some extent creating an on/off signal despite the desire not to, the Fund introduced criteria that a member should satisfy before enhanced surveillance could begin (specifically, a strong track record of adjustment and no foreseeable need for exceptional financing). At the same time, the Fund did not give itself the latitude to terminate the procedure unilaterally, so that the on/off signal lacked the “off” element.
- More broadly, the Fund saw several other reasons why enhanced surveillance should remain an exceptional procedure, and approved it only as a temporary and strictly limited expedient, essentially to help promote MYRAs:
 - The release of staff reports should remain exceptional, for fear of endangering the candor and frankness of policy discussions with members.
 - If enhanced surveillance became widespread, creditors might press for it at the first sign of market unease, which could “increase perceptions of Fund “tutelage”

³² “The Role of The Fund in Assisting Members with Commercial Banks and Official Creditors,” previously cited. Subsequent quotations in this paragraph are from the same source.

³³ The Fund’s reluctance to allow enhanced surveillance to operate on the basis of summings up was such that it deleted references to Board views expressed on previous occasions from staff reports when they were released, and even hesitated, in 1986, to countenance a proposal by the Paris Club—which received summings up through the normal channels—to approve a multiyear rescheduling on the basis of enhanced surveillance.

³⁴ In the discussion of enhanced surveillance for Yugoslavia, Executive Board Minutes, May 12, 1986.

and of a collusion between the Fund and banks, resented as such by members pressured into enhanced surveillance by their creditors, thus undermining the basis for cooperative dialogue between the Fund and its members.”

- In an echo of the debates of the early 1950s, there was seen to be a risk that the spread of enhanced surveillance could “narrow the range of members using Fund resources to only those with severe balance of payments difficulties,” so that “the request for use of Fund resources could become perceived by financial markets as providing a clear signal of severe difficulties.”

30. **Reflecting in part the unease surrounding it, enhanced surveillance was used sparingly but reviewed frequently.** In response to a growing demand from members for signaling mechanisms, its applicability was broadened in 1993 so that it could be requested by any member who might find it useful. Yet the procedure was still used in only six cases—and in almost all of these there were persistent policy slippages and divergences of views between the authorities and the staff.³⁵ In successive reviews, the Board expressed concern about the continuation of the positive signal conveyed by the procedure in the face of such slippages, and noted that creditors appeared to be misled by the mere presence of the procedure, attaching greater importance to it than to the content of the assessments. Procedures for unilateral termination of the procedure by the Fund were considered in 1989, but rejected as implying a clear “off” signal.³⁶ Instead, the Board reemphasized the importance of the track record criterion, and, in 1993, introduced a 12-month limit on the duration of enhanced surveillance, on the implicit assumption that nonrenewal conveyed less clear an “off” signal than termination.

31. **In the event, enhanced surveillance was undermined by the tensions noted above, and fell into disuse.** By 1994 the Board was clear not only that there was a contradiction between attempting to set an implicit standard for use of the procedure and not wanting to give an on/off signal, but that the implicit and rather vague nature of the standard left it prone to ambiguity: “While the enhanced surveillance procedures had been designed to avoid any Fund endorsement, in practice it may have been difficult to avoid the appearance of such endorsement, in view of the selectivity of the Fund regarding the programs it agreed to monitor under these procedures. ... Since no standard had been specified, some observers may have interpreted enhanced surveillance as support for programs that would meet the standards of upper credit tranche arrangements, while others may have viewed it as

³⁵ Enhanced surveillance was used to support MYRAs in Venezuela (1985), Yugoslavia (1986), and Uruguay (1987), and later for Ghana (1992), the Gambia (1993), and Bangladesh (1993).

³⁶ Executive Board Minutes, February 8, 1989.

indicating that policies fell somewhat short of this standard.”³⁷ Although enhanced surveillance formally survived the 1994 discussion and again garnered interest from some Directors in a 2003 discussion of signaling mechanisms, it has not been used again.³⁸

32. In the meantime, the Fund had experimented with a different signaling instrument in the form of a monitoring arrangement with Colombia in 1985. Following 15 Fund arrangements during 1957-74, Colombia considered itself to have “graduated” from UFR, and the authorities were determined to avoid a Fund arrangement. They asked the Fund to approve a “shadow arrangement” by certifying that their adjustment program was of sufficient strength to merit Fund financial support, monitoring implementation of that program, and authorizing the release of the staff report. In effect, they sought a seal of approval similar to that of an arrangement, without what they perceived to be the associated stigma. While the Board reluctantly approved the request, as banks had made this a condition for a MYRA, almost all Directors indicated that they viewed this as an exceptional case which should not be repeated.

33. The problems that the Board saw with this solution mirrored its thinking on enhanced surveillance. Many Directors felt that it was undesirable for the Fund to be drawn so deeply into debtor/creditor relations, fearing, in the words of one Director, that the Fund would assume “political and moral responsibilities vis-à-vis the commercial banks.”³⁹ The main difference between an arrangement and the proposed mechanism in Colombia was that the latter “had been designed with the explicit purpose of giving certain signals to the banks, whereas, under a regular stand-by arrangement involving the use of resources, the Fund was performing its normal role, leaving it up to the banks to decide whether or not they shared the assessment that the Fund made.” In addition, there was concern about “the perceptions that may develop of Fund policies and guidelines when these are applied outside the context of the approval of use of its own resources.”⁴⁰ there were clear incentives to provide positive assessments, and since the Fund’s resources were not at stake, the benchmark against which to measure success could become blurred, standards risked slipping, and the credibility of the Fund’s assessment would be weakened. (In the event, neither of these concerns was tested, as

³⁷ “Summing Up by the Chairman – Precautionary Arrangements, Enhanced Surveillance, and Program Monitoring; and Need as a Condition for the Use of Fund Resources, Executive Board Meeting 95/2, January 9, 1995,” January 13, 1995.

³⁸ “IMF Board Discusses the Fund’s Role in Signaling Assessments of Member’s Policies,” PIN 03/12, February 13, 2003.

³⁹ Executive Board Minutes, July 26, 1985. Unless otherwise indicated, subsequent quotations in this paragraph are from this source.

⁴⁰ “The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors,” July 23, 1985.

Colombia entered a period of strong economic performance thanks in part to a coffee boom—although over the period of the program Directors reiterated their hesitations about the mechanism of Fund involvement.⁴¹) Directors also pointed to the danger that UFR would come (again) to be perceived as a signal that other financing possibilities had been exhausted.

34. **The Colombia program remained a unique episode, although elements of it resurfaced in 1989 with the introduction of Fund-Monitored Programs (FMPs)**—the only other nonlending instrument whereby the Fund has certified a member’s program as being deserving of an upper credit tranche arrangement. FMPs—which soon evolved into Rights Accumulation Programs (RAPs)—were a step toward clearance of arrears to the Fund. In an FMP, the program of a member in arrears was endorsed by the Board as meeting the standards of upper credit tranche conditionality, so as to enable the Paris Club to reschedule and the member to gain access to new lending, particularly from official creditors, and eventually clear its arrears to the Fund. Successful implementation of these programs essentially committed the Fund to substantial lending to these members, which previously had very weak track records. Yet even in these cases, Directors thought that it might be difficult to maintain the standards of endorsement in the absence of the immediate commitment of Fund resources.⁴²

35. **While enhanced surveillance and the Colombia program had been designed to support MYRAs, by the early 1990s the demand for close Fund involvement in other circumstances led to the development of what would become “Staff-Monitored Programs” (SMPs).** SMPs were forward-looking quantified programs designed either to establish a track record toward a Fund arrangement or to signal to outside creditors (or, often conflated with the other two objectives, to provide a kind of “macroeconomic technical assistance”). The Board was typically kept informed in the context of Article IV consultations, but was not otherwise involved. Although SMPs—being monitored by the *staff*—were carefully designed to avoid the impression of *Fund* endorsement, it was understood from the outset that they should be reserved for members that met a certain minimum standard. In 1997, that standard was defined to be “situations where the staff judged that the authorities’ policy program was consistent with both its stated objectives and with the thrust of Fund advice provided in the Article IV context”—although a minority of the Board favored a more liberal approach, allowing for the possibility that a member’s

⁴¹ See Executive Board Minutes of May 23, 1986 and December 23, 1987.

