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June 30, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Fund Policies with Regard to Currency Stabilization Funds - Further Considerations

Attached for consideration by the Executive Directors is a paper on further considerations relating to Fund policies with regard to currency stabilization funds, which is tentatively scheduled for discussion on Wednesday, July 19, 1995. Issues for discussion appear on pages 26-28.

Ms. McGuirk (ext. 38363), Mr. Munzberg (ext. 36675), or Mr. Dhruba Gupta (ext. 38321) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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Fund Policies with Regard to Currency Stabilization Funds--Further Considerations

Prepared by the Policy Development and Review,
Legal, and Treasurer's Departments

(In consultation with other Departments)

Approved by Jack Boorman, François P. Gianviti, and David Williams

June 30, 1995

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I. Introduction

On December 14, 1994, during the preliminary discussion of Fund policies with regard to currency stabilization funds (CSFs), many Directors expressed general interest in and support for Fund financing for CSFs, while others questioned the need for policies in this area. More generally, Directors indicated that further elaboration would be welcome in a number of areas. 1/ This paper addresses such issues, building on the presentation in the earlier staff paper. 2/

Section II considers the circumstances under which Fund support for CSFs could be appropriate; the policy conditions for such support; the consistency of Fund financing for CSFs with Article VI; and the co-financing of CSFs.

Section III provides a further discussion of a number of possible operational features of CSFs. In particular, this section: reviews the pros and cons of providing financing for CSFs through a separate facility or a "window" under stand-by or extended arrangements; discusses factors bearing on the determination of access; elaborates on a number of operational modalities of CSFs, including the tranching provisions, conditions for activation and use of CSFs, reconstitution provisions, and related fees and charges; and considers possible procedures for handling Fund operations under CSFs.

Section IV summarizes the main issues for discussion.

II. Currency Stabilization Funds (CSFs)--General Considerations

The Executive Board has frequently discussed how the choice between different approaches to economic stabilization programs generally depends on the circumstances of each case. Staff papers reviewing the design of and experience under Fund-supported programs, including the role of exchange rate policy in stabilization programs, have served as the basis for many of

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1/ See "Aide-Mémoire by the Chairman, Currency Stabilization Funds--Fund Policies, Preliminary Consideration" (BUFF/94/115, 12/15/94).
2/ "Fund Policies with Regard to Currency Stabilization Funds--Preliminary Considerations" (EBS/94/230, 12/2/94).

these discussions. 1/ Typically, in cases of high and rising inflation, the problem stems from the monetization of large fiscal deficits and is reflected in a worsening of the external current account, currency depreciation, and entrenched inflation expectations. Against this background, both theory and experience indicate that under certain circumstances a nominal exchange rate anchor supported by potential access to a pool of precautionary reserves, i.e., a CSF, could be a powerful transitional instrument within a stabilization program, particularly in cases: (1) of high inflation where there are firm indications that policy measures are in place for achieving a rapid decline in inflation, and (2) where close monitoring is possible to ensure that the exchange rate peg and supporting policies continue to be appropriate. This section addresses in greater detail the particular circumstances and conditions under which Fund support for a CSF could be appropriate.

1. *Appropriate circumstances for successful use of CSFs*

As suggested by the staff during the preliminary discussion last December, Fund financing for CSFs would be intended to support the adoption of an exchange rate peg as part of an ambitious disinflation program. There are basically two broad approaches to rapid disinflation. The first approach involves addressing the root causes of inflation--typically a large public sector deficit financed by money creation, often in combination with pervasive indexation, especially of wages--through fiscal, monetary, and structural/institutional policy changes while maintaining some degree of flexibility in the exchange rate. As the policies take hold and inflation falls, the exchange rate should stabilize. This approach is referred to hereafter as a money-based stabilization policy.

The second broad approach also requires aggressive policies to address the root causes of high inflation, but complements these policies at a relatively early stage with a pegging of (or possibly an announced path for) the nominal exchange rate. This approach--referred to hereafter as an exchange-rate-based stabilization policy--carries significant risks insofar as shortcomings in the design or implementation of policies could render the peg unsustainable. At the same time, however, this strategy can capture potentially large, and often dynamic, stabilizing effects: the direct impact of stabilizing prices of traded goods; the building of the public's confidence by providing a highly visible anchor and a clear signal of policy

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1/ For example, see "Staff Studies for the Review of Stand-bys and Extended Arrangements, Volume I," Chapter I (EBS/94/84, 4/15/94) and "Staff Studies of Policy Experiences and Issues in the Baltic Countries, Russia and Other FSU States," Chapter IV (SM/95/46, 3/10/95, Supplement 1); as well as "Exchange Rate Policy in Developing Countries: Some Analytical Issues" Occasional Paper No. 78, "Characteristics of a Successful Exchange Rate System" Occasional Paper No. 82, and Sahay, R. and Vegh, C., "Inflation and Stabilization in Transition Economies: A Comparison with Market Economies." IMF Working Paper 95/8 (1995a).

intentions and discipline; and a fall in velocity that such improved confidence can produce. Moreover, an exchange rate peg can provide a much clearer guide for monetary policy than monetary or credit targets during a period of sharply declining inflation, when the behavior of money and credit demand is likely to be changing rapidly and unpredictably. Further, if the exchange markets have any depth, an exchange rate targeting approach provides indirect feedback to policy-makers in the event that policy begins to go off track, and thus helps discipline both monetary and fiscal policies.

In practice, the distinction between these two approaches is not clear cut: there can be a continuum of strategies for fixing the exchange rate at various points in the course both of designing and implementing stabilization policies and of seeing the results of these policies in the behavior of the exchange rate. However, a CSF would be meant to support stabilization strategies involving a relatively early pegging of the exchange rate--once there were adequate assurances of the ability and willingness of a government to implement the program, but before exchange markets had responded definitively to the incipient change in policies and perhaps simultaneously with the announcement and implementation of the full program. It is in this sort of strategy that a supplement to reserves, during a transitional period, for instilling confidence and for possible intervention is most likely to be needed and that the potential gains from pegging the exchange rate (in terms of both the pace and likely success of disinflation) are greatest. The need for Fund resources to support such a strategy would depend on the individual circumstances of the country involved, including its current and prospective level of reserves and access to other intervention resources.

