File "Trigger Clauses"

Mr. Sturc August 10, 1965

W. John R. Woodley

Morocco

We have had a couple of days of interesting discussions among the staff and with the Managing Director and the Deputy Managing Director regarding "trigger clauses" and bilateral agreements in connection with the Moroccan stand-by.

I protested regarding the Moroccan stand-by that the credit ceilings were for a 12-month period and that they should have been phased along with the drawings. The reply I got to this was that it was difficult to phase the credit ceiling for seasonal reasons and that the staff was not basically concerned with expansionary pressures in the present situation.

The draft letter which Merwin brought back "triggered" the introduction of new restrictions and the intensification of discrimination. I argued that I was concerned about making these "trigger" conditions where the quantitative restrictions were fairly complicated because cases might arise that we did not wish to take to the Board. The Managing Director and Legal did not want any "trigger clause" which involves any substantial degree of judgment, such as would be produced if we tried to "trigger" a major change in restrictions or a substantial intensification. We ended up by putting the introduction of restrictions and intensification of discrimination as an undertaking by the Government in a paragraph separate from the "trigger clause."

The Managing Director also stated his concern about "triggering" the introduction of new bilateral agreements. I argued that, although Tunisia was the only exact precedent, we had many cases where general statements of intent regarding bilateralism had been violated. In these circumstances it would be wise to introduce a "trigger clause" wherever we thought there was a possibility of deviations from the general commitment. I also argued that bilateralism in "trigger clauses" was a separate question from that raised by Mr. Saad regarding bilateralism in Article XIV decisions. The Managing Director is obviously concerned about this problem and is looking for some clarification of policy with regard to our Article XIV decisions.

Subj: Trigger clauses

Managing Director

August 9, 1965

Albert S. Gerstein
Charles L. Merwin
W. John R. Woodley

Morocco Letter of Intent

We have discussed the "trigger clauses" in paragraph 10 of the draft letter of intent of Morocco, and have come to the conclusion that it would be best to transfer the clauses about new restrictions and about liberalization to the end of paragraph 9, where they would be made subject to consultation with you. The addition to paragraph 9 would read as follows:

> "The Government undertakes that new restrictions on payments and transfers relating to current international transactions will not be introduced and that any liberalization of existing restrictions will not involve increased discrimination, except after agreement with the Managing Director of the Fund."

The payments agreement clause would be left in paragraph 10, as well as the credit ceilings.

cc: Mr. Southard
Mr. Gerstein
Mr. Woodley
N.Afr. Div.

CLM/js/8/9/65

Draft - 1/29/1965

To: The Managing Director

From: Ernest Sturc

Subject: "Trigger" clauses in stand-by arrangements

The Legal Counsel's paper of December 30, 1964, makes on pages 7 and 8 several provocative suggestions about "trigger" clauses used in stand-by arrangements. In general terms, I welcome the re-examination of this practice. Before commenting on Mr. Gold's specific points, I believe there are two additional aspects of the problem that should be taken into account:

1. When member countries depart from stipulated conditions in stand-by arrangements, there is at present no legal requirement that the Fund be informed. The staff frequently discovers departures through the periodic reporting procedure set up as part of the stand-by arrangement, but the general practice is to withhold such information from the Board until such time as a modification of the stand-by arrangement is proposed. Surely, if the Board approves stand-by arrangements, there are formidable reasons, including our responsibilities for certifying good behavior, for keeping it informed when drawing rights are in practice suspended. This point could be met by a draft of the "trigger" clause which read: "If at any time during the period of the stand-by arrangement the limits are exceeded, the Government will inform the Fund and will consult with it," etc.

2. The Fund has used to a considerable extent a clause requiring consultation and agreement with the Managing Director. This type of alternative to the standard "trigger" clauses has many advantages when problems such as formulation of new credit ceilings or changes in bank reserve requirements are involved. So far as I can recall, no Board member has questioned the appropriateness of the Managing Director assuming such responsibilities, and the arrangement has the advantage of considerable flexibility.

The essence of Mr. Gold's position, as I understand it, is that circumstances may exist (see top of page 7) when departures from specific commitments in stand-by arrangements are either unimportant (i.e., they do not go to the heart of the program) or where consultations may be inconvenient for the Fund or fruitless. In these circumstances, he suggests that the Fund should not have consultations unless a drawing is being considered.