⁴² Executive Board Minutes, July 26, 1985.

policies did not follow Fund advice and yet were consistent with the member's own objectives.⁴³

36. **In reviews of the SMP instrument during the 1990s the Board was generally well-satisfied with it, although concerns about possible misinterpretation and even misuse quickly arose.** Directors generally appreciated the flexibility afforded by SMPs, but were concerned that they could be misinterpreted as implying a formal endorsement by the Board rather than the staff, and/or policies of a strength equivalent to those required for an upper credit tranche arrangement. Indeed, there were instances where the authorities publicly pointed to staff monitoring as evidence of Fund support or endorsement of their policies. Concerns about misinterpretation grew with the increasing emphasis on transparency on the Fund's part (see below). As a result, and reflecting also concerns that the lack of formal procedures was endangering uniformity of treatment, the staff was asked to prepare guidelines for the use of SMPs.⁴⁴

37. **The 1998 draft guidelines for SMPs sought the solution to the problem of misinterpretation largely in raising the bar for use of the mechanism.** If the standard was high, misinterpretation would have lesser consequences, and so "to avoid misuse of such monitoring as representing a "Fund seal of approval," the staff should be circumspect in acceding to requests for monitoring"⁴⁵ Similarly, although formal resemblance to Fund-supported programs had previously been seen as problematic (in 1997, the staff had suggested that stand-alone Board documents initiating SMPs should be avoided on this count), it was now considered an important part of a bid to keep up standards, and it was agreed, for instance, that SMPs, like Fund-supported programs, should generally be set out in a letter of intent/memorandum of economic and financial policies (LOI/MEFP).

38. **By 2002, with increased emphasis on transparency, concerns about the ambiguity of SMPs had become overwhelming, and signaling SMPs were abolished the following year.** The recently-agreed requirement for LOIs/MEFPs was identified as having increased the potential ambiguity. A new problem was also highlighted, relating to the greater difficulty of switching the signal "off" than "on:" because publication policies regarding SMPs reflected the principle that publication should be voluntary, in practice the initiation of SMPs was always publicized, but subsequent performance assessments were not

⁴³ "Summing Up by the Chairman – Biennial Review of the Implementation of the Fund's Surveillance Over Member's Exchange Rate Policies and of the 1977 Surveillance Decision; and Transmittal of Fund Documents to Other International Organizations, Executive Board Meeting 97/30, March 28, 1997," April 3, 1997.

⁴⁴ These guidelines were discussed by the Board but never formally adopted.

⁴⁵ "Biennial Review of the Implementation of the Fund's Surveillance Over Member's Exchange Rate Policies and of the 1977 Surveillance Decision," February 19, 1997.

always made public. In any case, the risk of misinterpretation of the Fund's signal was in the end considered to be such that signaling SMPs were discontinued in 2003.⁴⁶

39. **Significantly, SMPs that served to establish a track record toward the use of Fund resources survived the 2002-03 discussions.** In these cases, the purpose—building a track record toward a Fund arrangement—established an implicit commitment that the staff would recommend Board approval of an arrangement after successful completion of the SMP, as well as a clear distinction from Fund-supported programs. Under these circumstances, any signaling to third parties was a by-product rather than the primary purpose of the instrument.

40. **As part of these discussions, the Board also considered in 2003 a staff proposal for a new signaling instrument, the so-called Enhanced Monitoring Procedure (EMProc), which would have eschewed standards altogether.** The EMProc—though a service to the member under Article V, Section 2(b)—would have been modeled on Article IV surveillance, with periodic interim assessments circulated to the Board for information. It would have resembled enhanced surveillance in that it would have provided a “textured and elaborate assessment.”⁴⁷ But, unlike enhanced surveillance, the EMProc would not have set a standard for “entry” into the procedure: the only standard would have followed from self-selection, as it was of course “unlikely that the authorities would want to proceed with the EMProc if the staff were to find their program wholly inadequate.” Thereby, the EMProc would have avoided giving a “simple binary—‘red light/green light’—signal,” and would have avoided risks of misinterpretation of the Fund signal. In addition, taking to heart the lessons learnt from the experience with SMPs, the EMProc was designed to avoid a formal resemblance to Fund arrangements and to provide for systematic reporting on performance with presumed publication of press releases.

41. **The EMProc was not adopted.** While many Directors supported it, a majority considered that existing Fund surveillance and precautionary arrangements were adequate to serve as signaling devices. In addition to the minority of Directors who saw a role for strengthened signaling SMPs with more Board involvement, Directors variously placed their hopes in precautionary arrangements, surveillance—especially given the trend toward greater transparency—and a revival of enhanced surveillance. Interest in the EMProc would, however, revive later that same year (paragraph 70).

42. **In considering signaling SMPs, the Board had also discussed “assessment letters” and affirmed their use as signaling instruments.** Assessment letters (also known

⁴⁶ “IMF Board Discusses the Fund's Role in Signaling Assessments of Members' Policies,” previously cited.

⁴⁷ “Signaling Assessments of Members' Policies,” January 8, 2003. Subsequent quotations in this paragraph are from the same source.

as “comfort letters”)—whereby the staff conveys its assessment of a member’s policies in response to ad hoc requests from multilateral development banks, donors, or other creditors—grew out of the staff’s early involvement with creditor groups of various kinds. Accordingly, they have been used in a wide variety of circumstances. Although experience with assessment letters is not well-documented, they are generally thought to be useful, flexible instruments. Their evolution, however, was anarchic, and guidelines were prepared in 2003 in an attempt to bring order to the process. Of particular importance was that assessments should be “sufficiently nuanced to account for different country circumstances,” but “written clearly so that the Boards of other IFIs or other donors will be able to distinguish between countries with strong macroeconomic policies and those without.”⁴⁸ These twin demands attempted again to reconcile the need for clarity with the avoidance of on/off signals that could be interpreted to confer a responsibility on the Fund for the lending decisions of others. A unique feature of assessment letters is that, unlike all the other mechanisms considered in this paper, they are “point in time” instruments: they are requested on a specific occasion, and there is no commitment to assess policies at a later time. Self-selection by members ensures that only helpful signals are given, and there need be no concern that a dangerously negative signal might need to be given down the road.

43. **In recent years, the Fund has begun to respond to requests for signals through what is being termed “intensified surveillance.”** As part of surveillance, the staff has always been expected to remain up-to-date on developments in member countries, and to inform the Board when necessary. This expectation forms the basis on which the staff is responding, in a few cases, to requests for monitoring and signaling by engaging in higher-frequency assessments (than just the annual Article IV report), which are provided to the Board. Such intensified surveillance may feature a forward-looking quantified framework, but, in contrast to the erstwhile signaling SMPs and in order to minimize the potential for misinterpretation, LOIs/MEFPs are not required. Signals can be given by means of the Board summing up on the occasion of the Article IV consultation (to official creditors and donors), assessment letters, and/or publication. However, publication has not been made a condition for such “intensified surveillance,” so that negative signals can only be inferred from non-publication.