2. Exchange-rate-based stabilization strategy

a. Types of exchange rate arrangements

In general, an exchange-rate-based stabilization is best served by the strict adherence to a pegged exchange rate with no margins for flexibility--that is, by an arrangement that sends clear signals to the market, has the maximum direct effect on prices of traded goods, and sets an unambiguous framework for policy discipline. Nevertheless, it is possible to envisage situations in which a preannounced crawling peg exchange rate rule might better provide scope for addressing possible difficulties in programs. For example, when it is clear that policy adjustments are sufficient to reduce inflation sharply but not to levels observed in the major industrial countries in recent years, it may be desirable to implement a preannounced crawl, rather than to peg at a fixed level. Alternatively, doubts about the appropriateness of the level of the real exchange rate may argue for preannouncing a floor, but no ceiling, on the foreign currency value of the domestic currency, and ratcheting the floor up in the event of large capital inflows: such an arrangement could produce the benefits of pegging without tying up the exchange rate as a tool for dealing with large capital inflows and the possible additional benefits of bringing down inflation. Such variations could be considered on a case-by-case basis, but without departing from the essential notions of preannouncing a rate or path, limiting discretionary use of the exchange rate, and moving as close as possible to exchange rate fixity in the context of the effort to sharply reduce inflation.

In the December 14 discussion, a number of Directors asked whether the introduction of a currency board might not also be supported by a CSF. While the institutional arrangements for operating currency board-type arrangements vary, the operational features of such arrangements are designed to strictly limit the scope for discretionary monetary policy. 1/ Essentially, a currency board guarantees to redeem local currency bank notes and, if applicable, reserve deposits of commercial banks held with the currency board (i.e., currency board liabilities) into foreign exchange at a fixed exchange rate by following rules that limit the increase/decrease in base money to the increase/decrease in foreign reserves of the currency board. 2/ Under such an arrangement, a distinction needs to be made between the foreign reserves that would be needed to back the liabilities of the currency board (hereafter referred to as base money) and reserves held in excess of this amount as a precaution against other risks, including risks to the domestic banking system. These risks to the banking system are inherent in any system in which bank deposits are available on a one-to-one basis into currency, as is conventional. A CSF would not appear to be the most effective way for the Fund to support the day-to-day operations of a currency board. Given the operational characteristics of a currency board and the need for sufficient reserves on a permanent basis, foreign exchange resources to back base money would best be provided through an appropriately phased (i.e., front loaded) stand-by or extended arrangement until the authorities built up their own reserves to underpin a currency board. This was the case in Lithuania where Fund resources provided under stand-by and extended arrangements helped to provide the foreign reserves needed to establish a currency board.

With regard to reserves in excess of base money, Fund resources could play a role in providing a cushion of excess reserves that would provide added confidence to the currency board arrangement and thus reduce the risk of a speculative attack. In the event of a speculative attack, the appropriate response would be to adhere to the rules of the currency board, which would automatically contract base money, as domestic currency is exchanged for foreign currency, and tighten monetary conditions. The resources backing base money would be sufficient for this purpose; however,

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1/ See "Currency Boards: Issues and Experiences" by Adam G.G. Bennett (PPAA/94/18, September 1994) for a description of different types of currency board arrangements.

2/ The simplest and most straightforward of such rules is where the currency board agrees to supply or redeem local currency bank notes (and, if applicable, reserve deposits of commercial banks) in exchange only for foreign currency.

a severe liquidity squeeze stemming from a speculative attack could threaten the solvency of the banking system. In this situation, a temporary deviation from the rules of the currency board in order to provide short-term liquidity could help to maintain the longer-term viability of the currency board arrangement. Potential access to Fund resources for this purpose, which would effectively be used to back the expanded monetary base, could be needed for a longer period of time than envisioned under a CSF, and would therefore be more appropriately provided under a precautionary stand-by or extended arrangement. Furthermore, the conditions under which Fund resources could be used for this purpose would need to be carefully considered, based on the circumstances of each case. For example, it would be inappropriate to use Fund resources to address a banking crisis of purely domestic origin and consequences.

A few Directors also raised the possibility that a CSF might be used to provide additional stability to a managed exchange rate regime or to an exchange rate peg adopted after inflation had been reduced and a period of relative stability in the exchange rate had been achieved. In these circumstances, the support offered by a CSF would likely add little to the overall credibility of the exchange regime and stabilization effort. If Fund support were needed, a regular Fund arrangement (which might be of a precautionary nature) would seem well suited to situations in which an exchange rate peg was used as a more lasting device to discipline policies, rather than as a transitional instrument to rapidly reduce inflation.

b. <u>The appropriate level for a currency peg</u>

Questions have arisen about whether the exchange rate at which the peg is established matters. In some circumstances, particularly in newly transforming economies and/or countries verging on hyperinflation, the structure of relative prices may be so distorted that well-informed judgments on the appropriate level of the real exchange rate are difficult. In these circumstances, dollar-valued average nominal wages may provide some indication of the appropriate peg. When distortions are so large, however, the precise level of the nominal peg (and the implied real exchange rate) may not be critical to the success of the effort to sharply reduce inflation; in essence, there is no choice but to let the economy adjust to the peg.

In countries with more meaningful relative prices, the choice of the initial level of the exchange rate can be critical to the success of the peg. It may be necessary to avoid adopting a peg when the prevailing real exchange rate is very low or very high relative to historical levels or other relevant benchmarks. A peg at a low real rate (reflecting either recent depreciation during a flexible regime or an initial devaluation) can entail an undervaluation that will impart inflationary pressures as the relative price of nontradables rises to a sustainable level. In these circumstances, an upward ratcheting floor without a ceiling may be preferable to a peg. This would permit any equilibrium real appreciation--

for example as productivity rises--to be reflected in the nominal exchange rate rather than prices.

A peg at a very appreciated real rate can produce unsustainable pressures on the economy in general and the balance of payments in particular that would be costly and quickly force the abandonment of the peg. Where the current exchange rate is at an historically high level, it is critical to consider the factors that could justify a peg at such a level. When sustainable increases in productivity are likely to be the underlying cause, pegging even at historically high levels of the real rate may be tenable although the risks could be relatively high. If, however, excessively high domestic interest rates (for example, stemming from an unsustainable fiscal/monetary policy mix) or speculative pressures have put pressure on the real exchange rate, a peg at this level is likely to prove costly and unsustainable. A reversal of the policy mix and lowering of interest rates would be necessary before pegging the exchange rate. In any event, in pegging an exchange rate it may be wise to err somewhat on the side of initial undervaluation which can be reduced through somewhat higher-than-planned inflation, rather than overvaluation, which in the presence of downwardly inflexible wages and prices can take a heavy toll on exports and growth and place unsustainable pressures on reserves.

c. Policy conditions for an effective currency peg

The specific conditions that need to be met in countries attempting an exchange-rate-based stabilization will vary with the particular circumstances and causes of inflation in each country. Whether the necessary conditions are met will be a matter of judgment, but several basic considerations will be relevant. First and foremost is the need to ensure that credit creation can be reduced to a rate consistent with targeted inflation and the projected behavior of money demand. 1/ This will require that the planned fiscal adjustment be both credible and consistent with the targeted level of credit expansion. In addition, it will be important to ensure that central bank credit to the banking system is under firm control: for example, it will be necessary to avoid unwarranted pressures to grant credit to the banking system to support the operations of state-owned companies. While the peg itself, as a disciplinary device, can help limit the need, or pressures, to respond to such demand for credit, measures to reduce credit creation need to be secured and perceived as sustainable; in addition, reductions in velocity and reverse Tanzi effects built into the program need to be realistic. In any case, it is necessary to form a judgement whether policies are capable of sustaining low inflation before entering an exchange-rate-based stabilization.