While I do not object to Mr. Gold's practical conclusion, I do not find his argumentation convincing. The standard "trigger" conditions are concerned with (a) credit ceilings, an abbreviated form of expressing norms for fiscal and monetary policy; (b) the associated problem of bank reserve requirements and advance deposit requirements in those instances where excess reserves exist or where the credit program could be frustrated by lowering the reserve requirements; and (c) areas where the Fund already has approval jurisdiction such as multiple rates and other restrictions on payments. All of these areas are vital to a Fund program (if they are not, they should not be governed by "trigger" clauses), and departures from them warrant discussion with the Fund staff and management. Such discussions if they turn out badly need not be reported to the Board (i.e., the consultations need not be with the Fund), but such discussions should occur as soon as possible after the "trigger" conditions are violated. The best solution for meeting our responsibilities to the Board and at the same time achieving the real purpose of "trigger" conditions (i.e., trying to persuade the country not to depart unnecessarily from appropriate policies) would appear to be (a) to inform the Board (i.e., the Fund) immediately of departures from prescribed conditions; (b) for the staff to discuss with the country as soon as possible the reasons for the departures; and (c) for the Board to consider the problem and act only if further drawings are anticipated or the country wishes to be made eligible once again. This procedure suggests language such as "consult the management and prior to any further drawings will agree with the Fund," etc.

With regard to clause 3 (the general clause used in the United Kingdom and Australian stand-by arrangements), there would seem to be a good case for incorporating some of the staff's "understanding" as set out in Mr. Gold's memorandum in the actual language. There appear to be three essential items in such a clause: (1) The member will inform the Fund of major changes; (2) the Managing Director may request consultation; and (3) new understandings may be necessary. It would obviously be an improvement to incorporate point (1) in the clause. We should also consider the wisdom of leaving the definition of a major change to the country concerned. It is possible under existing language that the country could deny that a major change had taken place. In view of this, perhaps we should consider a re-draft which stipulated that the Fund could call for consultation if a major change in policy occurred.

Mr. Gold also makes the point with regard to clause 3 that it should be used sparingly when "trigger" clauses of type 1 exist. This appears to make a good deal of sense on the face of it, especially as clause 2, incorporated in the stand-by arrangement itself, permits the Fund to suspend drawings. In practice, however, the Fund is most reluctant to use the ineligibility clause (Article V, Section 5) and other devices of a less formal nature are usual (e.g., Burundi). Moreover, despite our best efforts to develop comprehensive "trigger " clauses, unexpected things frequently happen. Most of these deviations will ultimately result in violation of the "trigger" clauses, but this is of little comfort if the country is able under the phasing to draw immediately and the violation appears likely to take some time to emerge. In view of this, I think we should look again at the question of a general protective clause. If one could be devised which would give us protection against unexpected deviations but which would not represent the simple addition of clauses of type 3, the developed countries "trigger" clause, to the "trigger" clauses of the less developed countries, progress would be made.

INTERNATIONAL MONETARY FUND

January 22, 1965

To: Mr. Woodley

These are some of my thoughts generated by reading Mr. Gold's memorandum on "trigger" clauses.

Erik Elmholt

January 22, 1965.

For ERD only

"Trigger" Clauses in Stand-by Arrangements

Over the years experience has shown, that although care has been taken to draft "trigger" clauses in stand-by arrangements in such a way that there would be as little doubt as possible that the "trigger" had been activated, in a number of cases neither the staff nor the member country has been certain whether a particular development (change in policy etc.) in fact had activated the trigger. The need for elimination of this uncertainty, and other considerations, has prompted these notes.

1. The "trigger" clause is, from the Fund's point of view, the central clause in a stand-by arrangement. Its activation brings about a temporary, sometimes a permanent, termination of Fund financial assistance under the stand-by arrangement.

It is of the greatest importance that there is complete agreement, prior to the signing of a stand-by arrangement, between the authorities of the member country and the Fund (including the staff) as to the meaning of the language of the "trigger" clause. In drafting the language, it should be kept in mind that the language should be free, as far as at all possible, of technicalities. It should be understandable by laymen (particularly Governors of Central Banks and Ministers of Finance), and it should not be necessary for Fund staff members to have to refer to the Legal Department in order to explain to representatives of member countries how and by what events a particular "trigger" clause is activated. Past history shows that the Fund has not always been successful in fulfilling these requirements.