44. **Intensified surveillance could in principle be conducted through the “supplemental surveillance procedures,”** although those procedures are designed to serve a somewhat different function. The supplemental surveillance procedures allow the Managing Director to initiate an informal and confidential discussion with a member where there are important economic or financial developments, and can lead to an additional ad hoc Article IV consultation and corresponding Board discussion.⁴⁹ The supplemental surveillance

⁴⁸ “IMF Board Discusses the Fund’s Role in Signaling Assessments of Members’ Policies,” previously cited.

⁴⁹ “Surveillance: Procedures,” Executive Board Decision, No. 6026-(79/13), January 22, 1979, as amended.

procedures were introduced in 1979 in an attempt to avoid the strong negative signal of a special consultation (under the 1977 Procedures for Surveillance) initiated where there is concern that a member's exchange rate policies may not be in accord with the exchange rate principles of the Fund. Nevertheless, the risk of a negative signal from engagement in supplemental surveillance exists, and the procedures have only been initiated in two cases (Sweden, 1982, and Korea, 1987). In contrast, as a signaling mechanism, intensified surveillance is intended as a supportive instrument, rather than an investigative one. (Indeed, to the extent that it is provided as a service to members, “intensified surveillance,” like “enhanced surveillance,” is misnamed (paragraph 28).)⁵⁰

C. Developing the Fund’s Role in Low-Income Countries—1986 Onwards

45. **During the 1980s, the Fund’s signaling role also expanded into the area of development financing.** Developed country governments already looked to the Fund in their decisions on rescheduling, but by the mid-1980s, they began increasingly to seek macroeconomic reassurances for their development assistance as well.⁵¹ A review of development assistance in 1984 had concluded that aid was effective only in the context of a strong macroeconomic framework.⁵² The resulting emphasis on sound macroeconomic policies gave the Fund a much more central role in low-income countries than before. The Fund had created its first concessional lending facility, the Trust Fund, in 1976, and progressively developed more elaborate instruments, with stronger conditionality and hence greater signaling potential, with the Structural Adjustment Facility (1986) and the Enhanced Structural Adjustment Facility (1987). Signaling has become still more important under the current strategy, centering on Poverty Reduction Strategy Papers (PRSPs) and, for the Fund, on the Poverty Reduction and Growth Facility (PRGF, 1999), in view of its emphasis on donor coordination. The 1990s also saw the creation of the Heavily Indebted Poor Countries (HIPC) Initiative, under which performance under a Fund-supported program for a minimum period is a requirement for debt reduction—a strong case of “seal of approval” signaling.

46. **The Fund’s concessional lending functions much like other arrangements in providing signals, and its on/off nature is variously seen as an advantage and a disadvantage.** On the one hand, many donors consider that the signal given by the presence

⁵⁰ Post-program monitoring, introduced in 2000, features procedures rather similar to supplemental surveillance, with two Board discussions a year, but is designed to monitor ability to repay where the Fund’s exposure is large.

⁵¹ This demand for reassurance is so strong that the Fund has also provided macroeconomic assessments for non-members where the international community was heavily engaged, e.g. in East Timor (before its admission to the Fund) or Kosovo.

⁵² Robert Cassen and Associates (1984), *“Does Aid Work? Report to an Intergovernmental Task Force”* (Oxford: Clarendon Press).

of an arrangement is clear and reliable.⁵³ On the other hand, some donors might be willing to continue providing financing in circumstances in which the Fund judges that policies are not sufficiently strong to warrant an arrangement, and might place more emphasis on the multidimensional assessments provided in staff reports and assessment letters. Certainly one consequence of the fact that many donors rely on the on/off signals of Fund arrangements is that interruptions in Fund-supported programs can have a large and sudden effect on total volumes of financing.

47. **The World Bank-IMF Joint Staff Assessments (JSAs) of PRSPs may illustrate the difficulty of sustaining candid multidimensional and on/off signals at the same time.** While the JSA is intended as both a multidimensional assessment for the benefit of donors and as a necessary (though not sufficient) condition for a PRGF arrangement, the latter function quickly turned it into an on/off signal, and some observers have argued that this function has undermined its candor.

48. **Very recently, low-access PRGF arrangements have been emphasized for low-income members that have limited balance of payments needs.**⁵⁴ These countries frequently have sustained “good” policy performance, triggering more concessional aid flows, and Fund financing is no longer critical—yet donors may still find the Fund’s “seal of approval” helpful. These country characteristics are broadly those that would warrant a precautionary arrangement (see paragraph 17)—but precautionary PRGF arrangements would be problematic for several reasons, including because, being concessional, they would present members with incentives to draw even in the absence of balance of payments need. Low-access PRGF arrangements are helpful in these circumstances not only because they can be augmented rapidly should circumstances warrant, but also because Fund endorsement through the form of a financial arrangement—instead of a more loosely defined monitoring mechanism—imposes a clear performance standard.

D. Transparency and Signaling through Surveillance—1994 Onwards

49. **The 1990s, with their change in attitudes toward transparency, mark the key dividing line in the evolution of Fund signaling.** In an environment of increased economic integration, better information was seen to hold potential to support the smooth functioning of capital markets, particularly after the Mexican crisis of 1994-95, and still more after the Asian crisis of 1997-98. Market scrutiny would discipline governments and lead to early

⁵³ See the survey of donors in Independent Evaluation Office (2002), “Evaluation of Prolonged Use of Fund Resources,” Chapter 6.

⁵⁴ “The Fund’s Support of Low-Income Member Countries – Considerations on Instruments and Financing”, February 24, 2004, and PIN No. 04/40, April 15, 2004. See paragraphs 69-70 for another instrument that was discussed, but not adopted, at the same time.

detection of problems instead of late overreaction. The Fund encouraged members to make their policies more transparent, but also became an active participant in the provision of information through its publication policies. It was thought that not only would public availability of Fund views on members' policies help prevent crises, but it would also foster better-informed domestic policy debates and allow outsiders to evaluate Fund work, increasing the institution's accountability. With increasing openness on the Fund's part, surveillance began for the first time to send signals to a wider audience, and the Fund's ability to send multidimensional signals was transformed.

50. **On the whole, the benefits of Fund transparency were seen to be such that they outweighed substantial risks.** Chief among these was the risk to the dialogue between the Fund and the member—both the provision of information by the member and the Fund's candid expression of its views. While it was not proposed that the Fund would publish its views without the consent of the member, it was (correctly) foreseen (as it had been in the 1977 debate about releasing REDs to the banks) that publication by some members would influence others to follow suit. The Board was also keenly aware that publicizing a negative assessment could trigger the very crisis that the Fund's admonitions were seeking to prevent. And the ever-present danger of being wrong—in the words of one Executive Director, of “predicting five out of the next two crises”—made the risk of making the situation worse even less palatable, and added to it the risk of undermining the Fund's credibility.

51. **Thus the Fund became increasingly transparent, while holding fast to the principle of voluntary publication.** The release of REDs was permitted from 1994, with the stipulations that staff would be generally expected not to include potentially sensitive information in REDs, and that the member would have the right to object to publication or to identify and delete data it deemed confidential. In 1997, the Board agreed to publication on a voluntary basis of the conclusions of summings up of Board discussions of Article IV consultations in the form of Press (later Public) Information Notices. In 1999, a decision was taken—initially in the context of a pilot project—to allow the publication on a voluntary basis of Article IV staff reports and on a presumed basis of letters of intent. Publication of UFR staff reports was allowed on a voluntary basis in 2000, and became “voluntary but presumed” as of July 2004. In all these cases, highly market-sensitive information may be deleted prior to publication.