1/ The demand for real money balances is likely to rise during a successful disinflation. This decrease in velocity or remonetization of the economy permits a transitory but sometimes large rate of money creation in the early stages of a stabilization program.

Alongside these basic fiscal and monetary aspects, the potential for inertial effects from backward wage or other indexation should be considered. Such indexation (de facto or de jure), which produces real wage gains as inflation subsides, slows the pace of disinflation and increases the likelihood of a loss of external competitiveness and output growth, calling into question the economic and political sustainability of the stabilization effort. It is important, therefore, that any automatic indexation practices be eliminated, replaced by forward-looking schemes, or otherwise addressed. In countries with poorly developed labor markets, assurances that de facto indexation will not emerge as a problem will be needed.

It will also be important that other structural and institutional elements be supportive of the effort to reduce inflation sharply. In this connection, the exchange system would need to be unified and relatively free of restrictions. As a general rule, a high degree of current account convertibility would be desirable. In addition, conditions should be conducive to the implementation of macroeconomic and financial policies required to stem and/or reverse capital flight. This may require, for example, measures to permit the emergence of positive real interest rates on domestic savings.

Regarding capital flows, any country adopting an exchange-rate-based stabilization must have contingency plans for dealing with large flows--outward or inward. Considering outward flows first, resources for intervention could be supplemented through a CSF. However, these resources would typically not be appropriately used for intervention beyond the shortest term or for intervention that is largely sterilized. In practice, therefore, the brunt of defending the exchange rate in the event of large outflows would have to be borne immediately by interest rate adjustments and thereafter by further fiscal adjustment. Accordingly, a critical condition for countries attempting an exchange-rate-based stabilization is adequate institutions to permit and the will to carry out rapid adjustments in interest rates (or more generally the stance of credit policy). It is usually more difficult to change fiscal policy outside the normal budget cycle; however, consideration should also be given to contingency measures that could be implemented quickly.

In exchange-rate-based stabilizations, capital inflows are expected and have been common. Often countries have experienced large capital outflows prior to the stabilization so that there is significant scope for reflows; more generally, initial success has resulted in a rapid turnaround in confidence and in increased demand for the currency of the stabilizing country. In fact, an important aim of most stabilization efforts is to rekindle or augment capital inflows, and removing disincentives--such as domestic distortions and restrictions--to such inflows is an important precondition. Nevertheless, inflows in some countries have become so large that they have threatened macroeconomic stability and slowed the pace of the decline in inflation. Ideally, such inflows are an expression of confidence in policies and a source of potential growth. In this case, no predetermined policy response may be needed, although it is clearly desirable to ensure that the conditions exist for efficiently absorbing inflows: for example, sound prudential regulations and bank supervision, already low or easily removable barriers to trade, and an active privatization program. Nevertheless, if inflows are very large and sterilized intervention is no longer effective, consideration needs to be given to how the inflationary impact can be minimized--typically deciding among the options of increasing the pace of trade liberalization and privatization, tightening the stance of fiscal policy to help lower interest rates, ratcheting up the exchange rate as discussed above, or allowing the exchange rate to float, possibly within a band. 1/

d. Review of the exchange rate peg

It should be emphasized that the potential contribution of an exchange rate peg to a rapid decline in inflation does not require that the peg be sustained indefinitely. Specifically, a fixed exchange rate can be a powerful contributing element to the early stages of disinflation, but once inflation has been reduced, greater flexibility may become necessary to redress a worsening of competitiveness or to adjust to subsequent developments (e.g., exogenous real shocks) and to avoid one-way bets against the exchange rate. In this context--and more generally--experience has shown that a political commitment to a permanently fixed exchange rate should be avoided. How long a period of fixity is needed will be a matter of judgment, but the experience of recent exchange-rate-based stabilization programs suggests that something on the order of one to two years is likely to be sufficient. 2/ 3/ Once a reasonable degree of price stability has

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1/ See "Recent Experiences with Surges in Capital Inflows," Occasional Paper No. 108, Chapter IV, for a discussion of policy responses to surges in capital inflows.

2/ See "Overview of Developments in Countries with Stand-By and Extended Arrangements Approved During 1988-91" (EBS/94/104, 5/19/94) and "Conditionality Review--Distilling the Main Message and Directions for Further Work" (EBS/94/164, 8/18/94).

3/ In the case of Poland, the initial peg against the U.S. dollar was adopted in January 1990 to be maintained for a period of at least three months. In fact, it was maintained until May 1991 when the zloty was devalued by 14.4 percent and pegged against a currency basket. In October 1991, the fixed exchange rate was replaced by a crawling peg against a currency basket with a preannounced 1.8 percent per month rate of depreciation. Another step devaluation of 10.7 percent occurred February 1992 followed by continuation of the preannounced crawl. During the period 1990-92, Poland's currency stabilization fund, set up at the beginning of the 1990 program, was extended for two further one-year periods--to end-1992. See "Staff Studies for the Review of Stand-By and Extended Arrangements, Volume I," Chapter 1 and Appendix Table 5 for a discussion of other cases where nominal exchange rate anchors were adopted.

been achieved, adjustments to the exchange rate could strengthen the credibility of the program rather than signal its failure.

Whether and when to adjust the exchange rate must be kept under continuous review by the authorities and the Fund, and will have to take into account all the variables relevant to the sustainability of the peg: inter alia, the developments and outlook for the current account, balance of payments financing, the adequacy of reserves, and international cost and price competitiveness. Such analyses would consider whether a change in the nominal anchor, or an alternative exchange rate arrangement would be appropriate. Of course, exchange rate management is not a science, and ultimately decisions will have to be made based on available quantitative indicators combined with judgment.

3. Fund financing of CSFs and Article VI

Questions were raised by some Directors with respect to the Fund's authority to provide its general resources to a member to finance a balance of payments deficit on capital account. The following points attempt to set forth some relevant principles.

a. The use of Fund resources to finance a capital account deficit in accordance with the provisions of the Articles, including Article VI, is not precluded. A capital account deficit can be financed even if it is not accompanied by a current account deficit.