2. Stand-by arrangements are concluded with many countries and in many

different situations. 1/ The tendency to want to treat members in the same way, i.e., to want to apply a few, perhaps two or three standardized "trigger" clauses, is unrealistic. Anyone who has been involved in stand-by negotiations will know that circumstances are hardly ever the same. The superficial similarities (balance of payments deficit, inflationary pressures, government deficit etc.) often hide certain basic attitudes, policies etc. which differ from those in "similar" cases. The present policy of imposing credit ceilings on underdeveloped countries - or at least those without substantial political power or backing - but not on developed countries, appears, on the surface, as a discriminatory policy in favour of the developed countries. The smaller the number of versions of "trigger"clauses, the more glaring the discrimination.

The conclusion to be drawn from these facts is, that the trigger clause in a particular stand-by arrangement should be designed to fit the particular case. The main consideration should be that its meaning is clear, as far as at all possible, to both the authorities of the member country and to the Fund staff. Thus, it is necessary that the language of the "trigger" clause should be considered by the staff and by the authorities of the member country just as carefully during the stand-by negotiations as is the language of the rest of the letter of intent.

3. The above paragraphs center on relations between the member country and the Fund. However, there is an important aspect of stand-by arrangements that concerns relations between the member country and the Fund, on one side, and the public on the other side.

1/ In the January 21, 1965 speech by the MD, the management perhaps for the first time indicated that there are "some countries in the less developed areas, which have not found political conditions conducive to corrective action or lacked administrative or technical ability to carry it out, (thus) the provision of outside short-term financial assistance is of no lasting help."

At the present time it is announced when a stand-by arrangement has been agreed on between the Fund and a member country. In general, the successful conclusion of such negotiations indicates Fund approval of the country's financial policies, and it is often the go-ahead signal for supplementary assistance from non-government sources. However, no announcement is made when the member country becomes ineligible to rely on the Fund's financial assistance, and the general public is left with the impression that the country is operating under the conditions of the stand-by until it runs out (and it disappears from the stand-by table in IFS). 1/

This aspect - the relation between the partners to the stand-by arrangement and the general public - is more prominent in some cases than in others. It would appear that in drafting "trigger" clauses in cases where it is known that non-governmental assistance is contingent on eligibility for Fund assistance, this fact should be taken into account. If the Fund's world image of guarantor of sound financial policies in member countries with which it has stand-by arrangements should be tarnished, our ability to help member countries, particularly under developed countries, would be seriously diminished.

4. The above considerations in respect to drafting of "trigger" clauses do not mention a more basic policy matter, viz., the purposes and effects of "trigger" clauses in stand-by arrangements. A study should be made of our experience in operating stand-by arrangements, e.g., in how many cases

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1/ It should be added, that it is rather general knowledge that the Fund's relations with a small number of member countries is such, that the interpretation of the existence of stand-by arrangements with any of those members should be most carefully evaluated from the very inception.

did activation of "trigger" clauses actually result in discontinuation of Fund assistance, in how many cases did it result in adjustments of "ceilings" etc., with a view to continuing financial assistance; in how many cases did countries actually carry out policies intended, apart from those enumerated in the "trigger" clause, and in how many cases did they succeed in getting continued financial assistance in spite of their disregarding other (important) aspects of a financial program; to what extent can it realistically be said that phasing of stand-by assistance induced member countries effectively to carry out intended policies etc.

For meeting at 3.30 pm Thurs, Jan. 21/65
(Mr Altre's office)

The Managing Director

December 30, 1964

Joseph Gold

The Duty to Consult and Agree New Terms in Stand-by Arrangements

Problem

Over the years protective clauses have been developed in connection with stand-by arrangements under which in certain circumstances a member has to consult and agree new terms for further drawings. In connection with all of these clauses, the basic problem arises whether a member has to consult under them even if it does not intend to make further drawings under its stand-by arrangement. This problem was raised for discussion recently in the cases of Chile and Burundi. This memorandum explains the clauses that have been employed, and makes certain recommendations on the future formulation and use of them.