52. **The issue of candor continues to resonate, not only in the context of publication, but also in recent concern about the Fund's ability to deliver candid assessments in program cases.** This concern centers on the need to step back from the program framework and take a fresh perspective, and is exemplified by the comparatively poor quality of surveillance in program countries. On the occasion of the 2002 Biennial Surveillance Review, staff commented that “the commitment to the program and its policy agenda readily turns the program into a framework of reference that, while useful, also tends to supplant a

fundamental reexamination of economic developments and policies. Of course such a fundamental reexamination could call into question the program strategy... [or could] reopen the debate on certain aspects of the program that had been settled earlier in complicated and prolonged negotiations.”⁵⁵ The Fund has made efforts since 2002 to ensure that surveillance in program countries is conducted with an appropriately fresh perspective, but the fact remains that it appears to be more difficult for the Fund to sustain candid and nuanced multidimensional signals once the “on” signal of an arrangement is given.

53. **At the same time as it relaxed its publication policies, the Fund opened many less formal channels of communication with the public.** Press conferences, speeches, and interviews became increasingly important modes of dissemination of Board and staff views, both at headquarters and in member countries. It increasingly became the practice to announce missions in advance, and thus sometimes to postpone or cancel them in full view of the media. In the process, the Fund developed ways of sending many informal signals, and thereby also of managing the gradual release of negative information.

54. **Even as the Fund itself became more open, it also encouraged members to make their policies more transparent, and began to publish assessments of their efforts against internationally accepted standards.** The standards and codes initiative following the financial crises of the 1990s involved the Fund both in creating or endorsing key standards for information provision by countries (notably the Special and General Data Dissemination Standards, SDDS and GDDS) and for the conduct of policy, and in assessing observance with them, through the Reports on Observance of Standards and Codes (ROSCs).⁵⁶ At the same time and in collaboration with the World Bank, the Fund created the Financial Sector Assessment Program (FSAP) and Financial Sector Stability Assessments (FSSAs). Through ROSCs and FSSAs, which can be published with the member’s consent, the Fund—at the request of the member and often in collaboration with the World Bank—provides a great deal of public information.

55. **Along with discussions of transparency in general came consideration—though not adoption—of systems that would allow the Fund to publish warnings to members.** This possibility attracted special attention in the aftermath of the Asian crisis, as the Fund reflected on the way it had correctly diagnosed the risk of crisis in Thailand, but had failed to

⁵⁵ “Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision—Surveillance in a Program Environment,” March 15, 2002.

⁵⁶ The Fund has recognized 12 areas and associated standards as useful for its operational work and that of the World Bank. These comprise accounting; auditing; anti-money laundering and countering the financing of terrorism (AML/CFT); banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation.

influence the authorities' policies.⁵⁷ Much of the ensuing discussion, in 1998, of a "tiered response" (or a "yellow card" approach) concerned ways in which the Fund could communicate the degree of its concern more clearly to the member. However, the final step in the various proposed "yellow card" schemes generally consisted of going public, e.g., under the still-unused provisions of Article XII:8 (see paragraph 9). This option brought with it the same risks as transparency in general—of damage to the dialogue between the Fund and the member, and of accelerating crises—but writ significantly larger: the staff paper discussing tiered response systems referred to Article XII:8 only in a footnote, and with the qualifier "probably never to be invoked."⁵⁸ A similar debate would recur in 2003 in the context of a suggestion by the Independent Evaluation Office (IEO) that the Fund engage in "escalated signaling" in cases where "key identified vulnerabilities are not addressed over several rounds of surveillance."⁵⁹

56. Although the Board rejected a tiered response system, a still more far-reaching option—that of having the Fund publish explicit ratings of countries—continued to attract attention. The idea was discussed by the Board in 2003, but there was little interest in pursuing the proposal.⁶⁰ In common with tiered response systems, a rating system would by definition involve publication of negative assessments without the consent of the member, and it would thus entail the same risks. The staff paper also highlighted the difficulty of establishing sufficiently objective and broad criteria against which to conduct assessments. These arguments against the proposal found some echo at the Board, although most Directors limited themselves to stating that they opposed the proposal: as in the past, the idea of the Fund becoming a rating agency aroused immediate distaste.

57. In one way, through the Financial Transactions Plan, the Fund does rate its members. The Fund's financial transactions are conducted with currencies of members that have a sufficiently strong external position; therefore, inclusion in the list of members participating in the Financial Transactions Plan is generally viewed as a signal of strength. However, the Fund seeks to avoid giving too strong signals: while the list of participating members has been published since early 2000, this is done with a delay of three months. In addition, the Fund asserts the caveats that "the assessment of a member's balance of

⁵⁷ "Review of Members' Policies in the Context of Surveillance—Lessons for Surveillance from the Asian Crisis," March 9, 1998.

⁵⁸ "Transparency in Members' Policies and Fund Surveillance," July 2, 1998.

⁵⁹ Independent Evaluation Office (2003), "The IMF and Recent Capital Account Crises—Indonesia, Korea, Brazil."

⁶⁰ "Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps," PIN No. 03/50, April 10, 2003

payments and reserve position is ultimately a matter of judgment, [and it] does not therefore rely on automatic indicators or define rigidly the notion of a sufficiently strong external position,” and that “members may be selected to participate in the financing of IMF transactions even though there may be some elements of weakness in their overall balance of payments and reserve position.”⁶¹

E. Designing New Financing Facilities—1997 Onwards

58. **The growing magnitude of private financing flows in the 1990s also led to more conscious attempts to design financing facilities with a special signaling effect.** Short-term balance of payments pressures experienced by some members were perceived to be the result of “speculative” capital flows, resulting from rapid shifts in market perceptions, or from misunderstandings of policies by markets. In this context, Fund financing could play an important signaling role, as long as the Fund’s assessment was based on better information, or less herd-like judgment, than the markets’, or as long as it resolved the coordination difficulties inherent in the maintenance of a “good” equilibrium.

59. **A Short-Term Financing Facility (STFF) was discussed as early as 1994, though never approved.**⁶² The STFF would have been a new, fast-disbursing facility, with high access (100-300 percent of quota), for very short-term financing needs and with repurchases within a commensurately short time frame. It was designed for members that might face short-term capital account pressures, but where no major reorientation of policies was deemed necessary. Qualification for the facility was to be tied to Article IV consultations.

60. **There were several problems with the STFF proposal, some of which would come back to haunt the CCL.** In particular:

- There were potential “entry” and “exit” problems. A request for approval of access to the facility could be seen as a signal of concerns about potential external difficulties, while nonrenewal could be read as an “off” signal. To counter these difficulties, the staff even suggested “maintain[ing] some degree of confidentiality about the availability of the facility to a member”—effectively eliminating any signaling effect.
- There was a tension between commitment and safeguards. To provide assurance of financing to the member, access to drawings needed to be automatic, following qualification. But the staff clearly worried that this provided insufficient safeguards

⁶¹ Quotations in this paragraph are from the regular publication “Financing IMF Transactions—Quarterly Report.”

⁶² “Short-Term Financing Facility,” September 26, 1994. Quotations in the following paragraph are from this paper.

for Fund resources, and put forward an alternative proposal under which, following qualification, drawings required separate approval—diluting the member’s assurance that it would be able to draw and thereby also the Fund’s seal of approval.