(i) In 1946, the Fund adopted an interpretation of the Fund's Articles of Agreement pursuant to which "authority to use the resources of the Fund is limited to use in accordance with its purposes to give temporary assistance in financing balance of payments deficits on current account for monetary stabilization operations."

(ii) This interpretation was revisited in 1961. At that time, a number of Fund members were removing capital restrictions and concern was expressed that the ability of members to finance capital outflows that might increase because of this liberalization would be precluded if, in fact, Fund resources could only be used to finance balance of payments deficits arising from the current account, as stated in the 1946 interpretation. The Executive Board decided "by way of clarification, that the [1946 interpretation] does not preclude the use of the Fund's resources for capital transfers in accordance with the provisions of the Articles, including Article VI."

b. For purposes of the use of the Fund's resources, the Articles identify three different categories of capital transactions. The limitation imposed in Article VI, Section 1 that resources may not be used "to meet a large or sustained outflow of capital" applies to only one of these three categories.

(i) Certain transactions which, although normally regarded as capital transactions, are deemed by the Fund in Article XXX(d) as being current, both for purposes of the Fund's jurisdiction over exchange restrictions and for access to its resources.

(ii) Other capital transactions, which are described in Article VI, Section 1(b), are related to current transactions:

"(b) Nothing in this Section shall be deemed:

(i) to prevent the use of the general resources of the Fund for capital transactions of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking, or other business; or. . . ."

For these transactions, access to Fund resources is the same as for current transactions, but restrictions may be imposed without Fund approval.

(iii) "Other" capital transactions are those referred to in Article VI, Section 1. Access to Fund resources is limited to outflows that are neither large nor sustained. Restrictions may be imposed without Fund approval and their imposition may even be requested by the Fund.

c. Regarding the concept of "large or sustained," it should be noted that the drafters of the Articles, the staff, and the Executive Board have consistently refrained from identifying or imposing any quantitative limits for the concept of "large or sustained." No precise figure can be assigned to the concept of large, nor any precise time frame to the concept of sustained. Rather, it was repeatedly emphasized that the application of this limitation required the exercise of considerable judgment, taking into consideration the circumstances of each particular case and a number of relevant factors.

Among relevant factors that were identified are the following:

(i) The limitation set forth in Article VI, Section 1 reflects, in part, a concern that priority be given to financing current account deficits. Such financing would assist in the elimination or avoidance of current account restrictions, which fall within the Fund's mandate. In contrast, restrictions on capital transfers do not require Fund approval and the Fund may even request the imposition of such restrictions to prevent the use of its resources when the outflow is large or sustained. This priority also explains why in 1961 the staff stated that, in order to determine whether a particular capital outflow was "large," an assessment had to be made as to whether the financing of such outflow would affect the Fund's ability to finance current account transactions of the member making the request or of other members. Therefore, the Fund's overall liquidity and the size of the member's quota were seen as relevant aspects that should be taken into account.

(ii) Although the only explicit limitation to the financing of capital outflows is the reference to "large or sustained" capital movements, the Fund's purposes are also relevant in the context of the financing of a capital account deficit, for two reasons. First, any use of Fund resources must be consistent with the purposes of the Fund. Second, while the consistency with the Fund's purposes and the concept of "large or sustained" are separate conditions for the use of Fund resources, in practice, the exercise of the Fund's judgment in the context of "large or sustained" has focused on the consistency of the use of Fund resources with the Fund's purposes as the main element in the Fund's decision to provide financial assistance. A large or sustained outflow will often be a consequence of inappropriate monetary or fiscal policies, for instance, with respect to the member's exchange rate or interest rates. In view of the fact that Fund resources are to be used to help members correct their balance of payments difficulties, a determination as to whether the capital outflows are "large or sustained" would involve an analysis of the causes of the outflows, and in particular an assessment as to whether the member's policies are such that the use of Fund resources would contribute to--rather than delay--the resolution of these difficulties.

4. Co-financing of CSFs

A number of Directors expressed interest in possible co-financing of CSFs, while others questioned whether significant resources would be made available through such arrangements. In considering the possibility of co-financing operations, it was noted that the potential benefits should be weighed against possible complications to CSF operations, which could adversely affect the credibility of a CSF.

In certain cases, co-financing could contribute to the financing of Fund-supported CSFs, and this possibility should not be precluded. Since CSFs are envisaged as being appropriate only in limited circumstances and on a temporary basis and each CSF is likely to have its own special characteristics, the possibility that co-financing might be available for one or more members should not be ruled out.

In practice, co-financing could be integrated with Fund support for CSFs under either the "window" approach or the new facility approach. A number of possible co-financing procedures and arrangements were noted briefly in the earlier paper. 1/ However, at this stage, it is not possible to be specific about the likely features of such arrangements. Considerations such as the scale of co-financing, the share of such financing in total CSF resources, the modalities for approving the release of co-financing resources, and the procedures for associating co-financing with Fund monitoring and financing would have to be considered in light of the particular circumstances of the member adopting a stabilization program and the sources of the co-financing. For example, procedures could differ

1/ See EBS/94/230, page 16.

depending on whether the counterparts were bilateral aid agencies, central banks, or multilateral organizations.

Nevertheless, certain basic principles would need to govern Fund policies with regard to co-financing for Fund-supported CSFs. First, the Executive Board would retain control over all use of Fund resources in support of CSFs. Therefore, the provision of Fund financing could not be subject to a joint decision-making process involving co-financing sources. Second, co-financing should not unduly complicate the operations of CSFs. There is a risk that where complexity is increased, the additional financing made available through co-financing may be at the expense of the credibility of the CSF's operations. In order to avoid such complexity, co-financing partners might take into account in their decisions to provide financing the Fund's assessments of the member's policies, including intervention activities, and might agree to provide financing in parallel with and in proportion to that provided by the Fund. And third, resources made available through co-financing procedures should not in any way affect the safeguards of Fund resources and the Fund's preferred creditor status. The terms associated with resources provided through co-financing should be at least as favorable to the borrower as those associated with Fund financing for CSFs.

III. Operational Features of Fund-Supported CSFs

This section discusses a number of possible operational modalities and features of CSFs, focusing on the main questions and concerns that arose in the context of the Board discussion of the earlier staff paper. The aim is to clarify certain principles that would apply to Fund policies with regard to CSFs, but to maintain a degree of flexibility in certain areas--as indicated below--so that CSFs might be designed with a view to meeting the circumstances of individual members.