Types of clause

The clauses that have been developed have fallen into three main categories. One category (discussed below as Clause 1) is made up of clauses that are associated with provisions that establish legal conditions for drawings. This category is divided into two sub-classes. The first of these now employs the phrase "if at any time" in referring to departures from the legal conditions. Under it, consultation and agreement on new terms are intended after a departure has occurred even though before consultation and agreement the departure is eliminated because the member has resumed compliance with the condition. The second sub-class now employs the phrase "during any period", and under it there is no need for consultation and agreement on new terms if before consultation and agreement a departure is eliminated by the resumption of compliance. The distinction between these two sub-classes was developed in order to distinguish between policies that were thought to be of such importance that any departure from them could shake the member's program as a whole and those policies that were not considered so fundamental.

Another category of clauses calling for consultation and agreement on new terms (discussed below as Clause 3) is one in which consultation is tied to a change of policies that are not made legal conditions for drawings.

A third category (discussed below as Clause 2) is a standard one. That is to say, in contrast to Clauses 1 and 3, it appears in all stand-by arrangements. This clause calls for consultation and agreement on new terms when a member has become unable to draw either because

it has become ineligible or because the Board has decided to consider a proposal that the member be declared ineligible.

Clause 1

Clauses that establish legal conditions for drawings provide that if there is a departure (any departure under the "if any time" form or a continuing departure under the "during any period" form) from the prescribed conditions, the member will consult and agree new terms. The provision concerning consultation and agreement appears to have had its beginning in 1958 when, for example, in the stand-by arrangement for Chile, the clause was drafted as follows:

> "If between April 1 and December 31, 1958, the limits described in ... are exceeded, Chile will consult with the Fund and agree with it on the terms on which further drawings may be made."

In order to understand the origin of the clause it must be recalled that legal conditions for drawings under stand-by arrangements were then in their early days and had to be defended against the charge that they were not in accordance with the concept of an "assured line of credit". It was thought advisable, therefore, to make it clear that if there was a departure from a condition, this did not necessarily mean that there was no possibility of making further drawings during the remaining life of the stand-by arrangement. For this reason, it was made explicit that the member could resume drawings if it consulted and agreed new terms. Therefore, the consult and agree clause had a limited purpose. It did not interrupt drawings because this had already occurred. It is even arguable that it was not legally necessary either because it was implied or because it was covered by the standard clause on consultation. The purpose was basically to draw attention to the possibility of restoring drawing rights, and therefore it is likely that if the question had been raised in 1958 it would have been said that the clause called for consultation only if the member contemplated further drawings.

The consultation clause in the 1958 Chile stand-by arrangement was revised for the 1959 Chilean stand-by arrangement, apparently with the intention of making it clear that Chile would have to consult if there was a departure from the conditions whether or not Chile wished to draw further amounts. It is likely that, in view of the uncertainties associated with Chile's program, the question had by then arisen whether the member should be required to consult forthwith on a departure. This might help to limit headlong deterioration, even though further drawings might not be envisaged within the near future. The revised clause read:

> "If at any time during the period of the stand-by arrangement the limits ... are exceeded, the Government will consult with the Fund prior to any further drawings and agree with it on the terms on which such further drawings may be made."

Of the twenty stand-by arrangements listed in the December issue of IFS four did not include Clause 1 (Japan, Somalia, United Kingdom, United States). In ten cases, the clause reads substantially as follows:

> "[the member] will not request any further drawing under the stand-by arrangement except after consulting with the Fund and agreeing with it on the terms on which further drawings may be made."

The ten cases are Bolivia, Chile, Colombia, Dominican Republic, Ecuador, Haiti, Honduras, Nicaragua, Peru and the Philippines.

In six cases (Liberia, Haiti, Tunisia, Turkey, Syrian Arab Republic, and United Arab Republic), the clause reads substantially as follows:

> "[the member] will consult with the Fund prior to any further drawings under the stand-by arrangement and agree with it on the terms on which further drawings will be made."

In the recent case of Burundi, at your suggestion the following language was adopted for the purpose of making it clear that consultation was required even though further drawings might not be contemplated:

> "The Government of the Kingdom of Burundi will consult the Fund and will not request any further drawing under the stand-by arrangement, except after agreeing with it on the terms on which further drawings may be made."