- Implicit in this search for stronger safeguards was also a recognition of fallibility. The staff paper elegantly referred to “transitional problems”—the problems that would arise “if what was initially thought to be a transitory problem persisted”—and sought their solution in “a very careful screening of requests for use of the ... facility.” The Board, too, commented on the difficulty of assessing when markets have misjudged a particular country’s policy stance and on the risks involved, for the member and for the Fund, of attempting to go counter to market forces.

61. **The capital account crises of the 1990s and early 2000s—starting with Mexico (1994-95)—raised the issue of signaling anew.** The massive capital movements that triggered these crises dwarfed the amounts that the Fund could deploy. In any event, even if the Fund had been able, on its own, to finance the very large capital outflows experienced by the crisis countries, the problem of moral hazard would have arisen with special intensity. Moreover, the ability—of the Fund and of central banks—to influence private creditors was diminished as bonds had to a large extent replaced loans, implying that creditors were less subject to regulatory suasion. These factors gave new prominence, in capital account crises, to the catalytic effect and to signaling.⁶³ In response to the crises, the Fund would commit large amounts of resources, and devise two new instruments in succession, the SRF and the CCL.

62. **The Fund handled the capital account crises by means of large-access stand-by arrangements, initially in the credit tranches, but soon, starting in 1997, using the SRF.** The creation of the SRF underlined the expectation that the Fund’s catalytic effect would be strong: the SRF was intended for short-term capital account pressures, which would reverse themselves rapidly enough, allowing the member to make repurchases within a short time frame (originally one year). Indeed, the initial projections under the relevant programs assumed large catalytic effects.

63. **The Fund has not generally had great success with signaling in recent capital account crises.** Detailed assessments of the success or failure of these arrangements are provided elsewhere.⁶⁴ While some arrangements were ultimately successful, in most cases

⁶³ Signaling was complemented in some early cases by concerted official financing and moral suasion on commercial banks, but use of these mechanisms became less frequent as the crises multiplied. More recently, some bilateral assistance has been associated with large Fund-supported arrangements (e.g. in Turkey).

⁶⁴ See, for example, Atish R. Ghosh, Timothy D. Lane, Marianne Schulze-Ghattas, Ales Bulir, Javier Hamann, and Alexandros T. Mourmouras, “IMF-Supported Programs in Capital Account Crises—Design and

(continued)

the catalytic effects they counted on did not materialize, at least initially, and the adjustment that countries underwent was much greater than anticipated.

64. **To help avoid future crises, the Fund turned its attention to the possible design of a facility aimed at *preventing* crises, and created the CCL in 1999.** The CCL was aimed at countries that might be hit by international financial contagion. Its essence was to prevent private capital outflows in the event of international financial contagion by means of a signal of “first class” policies, coupled with the availability of large amounts of Fund resources (expected to be in the range of 300-500 percent of quota). The standard that policies needed to meet was higher than that of upper credit tranche conditionality, and was defined by reference to eligibility criteria focusing in particular on external vulnerability, including satisfactory policies, both in the recent past and planned for the future.

65. **The CCL was bedeviled by problems from the outset.** Its objective was to encourage sound policies, but members knew that, even if they did *not* follow sound policies, the Fund would stand ready to assist them if a need arose and as long as they mended their ways.⁶⁵ Members saw little advantage in accessing the CCL in “good times” rather than the SRF in “bad times,” especially since CCL resources were provided on the same terms as SRF resources (indeed, were more onerous to the extent that they carried a commitment fee even if the resources would never be used). Thus any appeal of the CCL would have had to come from its signaling effect—and members had a number of reservations on this score:

- Members feared that an arrangement providing for CCL resources would be regarded by markets as a sign of weakness rather than strength. This fear was exacerbated by uncertainty surrounding the strength of the CCL standard: members that might have considered requesting CCL resources were concerned that admission to the CCL “club” of other countries regarded as less solid might send an adverse signal.
- Relatedly, some members feared the perceived stigma of having any sort of Fund arrangement—the more so since access to CCL resources was through stand-by arrangements, thereby entailing the key trappings of the latter (a LOI/MEFP and a quarterly quantified framework).
- These problems were compounded by the very demanding standard expected of CCL-eligible members—in practice, an almost zero risk of suffering a crisis of their own

Experience,” IMF Occasional Paper No. 210; and Independent Evaluation Office (2003), “The IMF and Recent Capital Account Crises: Indonesia, Korea, and Brazil.”

⁶⁵ Hence, the CCL was not modeled on proposals to provide support for sound policies while *foreclosing the possibility of support* if a crisis resulted from unsound policies (proposals which raise important time consistency issues).

making. For such members, already enjoying low spreads on their debt, the upside potential from a Fund signal was bounded, while the downside risk should markets read access to the CCL as a negative signal was large.

- Moreover, in an echo of the STFF discussion five years earlier, the Fund initially retained the right to require additional policy action, in a so-called “activation review,” before it released any significant resources in the event of a crisis. This procedure raised the possibility of a serious disconnect between the strong signal (with very large headline “commitment” figures) and the underlying assessment of policies (which might not warrant the provision of such large-scale resources). The activation review thus diluted the confidence of markets not only in the availability of resources, but also in the credibility of the Fund’s signal.
- Members also feared that exit from the CCL would be read as a sign of deterioration of policies. Mirroring these concerns, some in the Board were concerned that “the risk of triggering a crisis by making a member exit from the CCL in the event of a weakening of policies could make the Fund reluctant to enforce the CCL criteria as strictly as it should.”⁶⁶

66. **Even if the CCL had been used, some believed its costs to the international financial system as a whole would outweigh its benefits, and emphasized its potential to foster creditor moral hazard.** In a sense, this concern was an updated form of the desire to avoid interference with markets, which had been prominent in the debt crisis—although this time creditors were not seen as following the Fund’s signals “blindly,” abdicating their responsibility for analysis, but rather would perceive a signal of Fund financial support and behave accordingly. “Constructive ambiguity” was viewed as a useful tool to lessen possible moral hazard.

67. **Changes were made to the CCL in November 2000, and more were considered in March 2003, but the facility was never utilized.** Targeting several of the problems noted above, the Fund reduced the rate of charge and the commitment fee on the CCL; essentially eliminated its discretion to ask for policy changes in the activation review; and attempted—perhaps to little effect—to make the monitoring arrangements less intrusive, by specifying that neither the “quantified framework” nor the structural program would feature benchmarks, and that there would be no need for a Technical Memorandum of Understanding. In early 2003, more revisions were considered, but not adopted. In particular, in an attempt to mitigate the “entry” problem, consideration was given to agreeing on and publishing a Board-endorsed list of countries that would qualify for the CCL. There was limited interest in this option, which was considered to be a variant of the “rating agency”

⁶⁶ “Review of Fund Facilities – Follow Up,” August 31, 2000.

option, and particular concern was expressed about the implicit negative signaling such a mechanism would imply for countries omitted from the list.