1. Alternative approaches for establishing CSFs

As noted in the earlier staff paper, there are two main ways in which the Fund could establish general policies to provide financing for CSFs: first, under a policy (or "window") within stand-by or extended arrangements; and second, under a special facility for CSFs. 1/ Directors

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1/ As explained in EBS/94/230 (page 4, footnote 1), all or most features of a CSF could also be incorporated into a stand-by or extended arrangement on an ad hoc basis for an individual member country. However, in accordance with the principle of uniformity of treatment, the Fund would have to be prepared to introduce similar features into arrangements for other countries in similar circumstances. In this case, the Executive Board would need to address the same general policy issues regarding the use of CSFs discussed in this and the earlier paper.

generally preferred the window approach, but a number were undecided and sought clarification of the implications of each approach.

Under the "window" option, the Board could establish by a simple majority a policy under which CSFs would operate as an element within stand-by or extended arrangements. Special operational features--including the revolving character of CSFs, a sublimit on access under the CSF element, tranching of CSF resources, and repurchase expectations of short maturity--could be incorporated under general Board guidelines establishing the policy. A repurchase obligation could be established as a condition for granting a waiver under Article V, Section 4 upon approval of an arrangement, if purchases under the arrangement, including the CSF element, would cause Fund holdings of a member's currency to exceed 200 percent of its quota. 1/ Combined access under the traditional arrangement and the CSF element would be subject to the overall access limits (annual and cumulative) established for stand-by and extended arrangements. Appeal could be made to the exceptional circumstances clause, as necessary.

The "window" approach would have the benefit of strongly integrating the CSF into the stand-by or extended arrangement, which would emphasize the intended role of CSFs as an exceptional and transitional form of support, rather than a permanent facility to which members might have repeated recourse. Moreover, the "window" option has the advantage of not precluding access to GAB resources for financing CSFs for non-GAB participants under certain circumstances. However, since access would be subject to the overall access limits--annual and cumulative--applicable to stand-by and extended arrangements, the exceptional circumstances clause would need to be invoked whenever access under the arrangement, including the CSF element, would cause these limits to be exceeded.

A special facility for CSFs could be established by a Board decision taken by an 85 percent majority of the total voting power. The decision

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1/ Article V, Section 4 provides that as a condition for waiver of the 200 percent of quota limit on holdings of a member's currency, the Fund may establish terms that safeguard its interests. In the present context, a repurchase obligation, designed to help assure that a stabilization fund is used for the purposes intended, would represent such a safeguard. A waiver would be required in all instances where access under the arrangement, including the CSF, exceeded 100 percent of quota (assuming that the member has drawn its reserve tranche) and for lower levels of access where a member has outstanding purchases under prior arrangements, the CCFF, or the STF. If resources were committed under a stand-by or extended arrangement, obligations so established would apply from the outset, that is, before holdings actually exceed 200 percent of quota. In most cases where an arrangement would include a CSF, it would be expected that a waiver would be required. If the commitment for the CSF element is made at the time of activation subsequent to the initial approval of an arrangement, a waiver may be required when the commitment is made.

would establish all modalities and conditions, including short repurchase expectations and obligations, renewed access to reconstituted resources, tranching, and the need for a parallel upper credit tranche stand-by, extended, or ESAF arrangement. Access under such a special facility could be additional to the established limits under Fund arrangements.

There are two possible advantages to a new facility. First, short repurchase obligations could be explicitly established without reliance on conditions for granting a waiver under Article V, Section 4. Second, access under a special facility could be additional to that under the associated Fund arrangement, avoiding too-frequent resort to the exceptional circumstances clause. A possible drawback to the new-facility approach is that, for non-GAB participants, under current GAB provisions, resources could not be made available to the Fund through the GAB to finance operations under a special facility. However, even if a new facility were established to provide financing for CSFs, this would not preclude the Fund from deciding to provide financing for CSF purposes through a "window" in a stand-by or extended arrangement in the event that, in a particular case, it was considered necessary for the Fund to call on the GAB.

It was clarified at the previous discussion that ESAF-eligible member countries could use CSFs through operations parallel to an ESAF arrangement (either under a special facility or under a parallel stand-by or extended arrangement that would contain the CSF element) on the basis of the same conditions and on the same terms that would apply to members using CSFs in the context of stand-by or extended arrangements. 1/ Under the existing ESAF Trust Instrument it is not possible to provide financial support from ESAF resources for the purpose of establishing a CSF. The structure of the ESAF would not permit establishment of the particular modalities required for effective CSF operation (e.g., timely purchase and early repurchase). Even if the ESAF instrument were to be amended, use of the ESAF for financing CSFs could substantially burden the limited ESAF resources. While resources made available through CSFs in parallel with ESAF arrangements would be on GRA rather than concessional terms, this would not seem problematic given the purpose of the financing (for very short-term intervention rather than to meet medium- to longer-term balance of payments financing needs), the short repurchase period, and the expectation of limited, if any, use of CSF resources.

In summary, although there are differences in structure between the "window" and the new-facility approaches, the same basic operational features of CSFs could be established under either approach. However, if it

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1/ The documentation requirements under the special facility or the "window" approach would not differ materially. However, for ESAF-eligible members, outstanding credit under the General Account could be low or nil. In this case, under the window approach, it may not be possible to establish a repurchase obligation as a condition for a waiver under Article V, Section 4.

were considered essential to establish a relatively short repurchase obligation for CSF purchases in all circumstances (i.e., even when a waiver under Article V, Section 4 was not necessary), this would require the establishment of a special facility.

2. Access under CSFs

In their preliminary comments on Fund policies with regard to CSFs, a number of Directors considered that an access limit of 100 percent of quota should enable the Fund to provide meaningful support for CSFs, particularly in view of the potentially higher access already available to support strong programs. However, some Directors requested further discussion of the issues relevant to the determination of an access limit under CSFs. As noted earlier, the limit would be set at a level consistent with the intended role of CSFs: that is, with a view to enabling the Fund to contribute substantially to the credibility of members' currency stabilization efforts in the context of a strong disinflation program.

Annex I considers some alternative approaches that could be used to assess reserve adequacy and an appropriate access limit under CSFs. For a sample of 40 countries maintaining pegged or managed exchange rate regimes, it analyzes reserve levels in relation to two common measures of reserve adequacy: reserves relative to imports and reserves relative to the country's domestic monetary base. On the basis of this analysis and illustrative calculations for the Baltics, Russia, and other FSU countries, it appears that an access limit for CSFs of 100 percent of quota would be adequate in most cases. This assessment is underpinned by the following factors: 1) CSFs would be used in the context of fully financed Fund arrangements of upper credit tranche conditionality; 2) the arrangement (not the CSF) would provide access to other Fund resources for the purpose of strengthening the reserve position on a lasting basis; and 3) the policy conditions associated with use of CSF resources for intervention would aim to ensure an appropriate and rapid policy response to exchange market developments--in particular they would not envisage significant sterilization--rather than sustained intervention.