It was also felt that to be consistent with this provision, certain clauses which had been prepared in the "during any period" form should be changed to the "if at any time" form.

It should be noted that in relatively rare cases, consultation and agreement have been tied to the phasing of the available amount. In the 1964 stand-by arrangement of the Dominican Republic this reads as follows:

> "... further, that if purchases under this stand-by arrangement reach a total equivalent to US$15 million the Dominican Republic will consult the Fund and agree with it on the terms on which further purchases under this stand-by arrangement may be made."

Clause 2

The policies that have been made legal conditions of drawings under Clause 1 in stand-by arrangements have been of an objective character, and on any departure (or any continuing departure) from one of these conditions the member's ability to draw was automatically interrupted. It followed that some policies could not be made legal conditions, and that the member's ability to draw could not be automatically interrupted. Two techniques have been adopted in the practice of the Fund to cope with this difficulty. The first of these was the "prior notice clause" in stand-by arrangements under which a member would cease to be able to draw if the Fund gave notice that the member's rights were in abeyance. The reasons for which the Fund could give notice were never specified (except in one unusual case), but they were tacitly understood to be a failure to follow those policies that had not been made conditions and that did not bring about an automatic interruption of drawings on a departure.

The "prior notice clause" was of a legal character. It gave the Fund the legal right to interrupt drawings that had not yet been requested, apparently for any reason that the Fund thought proper. In due course, the Board felt that this was unacceptable because it did not give members an adequate assurance of their ability to draw. A compromise was reached by amending the standard ineligibility clause in stand-by arrangements, and the formulation that was adopted involves a consultation and agreement clause. The paper that went to the Board (SM/61/10, February 14, 1961) proposed an amendment which involved the elimination of the "prior notice" clause and the addition of the following sentence to the paragraph in the stand-by arrangement dealing with ineligibility:

> "When notice of a decision is given pursuant to clause (b) of this paragraph, the member will consult the Fund and prior to any further drawings will agree with it the terms on which such further drawings may be made."

This text was not accepted by the Board because of the position of some Executive Directors that there was no good reason for requiring a member to consult when it had no intention of making further drawings under the stand-by arrangement (EBM/61/6, 2/20/61). The text as finally agreed was intended to indicate that consultation would be essential only when the member wished to make further purchases under the stand-by arrangement:

> "When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph, purchases under this stand-by arrangement will be resumed only after consultation has taken place between the Fund and the member and agreement has been reached on the terms for the resumption of such purchases."

Clause 3

The second technique that has been developed to widen the scope of protective clauses is the relatively recent clause that was first adopted in the case of Australia. This clause was intended to fill the gap that is felt to result from the fact that not all policies can be made legal conditions and from the rejection of the "prior notice clause" by the Board. In contrast to the defunct "prior notice clause", this later clause has not been given legal force.

In the case of the Australian stand-by arrangement, the letter of intent stated that:

> "Should any major shift in the direction or emphasis of policy become necessary during the currency of the stand-by arrangement the Australian Government would, at the request of the Managing Director, be ready to consult with the Fund and, if necessary, reach new understandings before any request for a further drawing under the stand-by arrangement is made."

In the staff paper concerning Australia's use of the Fund's resources (EBS/61/54, Sup. 1, 4/21/61) an explanation was given of this new clause:

> "In addition, should any major shift in policy become necessary during the currency of the stand-by arrangement, the Australian Government has indicated its readiness to consult with the Fund at the request of the Managing Director before making any request for a further drawing under the stand-by arrangement."

In the case of Australia and certain other cases in which this clause has been used, there have been no legal conditions at all, and originally it was undoubtedly intended to be a moral equivalent for those conditions. However, more recently there has been a tendency to use the clause even where there have been numerous legal conditions. There has even been a tendency to stiffen the clause in these cases. In the case of Chile's 1964 stand-by arrangement, the language read:

> "Should any major shift in the direction or emphasis of any of the policies outlined in this letter become necessary during the period of the requested stand-by arrangement, the Government of Chile will consult with the International Monetary Fund and, if necessary, reach new understandings before any request for a drawing under the stand-by arrangement is made."