68. **The CCL was allowed to expire in November 2003, but not before a search had begun for other ways to meet its objectives, including notably discussion of a possible Enhanced Monitoring Policy (EMPol).** The Board discussed ways of adapting precautionary arrangements to capital account crisis prevention in June 2003, but many Directors did not wish to encourage high access, while a number of Directors also saw precautionary arrangements as carrying still more stigma and risks to entry than the CCL.⁶⁷ In November 2003, the Board considered a staff proposal for an EMPol—a procedure that could be said to resemble either (i) a precautionary arrangement in which the usual conditionality is replaced by an activation review, and (ii) semiannual Board assessments of a member’s policies (along the lines of the Enhanced Monitoring Procedure earlier proposed, paragraphs 40-41), with a limited financial backstop subject to an activation review by the Board.⁶⁸ Presentation of the EMPol as an alternative to the CCL implied great reliance on the signaling effect of both (and despite the ten-fold discrepancy in access between them). The EMPol’s main advantage relative to precautionary arrangements was thought to be the absence of the standard structure of an arrangement, which might lessen stigma. Lacking high access and resembling precautionary arrangements, the EMPol was not viewed by the Board as a useful substitute for the CCL.

69. **The EMPol was discussed again in the context of low-income countries in March 2004.** Against a background of some concern that close Fund monitoring in these countries was not fostering, and was perhaps even hindering, the development of policy formulation capacity, the less detailed conditionality of the EMPol was here considered an advantage, not so much with a view to reducing stigma, but in order to help low income countries “make the transition to a pure surveillance relationship.”⁶⁹

70. **Although arguments were made both for and against the financial backstop of the EMPol, in the end interest centered on a signaling mechanism without a link to Fund financing.** In the low-income country context, it was felt that “the Fund’s readiness to provide financing, when appropriate, under the [EMPol] would enhance the credibility of the

⁶⁷ “IMF Concludes Discussion on the Review of Contingent Credit Lines,” PIN No. 03/146, December 19, 2003.

⁶⁸ Ibid.

⁶⁹ “The Fund’s Support of Low-Income Member Countries – Considerations on Instruments and Financing”, February 24, 2004, and PIN No. 04/40, April 15, 2004. For the background to concerns about the effect of prolonged use of Fund resources on policy formulation capacity, see Independent Evaluation Office (2002), “Evaluation of Prolonged Use of Fund Resources.”

signal to donors;”⁷⁰ and the same should be true in middle-income countries with regard to private creditors. At the same time, under the proposed EMPol, the Fund would again, like in the original CCL, have retained the discretion to require policy changes in the activation review, and one could ask, therefore, whether it would truly be committing its resources. While this construct risked diluting the Fund’s signal, it was the *quid pro quo* for the proposed weakening of the traditional methods of conditionality, which was seen as the main benefit of the EMPol. Overall, doubts about the potential benefits of the EMPol, especially compared with precautionary arrangements, led the Board to suggest that consideration be given to an instrument akin to it but without a direct link to Fund financing (possibly, resembling the previously rejected Enhanced Monitoring Procedure).

III. SUMMARY AND CONCLUSIONS

71. **As is evident from this review, the Fund has, over the decades, returned repeatedly to the issue of signaling—and for good reason.** Instruments for signaling have been created and abandoned; attempts have been made to strengthen or weaken signals. The motivation that has driven this search remains valid: the wish to ensure that the Fund does its part, as effectively and efficiently as possible, in remedying information failures.

72. **Similar themes have recurred over the decades in the Fund’s thinking about signaling, though their relevance has changed over time.** The historical experience suggests seven reasons—discussed in turn below—why it has been so difficult to design a successful signaling mechanism. Some of these problems may have become less relevant as the world has changed, and some capture tradeoffs on which the Fund could choose to go one way or the other, as long as it was prepared to pay the associated cost. But testing any new proposal for a signaling mechanism against these seven problems should help to clarify potential difficulties and necessary choices.

73. ***Problem 1—The “gatekeeping” problem: There is a tension between the wish to influence creditors and the wish to leave them to arrive at their own judgments.***

- This problem is by far most pronounced with regard to private creditors. The Fund has sought to influence private creditors without becoming their “gatekeeper:” it has wanted to leave markets to their job of allocating resources, assessing risk, and disciplining policy, and has recognized that the Fund should not assume “political and moral responsibilities” for actions it cannot control.⁷¹ The Fund’s ambivalence in this regard is strengthened by the tension between its belief in its own informational advantage and its recognition that it is not infallible.

⁷⁰ Ibid.

⁷¹ Executive Board Minutes, July 26, 1985.

- The problem also exists with regard to official creditors and donors, although in this case the international division of labor mitigates the Fund's concern that it may unduly influence the decisions of others. Gatekeeping does, however, lead to a separate problem in the case of official providers of finance—namely, the risk that, through large multiplier effects, the Fund's actions will result in unduly large swings in the availability of financing.
- Gatekeeping, both as regards private and official sources of finance, also brings with it the risk of “reverse” leverage—namely, the risk that the Fund will be less selective in its signaling because of the inflated consequences of its signals for members.
- While financial arrangements may fulfill a gatekeeping function, in their case the Fund takes some comfort in the fact that its signal is a by-product of activities it undertakes on its own account. Certainly the notion that the Fund might act as a rating agency—a gatekeeping function *par excellence*—has consistently been viewed with great distaste. Indeed, the Fund has considered all on/off signals outside Fund arrangements as problematic in this regard: strenuous (if unsuccessful) efforts were made to avoid on/off signals under enhanced surveillance; the Colombian no-money “arrangement” of 1985 was not repeated; and assessment letters must avoid passing judgment on the appropriateness of others' financing operations.
- With the maturing of financial markets and with increased availability of economic information, there is surely now less reason to worry that private creditors would come to rely excessively on the Fund's judgments, although perhaps simultaneously less of a role for a gatekeeper to play: with the CCL, the Fund explicitly sought to take on the gatekeeping role, but with little success. Moreover, there remains a concern that a clear signal of support for a member—as in the CCL—might distort markets' decisions by fostering moral hazard.

74. *Problem 2—The problem of negative signals: The Fund tends to dislike giving negative signals, yet meaningful positive signals entail the possibility of negative ones.*

- Negative signals can play a role in fostering sound policies, and their absence robs positive signaling mechanisms both of their credibility and of their power to signal commitment.⁷² Nevertheless, the Fund tends to avoid them, for two main reasons. First, the Fund fears that negative signals would undermine the frankness of its dialogue with the authorities. Second, the Fund is concerned that negative signals

⁷² A cost to exit from a signaling mechanism allows the latter to signal commitment either by countering moral hazard (a country is less likely to deviate from agreed policies if there is a cost to doing so) or by countering adverse selection (a country that knows it is likely to deviate from sound policies is less likely to commit to them if there is a cost to deviating from them) (see paragraph 6, second bullet point).

could bring serious negative consequences for the member: in a country with access to capital markets, they could trigger the very crisis the Fund would be seeking to avert; and in an aid-recipient country, they could lead to a sharp reduction in foreign financing.

- Thus systems relying on outright negative signals (e.g., “yellow card” systems, “rating agency” systems, even the use of Article XII:8) have uniformly failed to attract support, and even systems that merely imply negative signals for members that do not receive positive ones (e.g., publication) have been the subject of some hesitation. The Fund does not even fully trust its own ability to deliver negative signals even when it has a system in place for doing so—witness, by way of illustration, the concern that surveillance staff reports are insufficiently candid.
- The problem of negative signals is especially intense in on/off mechanisms. The Fund operates successful on/off mechanisms in the form of arrangements, where its hand is strengthened by the need to safeguard its resources and exit takes place in a gradual fashion; but other on/off signals have been stymied by the difficulty of managing exit:
 - In some cases, these mechanisms have not provided for a clear exit, resulting in a less-than-completely honest signal. Under enhanced surveillance the Fund denied itself the option of unilateral termination; and signaling SMPs were not subject to a publication requirement, leading to nonpublication when policies went off-track.
 - Alternatively, where the mechanism has provided for a clear exit—i.e., in the CCL—it has remained unused partly for this reason.
- Assessment letters represent the only example of a mechanism that avoids the problem of (overly) negative signals altogether—as they are requested on a case-by-case basis, and hence presumably only when the assessment will be helpful—which may go some way toward explaining their popularity.