Given the overall limit on resources available under CSFs, the determination of access in individual cases would continue to be guided by the usual criteria: (i) need, (ii) the strength of policies, and (iii) the capacity to repay the Fund. These basic criteria would remain the guiding principles under an exchange-rate-based stabilization supported by a CSF. In assessing "need," consideration would be given to the need for balance of payments financing under the "traditional" element--taking into account flows across both the external current and capital accounts and the need to build reserves to an adequate level--as well as the need for precautionary reserves under the CSF element. The latter "need" would relate importantly to the specific (though judgmental) objective of instilling confidence in the exchange rate peg.

In practice, the adequacy of reserves to support a pegged exchange rate would be assessed in light of relevant factors including the level of reserves in relation to imports and the monetary base, the volume and volatility of exchange market transactions, openness of the capital account, short-term liabilities, and access to short-term borrowing facilities. Access under CSFs could vary considerably on a case-by-case basis, depending on the degree to which the expected need for reserves is already met through existing reserve holdings or through the buildup of reserves programmed under the "traditional" element of a Fund arrangement.

3. Tranching of access

Most Directors were in broad agreement with the general approach to the tranching of resources under CSFs discussed in EBS/94/230. However, several Directors expressed concern that a large number of tranches or complexity associated with drawing procedures could diminish the confidence effects of a CSF. Ideally, the tranching provisions should provide scope for flexibility while adequately safeguarding Fund resources. With these considerations in mind the following approach is suggested for consideration.

Normally, a CSF would have four equal tranches, but there would be flexibility to raise access under the first tranche to a maximum of, say, 35 percent of the size of the CSF, with access under the third and fourth tranches reduced pari passu, i.e., each tranche reduced by one-half of the amount added to the first tranche. However, it would be desirable to allow for some flexibility for departures with respect to the number and size of tranches (e.g., to provide for not less than 3 nor more than 6 tranches) in view of the particular circumstances in each case, including the initial level of the member's reserves; the size of the stabilization fund; the potential volatility of flows in the foreign exchange market; and the availability of other resources, including the planned buildup of reserves under the arrangement.

The first tranche would be available on activation of a CSF and would operate as a working balance for the duration of the CSF. Drawings beyond the first tranche would normally be for the purpose of replenishing some proportion of the member's own reserves used in intervention (see following section) and would be subject to Board review and approval of requests for the availability of resources beyond the first tranche. The maximum size of a request for availability of resources would be linked to the level of outstanding credit under the CSF. At any given point in time, if the member's outstanding credit under the CSF fell into a particular tranche, the maximum size of the next request for the availability of resources under the CSF would be equal to the size of the subsequent tranche.

4. Conditions for activation and use of CSFs

Activation and use of CSFs would be conditioned on prior establishment of integrated operational management of foreign exchange reserves and intervention policy 1/ and subject to continuing compliance with specific reporting provisions intended to enable the Executive Board to assess the appropriateness of (i) activating a stabilization fund element; (ii) requests for the availability of tranches under a CSF; and (iii) requests for extension of repurchase expectations relating to CSF drawings (see Section III.5). Conformance with reporting requirements would be a prior condition and a continuing requirement for access to CSF resources. Precise details of the information subject to the reporting requirement would be specified by the Board in the context of the activation of a CSF, and it could be provided that they would be modified or supplemented during the operation of the CSF as a condition for approving the availability of CSF tranches or completing reviews under the arrangement. These reporting requirements would require very close cooperation and consultation of the authorities with staff on request. Considering the need to maintain close contacts and monitoring, it would be desirable to have a Resident Representative in place.

The CSF element of an arrangement would be activated only following a determination by the Executive Board that the conditions were appropriate; this could be at the time an arrangement was approved or at the time of a review under the arrangement. In assessing whether to activate the CSF element, the Executive Board would consider whether the exchange rate and exchange rate policy were realistic and sustainable; whether the exchange rate policy would be firmly supported by fiscal and monetary policies, including rapid policy adjustments, as necessary; whether the program was fully financed; and whether monitoring and reporting procedures were already in place and functioning properly. As discussed in Part II above, it would normally be expected that CSFs would be activated relatively early in the stabilization process--or even at the beginning--at a point when the Fund could have confidence in the member's intention and ability to implement a strong program, but possibly well before policies had achieved their intended results in full. Following the pegging of the exchange rate, the continued appropriateness of the nominal exchange rate anchor would need to be kept under continuous review.

The first tranche of the CSF would become available on activation of the CSF, and the member would be free to draw on resources in this tranche to replenish reserves that had been drawn down for intervention purposes or to supplement reserves on a precautionary basis. The first tranche would thus represent a form of working balance, which could be purchased and held for the duration of the CSF or drawn, repaid, and drawn again without the need for further review by the Executive Board so long as the member remained in compliance with the arrangement, including supplementary measures (objectively defined) as might be required by the Board in connection with the CSF element, such as reporting requirements. Access

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1/ For example, where both the Treasury and the Central Bank hold foreign exchange reserves, their management would need to be vested within a single authority or a designated decision-making body.

under the first tranche would provide the member with supplemental resources to respond immediately to currency market pressures. As these resources were used, the member could request the availability of a further tranche.

Requests for the availability of resources above the first tranche would require Board approval subject to appropriate conditions. There would be no set interval between requests for the availability of resources. However, given the possibility of rapidly changing circumstances in foreign exchange markets, it would seem appropriate that Board approval of availability of resources in the upper tranches of the CSF would provide for only a limited amount of time within which to make purchases, for example, two weeks. Beyond that period, the availability of the resources would expire and the member would have to approach the Board with a new request, even if it had not drawn on the previously approved amounts. In general, it would be expected that drawings beyond the first tranche would be used to replenish all or some proportion of reserves that had been used for intervention, so that a member could continue to maintain an adequate level of precautionary reserves throughout the life of the CSF; such understandings would be specified in documents establishing a CSF.