The most recent gloss on this type of clause was in connection with the current stand-by arrangement of the United Kingdom, in which the formulation is substantially the one quoted above for Australia. The staff memorandum records that:

> "The staff's understanding of this formulation is that the member will inform the Fund of any major shift whatever may be the reason for it. In addition, the staff understands that the member would give the Managing Director such information in sufficient time to enable him to decide whether to request consultation in accordance with the paragraph."

Understanding of the clauses

It cannot be asserted that there is a clear understanding on whether consultation is required under the various clauses discussed above if the member does not intend to draw. On the basis of the history of Clause 2, it would seem that "the member will consult and prior to any further drawings will agree" involves a duty to consult whether or not the member intends to draw again. This seems to be the implication in the change of language in Chile's 1959 stand-by arrangement as compared with the 1958 arrangement. The purpose of the language seems to have been to provide for consultation in any event and agreement only if further drawings are intended.

On the basis of the same evidence, it would seem that formulas on the model of "consult and agree on the terms on which further drawings etc." were intended to cover only one event: consultation together with agreement for the purpose of further drawings. However, there are elements of doubt that obscure the clarity of this distinction. For example, the clause in the Dominican Republic stand-by arrangement dealing with drawings in excess of $15 million is in the "consult and agree" form and not the "consult and before drawing agree" form, and yet there is some evidence that it was intended that there should be consultation as soon as $15 million was drawn whatever the member intended thereafter.

The distinction referred to above would indicate that Clause 3 calls for consultation if there is "a major shift" of policy whether or not the member intends to draw again. This is probably the more reasonable inference in the light of the implications of a major shift of policy, and in view of the fact that there are no legal conditions that bring about an automatic interruption of drawings. The staff understanding in the U.K. case also supports this understanding in the sense that the member is supposed to give information about a major shift without reference to its intentions on drawing.

The major problem of policy arises in connection with Clause 1. Protection of the Fund's resources is not in issue because drawings are interrupted by a departure from a legal condition and not by the requirement of consultation. The issue is whether it is desirable to have members consult forthwith on a departure from any condition. It should not be assumed that a duty on the part of the member to consult on any departure from a condition, whether or not the member hopes to draw again, is necessarily an advantage for the Fund. This may place a heavy burden on the Fund, and the member's circumstances may be such that consultation would obviously be fruitless for the time being. Again, not all of the conditions attached to the right to draw go to the heart of a member's program. In any event, the standard paragraph 3 of stand-by arrangements gives the Fund the right to call for consultation at any time and for any reason. The conclusion would seem to be that more often than not a Clause 1 that calls for consultation without regard to further drawings should not be contemplated.

Recommendations

The following recommendations are advanced for discussion:

Clause 1

(i) Clauses calling for consultation forthwith on any departure from a condition, even though further drawings are not contemplated, should not be routine. If there is sufficient reason to adopt one, consultation should normally be required for departure from a prescribed condition only if the condition is sufficiently important for the progress of the program as a whole. 1/

(ii) A consultation clause in the form referred to in (i) should normally not be required where the clause is in the "during any period" form. If the Fund is willing to dispense with consultation where a member departs from and then complies with a condition, it would seem more appropriate as a rule to refrain from requiring the member to consult as soon as it departs from such a condition.

(iii) It would be advisable to take advantage of our experience, and hence completely new language need not be resorted to. When it is appropriate to adopt a consultation clause in the form referred to in (i), it could follow the form of "consult the Fund and prior to any further drawings will agree". The form of other consultation clauses could be "consult and agree on the terms on which further drawings ..."

Clause 2

(iv) This clause would remain unchanged. It is substantially in the form of "consult and agree on the terms on which further drawings",

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1/ All of the references to consultation are without prejudice to those cases in which consultation is required under other Fund rules, e.g., on the introduction of multiple rates or restrictions.

and therefore would be understood to call for consultation only as a prelude to further drawings. This corresponds to the Board's intention in adopting the language.

Clause 3

(v) This clause would be used sparingly, i.e., only where there is no clause 1 or where the conditions under a clause 1 are not sufficient to embrace a major shift of policy.

(vi) The present language would be retained and would be understood to call for consultation even though no further drawings were intended. Consultation would be automatic under the Chile form quoted above, but would be at the request of the Managing Director, after information supplied by the member, under the Australia-United Kingdom model.

cc: Deputy Managing Director
Area Department Heads
Exchange Restrictions Dept.
Mr. Polak