75. *Problem 3—The risk of misinterpretation: On-off signals are open to misinterpretation if they set a standard other than upper credit tranche conditionality.*

- In creating on/off mechanisms, the Fund has tended to create varied standards for their use. But the standard of Fund upper credit tranche conditionality is so well-known that any other standard tends either to be misinterpreted as equivalent (as happened with enhanced surveillance and signaling SMPs) or to be mistrusted (as happened with the CCL). In any event, in the absence of an ultimate benchmark, it is inherently difficult to establish clear standards that can be applied uniformly across the Fund’s membership: while it is often tricky to operationalize the capacity to repay requirement that underlies use of Fund resources, it is trickier still to establish a standard without such a benchmark.

76. ***Problem 4—The incentive problem: The credibility of signals is helped when the signal is backed by financial resources, and hindered when an instrument is designed for the sole purpose of signaling.***

- The credibility of signals depends on the incentives faced by the Fund and its staff. As a member-owned organization, the Fund may be suspected of making its assessments overly optimistic in order to protect the member. Its tendency to avoid negative signals (see Problem 2) underlines this danger, especially when exit from a positive signal may be necessary. It is not necessary for the Fund to succumb to this temptation for its signal to be devalued: the mere presence of incentives for the Fund to inflate its assessment will affect signal credibility. These incentives are somewhat mitigated when the Fund commits resources and “puts its money where its mouth is.”
- Thus it is significant that monitoring mechanisms intended to establish a track record for the use of Fund resources (FMPs and track record SMPs) have generally been viewed as successful, whereas the no-money “arrangement” with Colombia in 1985, which had no purpose other than signaling, was not repeated. It is also striking, in this connection, that the Fund has repeatedly been tempted by what might be termed “quasi-commitments”—“committing” resources while retaining the discretion to withhold them. This construct was a feature of the original CCL, but has been recognized to hinder the credibility of the Fund’s signal. Arrangements, by contrast, involve a tight link between the seal of approval and availability of resources: the typical design of conditionality, with phasing and performance clauses, curtails the Fund’s discretion to withhold resources during the course of an arrangement and thus strengthens its seal of approval; and the Fund has gone to some lengths to ensure that resources are released whenever an arrangement is approved or a review completed.
- It is true that that the opposite concern may also arise—that the Fund might “put its mouth where its money is,” with a view to enlisting the support of other creditors in order to protect its own resources. This incentive becomes stronger with increasing Fund *exposure* (not with increasing access under a given arrangement), and arguably a financial commitment under an arrangement still makes the signal more credible than it would otherwise be.⁷³ (Consider, for instance, that in a country with high Fund

⁷³ Consistent with this, the empirical literature so far suggests that large-access arrangements are associated with a stronger catalytic effect, be it because the commitment of larger sums by the Fund sends a stronger and more credible signal or because the country’s liquidity situation improves more decisively; and that the catalytic effect diminishes in strength the longer the use of Fund resources continues, possibly because creditors lose faith in the credibility of the Fund’s signal as the Fund’s exposure in, or more generally involvement with, the country grows. (Ashoka Mody and Diego Saravia (2003), “Catalyzing Private Capital Flows: Do IMF-Supported Programs Work as Commitment Devices?,” IMF Working Paper, WP/03/100).

exposure, where the signal of a Fund arrangement may be compromised, a no-money “arrangement” à la Colombia 1985 is likely to be even less credible.)

77. Problem 5—The “crowding-out” problem: On/off signals tend to crowd out multidimensional ones.

- The Fund has experienced difficulty sustaining clear multidimensional signals when it has also given on/off signals. In part, this difficulty is in the eye of the reader: in enhanced surveillance, for instance, creditors appeared to attach greater importance to the mere presence of enhanced surveillance than to the content of its assessments. It may also be in part in the hands of the writer (and thereby, in the case of arrangements, not unrelated to the issue of “putting one’s mouth where one’s money is,” noted above): witness the concern about ensuring candor in multidimensional assessments of program countries, such as in surveillance.

78. Problem 6—The dual signaling role of UFR: Recourse to Fund resources can be a signal of need as well as, or instead of, strength.

- Use of Fund resources involves ambiguous signals. Although the Fund provides financing only if it considers policies sound, it is also true that financing is needed only if there is a problem; and indeed higher access under an arrangement may signal either stronger policies or greater need, or both. In the early days of the Fund, the negative signal inherent in UFR deterred members from approaching the Fund. Of course, the significance of the negative signal inherent in UFR will depend on the pre-existing perception of the country’s position. Moreover, creditors nowadays have considerably more ability to identify external problems at an early stage—but that ability is probably not perfect (and governments may also be concerned about what they are signaling to the general public, as a clear signal of need can be interpreted as an admission of failure of past policies).
- As a result, and as illustrated by the CCL, there are great difficulties in investing a financing facility with a *special* signaling role—although precautionary arrangements appear to have overcome these difficulties to an important extent, perhaps thanks to their long pedigree.
- Moreover, as was debated upon the introduction of enhanced surveillance and on the occasion of the Colombian no-money “arrangement” of 1985, the existence of a nonfinancial signaling mechanism may affect the balance of signals conveyed by UFR. If an instrument could be conceived that permits a seal of approval of similar strength and credibility as an arrangement, a Fund arrangement would come to signal primarily balance of payments need—as policy strength could then be signaled by different means—potentially deterring members from coming to the Fund for an arrangement until their difficulties have become overwhelming.

79. ***Problem 7—The “stigma” problem: Signaling mechanisms that seek to be less intrusive than Fund arrangements are likely to be less effective.***

- While many members consider Fund endorsement of their policies helpful in the domestic political context as well as in the international arena, in some countries Fund involvement may provoke a political backlash. At the same time, in a number of low-income countries close monitoring by the Fund on a long-term basis has been suspected of undermining the development of national capacity. In both these cases, less intrusive signaling and/or less close monitoring procedures might be more constructive. But attempts to distance the procedures of signaling mechanisms from those of financial arrangements have foundered on the strengths of the latter’s design: there can be little close monitoring without a clearly specified and quantified policy framework—a framework which quickly becomes reminiscent of an arrangement.
- The Fund has tried to create mechanisms that overcome the stigma sometimes attached to its involvement, but with little success. In the CCL, it made an ineffectual attempt to improve the cosmetics of monitoring without weakening the signal. And in the proposed Enhanced Monitoring Policy, the staff suggested essentially that traditional conditionality could be replaced by an activation review—but less close monitoring would have gone hand in hand with reduced assurance to the member of the availability of resources, and thereby a weaker signal.

80. **Over the years the Fund has tried different ways through these various dilemmas:**⁷⁴

- The most basic choice has been the one between on/off and multidimensional signals. In principle, this choice should depend in large part on whether signal recipients are seeking information that can be relatively easily collapsed into a single dimension, or more complex kinds of information. But the Fund’s choices have been marked by the tension between, on the one hand, the wish to avoid “gatekeeping” (Problem 1) and negative signals (Problem 2), which argue *against* on/off mechanisms, and, on the other, a clear leaning toward minimum standards, which *create* on/off mechanisms. There have been several reasons for introducing minimum standards: a wish to avoid the use of monitoring mechanisms, which are after all a service to members, by members that would be better served by a financial arrangement; a belief (including by some donors) that on/off signals are particularly clear; and a belief that a minimum standard will help lessen the need to send negative signals. The result of this ambivalence toward on/off signals has been the creation of mechanisms

⁷⁴ Annex II provides a summary of the degree to which different instruments are affected by the various problems.