In deciding whether to make resources available in tranches beyond the first tranche, the Board would need to determine whether performance under the arrangement remained satisfactory, whether the purposes and conditions of the CSF continued to be met and, in particular, whether intervention and/or policy adaptation was warranted. Decisions regarding the availability of upper tranches would take into account, inter alia, assessments of monetary, fiscal, and exchange market developments and sources of exchange market pressure; evaluations of past intervention operations and use of CSF resources; evaluations of the stance of monetary and fiscal policies, including adherence to performance criteria under the arrangement; and continuous adherence to ongoing reporting and monitoring requirements. 1/ Policy adaptations could be required. 2/ In this connection, contingency measures to address exchange market pressures could be agreed in the arrangement, such as the amount of own reserves to be used and the timing and nature of adjustments to interest rates. Provision could also be made for adjustments to program targets to provide for a more rapid accumulation of reserves in the event of larger than anticipated capital inflows. The criteria for consideration of requests for the availability of first and subsequent tranches of the CSF would be specified as far as possible in the arrangement, but decisions would likely require the exercise of considerable judgment and speed by the Executive Board. Resources in the upper tranches that were reconstituted to the CSF (i.e., repurchased) would

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1/ The demanding monitoring required to operate CSFs and to ensure that CSFs are serving their intended purpose underscores the need for appropriate monitoring mechanisms to be in place before a CSF is approved.

2/ Action might be required before or in conjunction with release of the next purchase, or the Board could indicate what it would expect in the way of policy action before it would consider another request.

again become available for drawing, subject to the conditions for the availability of each tranche.

During the previous discussion of Fund policies regarding CSFs, a number of Directors favored CSF rules that would require any country seeking to draw on CSF resources for intervention purposes to use its own reserves on a pari-pasu basis. It was also suggested that in the event of unexpected capital inflows the member should be obliged to build up its reserves. These views are consistent with the approach outlined above. As part of the general provisions for CSFs, it could be provided that purchases of CSF resources above the first tranche would be used to partially replenish some portion of own reserves used by the member country specifically in foreign exchange market intervention. The exact proportion of matching of own reserve use to CSF drawings could be determined in the special provisions for each CSF, taking into account, inter alia, the level of a member's initial reserves and not exceeding a prespecified share of, say, 50 percent. Similarly, it could be provided that a prespecified proportion of net foreign exchange purchases in excess of those planned under the Fund arrangement would be "saved," that is, reflected in a higher net international reserve target under the arrangement.

5. <u>Reconstitution (early repurchase)</u>

Directors considered that it would be appropriate to establish reconstitution provisions along the lines of those described in EBS/94/230 in order to ensure that CSF resources were used for their intended purpose and not for general balance of payments financing. Most Directors favored a relatively short reconstitution period based on a three-month repurchase expectation and a one-year repurchase obligation. A few Directors would prefer a repurchase obligation shorter than the proposed 12-month period, and one Director would prefer reconstitution provisions structured solely in terms of repurchase expectations rather than obligations. Questions were also raised about the possible consequences of a failure to meet a repurchase expectation.

Drawing on this discussion, reconstitution provisions could be structured in the following way. To the extent possible, all CSF purchases would be subject to a one-year repurchase obligation and, in addition, CSF purchases beyond the first tranche would be subject to an early repurchase expectation that would provide for repurchase within three months. Consideration of requests for an extension of a repurchase expectation would be permitted, up to three extensions, allowing, with successive approvals by the Executive Board, effective extension of the repurchase period by up to one year from the date of the initial purchase. 1/ Purchases under the first tranche, which would provide a basic working balance, would not be subject to a three-month repurchase expectation; further, it could be provided that for stand-by arrangements covering a period greater than one year the repurchase obligation for purchases in the first tranche would coincide with the expiration date of the arrangement. 2/

The consequences of failure to meet a repurchase expectation would be established by the Board under agreed policies pertaining to CSFs. Consistent with past practice, it is proposed that a member that failed to comply with a repurchase expectation under CSF operations would not have further access to the Fund's resources--purchases under stand-by and extended arrangements or other Fund facilities and policies drawing on the General Resources Account--until the repurchase expectation had been satisfied. Such a decision would require a simple majority and would treat failures to comply with repurchase expectations under a CSF in the same way as failures to comply with repurchase expectations in the case of noncomplying purchases under stand-by or extended arrangements and under the decisions on debt and debt service reduction operations and the Compensatory and Contingency Financing Facility. 3/

Failure by a member to meet an early repurchase obligation would result in an overdue obligation to the Fund with the consequences that apply in other cases of overdue obligations, including the inability to make further use of Fund resources and the possibility of suspension and eventual compulsory withdrawal from the Fund. The Fund could not extend the period for an early repurchase pursuant to an obligation except by recourse to Article V, Section 7(g) regarding the postponement (rescheduling) of repurchase obligations.

There are two reasons for establishing a one-year repurchase obligation for CSF purchases. First, this would be consistent with the purposes for which Fund resources are made available, namely, for short-term intervention. Second, it would ensure that there is no misunderstanding regarding the seriousness of members' undertaking to repurchase CSF purchases relatively quickly. In the absence of a repurchase obligation,

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1/ As discussed in EBS/94/230, there would be a trade-off between requesting an extension of a repurchase expectation and requesting a new purchase under a CSF; therefore, the criteria for granting such an extension would involve essentially the same considerations relevant to approval of a new purchase following reconstitution.

2/ For a multi-year extended arrangement, the repurchase obligation could coincide with the end of an annual program under the arrangement. Similarly, for arrangements supported by the ESAF, the repurchase obligation could coincide with the end of an annual ESAF arrangement.

3/ See "Debt and Debt Service Reduction Operations - Early Repurchase Expectations" (EBS/89/224, 11/22/89) and "Compensatory and Contingency Financing Facility - Proposed Amendments" (EBS/93/96, 6/16/93).

amounts drawn under a CSF would effectively provide medium-term balance of payments support in the event that a member failed to meet a repurchase expectation.

Nevertheless, reconstitution provisions could rely solely on repurchase expectations. The consequences of a failure to meet a repurchase expectation would be as described above--i.e., the member would have no further access to Fund resources. If it were decided to structure repurchase expectations in this way, this would remove one of the considerations in favor of establishing a special facility to implement CSF policies. Also, it would still be possible to consider whether it would be appropriate to establish a repurchase obligation shorter than that under the arrangement on a case-by-case basis as a condition for granting a waiver under Article V, Section 4, when applicable.

6. Costs of CSF transactions

Questions have been raised concerning the transaction costs associated with CSFs, and the staff was requested to examine further possible means to offset or reduce these costs. Three types of charges are relevant in that context: periodic charges pursuant to Article V, Section 8(b); the arrangement charge (or "commitment fee") pursuant to Article V, Section 8(a)(ii); and the service charge pursuant to Article V, Section 8(a)(i). All these provisions deal with charges in the General Resources Account.

a. Periodic charges

Under Article V, Section 8(b), the Fund must levy charges on the average daily balances of a member's currency held in the General Resources Account that (i) have been acquired under a policy that has been the subject of an exclusion for purposes of calculating the reserve tranche pursuant to Article XXX(c) 1/ or that (ii) are in excess of a member's quota after the exclusion of the balances under (i).