(enhanced surveillance and signaling SMPs) that overtly shunned, but implicitly incorporated, an on/off element—while blurring the “off” alternative.

- The Fund operates a successful on/off mechanism in the form of Fund arrangements. These avoid the problem of misinterpretation (Problem 3) by definition, most of the problem of gatekeeping (Problem 1) by construction, and the problems of negative signals (Problem 2) and incentives (Problem 4) to the extent that the Fund holds fast to its responsibility to protect its resources. However, the on/off signal of an arrangement does tend to overshadow multidimensional signals, which some providers of finance may prefer (Problem 5). Moreover, the degree to which the signaling role of arrangements can be stretched is limited by their ambiguous signal (Problem 6) and by the fact that they carry a stigma in the eyes of some members (Problem 7).
- The Fund also has other financing policies and facilities under which the member’s policies are not expected to meet the standard of upper credit tranche conditionality. Although some of these fulfill targeted signaling functions, they arguably avoid the problem of misinterpretation of their standard (Problem 3) by avoiding the trappings of arrangements, and perhaps thereby also weakening their own signal (Problem 7).
- Nonfinancial on/off signals have had to make a choice between the standard of upper credit tranche conditionality, and other standards. But mechanisms with other standards stumble on the problem of misinterpretation (Problem 3), and mechanisms with the standard of upper credit tranche conditionality on the dilution of the Fund’s incentives (Problem 4) and on a weakening of the appeal of Fund arrangements (Problem 6).
- The Fund’s surveillance, intensified surveillance, and the proposed Enhanced Monitoring Procedure do not feature minimum standards (relying as they do either on universal coverage or on self-selection), and convey multidimensional rather than on/off signals. They thereby avoid the problems of gatekeeping and misinterpretation (Problems 1 and 3), and, by not involving use of Fund resources, interaction with the signals of Fund arrangements (Problem 5). They do not fully avoid the risk of corruption of negative signals (Problem 2), the more so as they have no duty to protect Fund resources (Problem 4), but are perhaps less subject to it because they give graduated rather than sudden on/off signals.
- Finally, any nonfinancial mechanism may try to capitalize on the fact that no Fund resources are involved to reduce the intrusiveness of monitoring, but the scope in this regard is very limited (Problem 7).

81. **The problems outlined above could thus constitute a “checklist” against which to test the design of any new signaling mechanism.** While the various dilemmas do not preclude *per se* any particular signaling mechanism, they would need to be taken into

account whenever the issue of signaling arises—either in the design of new signaling devices, or more generally in the conception of any new policy.

Table 1: Characteristics of Signaling Instruments

Instrument	Period	Financing	Approval	Monitoring	Signal Type	Standard	Documents released
UFR (arrangement)	1952 -	Yes	Board	Board	On/off	Upper credit tranche	Initially none; Chairman’s Statement (1999); LOI/MEFP (1999); Staff Report (2000)
SRF	1998 -	Yes	Board	Board	On/off	Upper credit tranche	As under general publication policies
STFF	Consid. 1994, not introduced	Yes (w/ caveats)	Board	Board	On/off	Upper credit tranche	None—very confidential
CCL	1999-2003	Yes (w/ caveats)	Board	Board	On/off	Upper credit tranche	As under general publication policies
EMPol	Consid. 2003, not introduced	“Limited financial backstop”	Board	Board	On/off	“Effectively” upper credit tranche	As under general publication policies
Colombia	1985	No	Board	Board	On/off	Upper credit tranche	Staff Report to creditors
FMP/RAP	1989 -	No (but in the future)	Board	Board	On/off	Upper credit tranche (in context of arrears to Fund)	Initially none; now following general publication policies
Track record SMP	1994 -	No (but in the future)	Staff	Staff	On/off	“Program consistent with staff advice and authorities’ objectives” (1997)	Initially none; now following general publication policies
Enhanced Surveillance	1985 – 1/	No	Board	Board (only staff views dissem.)	On, but no off	“Strong track record and no foreseeable need for exceptional financing”	Release of Staff Report to creditors (not of summing up)
Signaling SMP	1992 - 2003	No	Staff	Staff	On, but no off	“Program consistent with staff advice and authorities’ objectives” (1997)	Initially none; now following general publication policies
Assessment Letter	1960s -	No	Staff	N/A	Multidim., one-time occurrence	None	The letter
EMProc	Consid. 2003, not introduced	No	Staff	Staff	Multi-dimensional	None	As under general publication policies
Intensified Surveillance	2003 -	No	Staff	Staff	Multi-dimensional	None	As under general publication policies
Surveillance	1946 -	No	N/A	Board	Multi-dimensional	None	Initially none; REDs (1994), Staff Report (1999), PIN (1999)

1/ Last use in 1993.

Table 2: Problems Faced by Signaling Instruments

	UFR	Designed Signals	Surveillance	“Super-Signals”
Instruments	<ul style="list-style-type: none"> • SBA • EFF • PRGF 	<ul style="list-style-type: none"> • Enhanced Surveillance • Colombia 1985 • Signaling SMP • EMPol 	<ul style="list-style-type: none"> • Surveillance • EMProc • Intensified surveillance 	<ul style="list-style-type: none"> • STFF • CCL • SRF/Exceptional access
Problems				
Gatekeeping	<i>Low:</i> Signal is in essence a by-product	<i>High:</i> All have on-off component	<i>Low:</i> Textured assessment	<i>High:</i> Success relies to a large extent on signaling effects
Negative signals	<i>Medium:</i> Off-signal mitigated as arrangements are not terminated by the Fund	<i>High:</i> Textured assessment; no off-signal	<i>Medium:</i> Textured assessment	<i>High (CCL, STFF):</i> Entry/exit problems <i>Medium (SRF/Exc. Access):</i> Off-signal is mitigated
Misinterpretation of standards	<i>Low:</i> Standard defined by ability to repay	<i>High:</i> Textured assessment; standard for entry	<i>None:</i> No standards	<i>Low:</i> Standard defined by ability to repay, high threshold for qualification
Fund incentives	<i>Low:</i> Commitment of Fund resources	<i>High:</i> To different degrees, incentive to provide positive assessments	<i>Medium:</i> No money at stake, but fear of triggering crisis	<i>Medium:</i> Large commitment of resources, but after large disb., incentive to provide positive assessments
Crowding out of multi-dim. signals	<i>High:</i> On-off signal	<i>Medium:</i> All have on-off component	<i>Low:</i> Textured assessment	<i>High:</i> On-off signal
Dual signaling (need as well as strength)	<i>Medium:</i> UFR reflects need (<i>High if alternative certification exists</i>)	<i>Low:</i> Need for a signal from the Fund, but no money	<i>None:</i>	<i>Med. (CCL, STFF):</i> Markets may mis-read as needing UFR <i>Medium (SRF/Exc. Access):</i> As for other UFR
Intrusiveness	<i>High:</i> Conditionality	<i>Medium:</i> Possible impression of tutelage	<i>Low:</i> No conditionality	<i>Med. (CCL, STFF):</i> Certification of policies already enacted, but pressure to maintain them. <i>High (SRF/Exc. Access):</i> Extensive conditionality