Pursuant to Article V, Section 8(d), periodic charges must be uniform for all members. Uniformity does not mean that a single rate of charge should apply, but it does mean that differences in rates must be based on objective, relevant criteria. Consequently, different rates may apply to different types of holdings. The Fund could take into account that these holdings have been acquired under a particular policy on the use of its general resources. For instance, special rates were in place for the use of resources financed from borrowed resources, e.g., under the enlarged access policy. It should be noted, however, that the Fund has recently unified the periodic rates of charge on holdings in the General Resources Account. The

1/ Currently, all use of Fund credit is excluded for purposes of calculating the reserve tranche. This allows a member to hold a reserve tranche position while using Fund credit under any facility or policy.

same rate of charge applies whether outstanding purchases were financed from the Fund's ordinary resources or from borrowed resources, and irrespective of maturity. The staff does not recommend the reintroduction of a system of different rates of periodic charge applying to different types of holdings, especially since the Fund recently adopted a series of decisions to simplify the rate structure. Also, a different rate structure would raise a number of difficult issues, including those related to the distribution among members of the cost of operating the Fund.

b. <u>Arrangement charge</u> 1/

Pursuant to Article V, Section 8(a)(ii), the Fund may levy a charge for stand-by or similar arrangements. The Fund could decide not to levy such an arrangement charge. The arrangement charge must be uniform for all members pursuant to Article V, Section 8(d); a differentiation for different categories of arrangements could be made in light of the nature of the arrangements and the purpose of the arrangement charge.

The purposes of the arrangement charge were explained in some detail in 1952. The main justifications for that charge were seen to derive from the assurance provided to members that resources would be available when needed, and from the services provided to the member even in the absence of an actual drawing, as well as from the possible deterring effect on members that might request an arrangement in the absence of charges.

It is possible that the Fund could levy an arrangement charge only on the net amount of resources committed under the CSF element of an arrangement, but this would be a departure from previous practice. 2/ Such an approach would take into account the fact that, contrary to current augmentations of stand-by or extended arrangements which are not linked to repurchases, the revolving feature of the stabilization fund would avoid any increase in the net amount committed to the member; a reconstitution of the member's drawing rights would simply reflect the fact that earlier repurchases of that same amount have been made. If it was decided that the arrangement charge should be levied only on the net amount of resources committed, a specific rule would have to be adopted, which would need to apply to all cases that contain the same feature. However, it should be noted that such an approach may not be of much relevance because the arrangement charge is refundable at the time of purchase. Under current *provisions, if a repurchase is made and a corresponding augmentation takes* place, an arrangement charge will be levied for the augmented amount, prorated based on the remaining period of the arrangement, and this charge will be refunded when purchases take place. It should also be noted that, until 1978, when the Fund's practice was to allow a reconstitution of

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1/ Referred to as the "commitment fee" in EBS/94/230.

2/ The net amount of resources committed under a CSF element refers to the maximum amount that could be outstanding under that element over the relevant commitment period.

drawing rights through early repurchases before the expiration of a stand-by or extended arrangement, an arrangement charge was levied whenever a commitment of amounts was restored through such repurchases. Therefore, the staff would not propose to amend the current rules pertaining to arrangement charges. 1/

c. Service charge

Pursuant to Article V, Section 8(a)(i), the Fund must levy a service charge on the purchase by a member. In accordance with Article V, Section 8(d) the service charge must be uniform for all members.

(i) Since the service charge must be levied on each purchase, no net concept as discussed above with respect to the arrangement charge could be used. If a member reconstitutes access by making a repurchase under the CSF, a subsequent purchase would again be subject to the service charge. This was also the practice before the Second Amendment: when amounts were reconstituted and redrawn, the Fund consistently levied a service charge on each purchase.

(ii) Service charges must be uniform for all members; however, distinctions based on objective, relevant criteria are not precluded.

The Fund may levy a lower service charge on reserve tranche purchases than on other purchases, and the service charge on reserve tranche purchases cannot exceed one half of one percent. By making a particular reference to the service charge on reserve tranche purchases, the Articles identify one category for which a different service charge may be determined. However, the general reference to uniformity would not preclude other types of differentiation.

It must be noted, however, that any differentiation would have to take into account the purposes of the service charge, including, in particular, the cost for the Fund associated with a particular transaction. A provision on service charges was included in the original Articles. This service charge could be varied within a margin of 0.5 to 1 percent and it was initially set at 3/4 of 1 percent. 2/ It was explained at that time that the service charge served essentially two objectives, i.e., to generate income for the Fund and to deter a member from making unnecessary purchases. In addition it was explained in 1948 that the service charge also served the

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1/ If the special facility option were utilized, arrangements within such a facility would have to be established. To the extent that an arrangement fee was to be charged for such arrangements, Rule I-8 would have to be amended.

2/ In November 1951, the Fund reduced the service charge to the minimum of 1/2 of 1 percent. The minimum and maximum were deleted in the Second Amendment of the Articles of Agreement but the service charge was maintained at 1/2 of 1 percent.

purposes of covering the Fund's cost that might arise, in particular, with respect to repurchases in gold. 1/

The staff and the Executive Board have consistently refrained from defining criteria for making distinctions in the application of service charges, and, in practice, no differentiation has ever been made. For instance, the question was raised in 1948 whether the fact that a member intended to use the Fund's resources only for a short period of time could be taken into account in setting the level of the service charge. The Executive Board determined that the length of the period during which a purchase would remain outstanding would not provide a basis for differentiation of the service charge. It was noted that the time factor is specifically taken into account through the levy of periodic charges. 2/ Moreover, the distinction between interest that is due on balances outstanding and a service charge that is related to individual transactions was also emphasized.

As already noted, any differentiation in the service charge would need to take into account the purpose of the charge and, in particular, that the service charge bear some relation to the cost to the Fund of administering CSFs. In this connection, it is relevant to note that CSFs are likely to be relatively costly arrangements to administer, compared to the costs incurred by the Fund regarding the use of Fund resources under other policies and facilities. It would seem inappropriate, therefore, for the service charge applicable to purchases under a CSF to be less than that on purchases under other Fund policies and facilities.

7. Possible procedures for handling Fund operations under CSFs

At the December 14 Board discussion of CSFs, few comments were made on possible procedures for handling Fund operations under CSFs. It may be useful at this stage to consider more concretely the possible implications of CSFs for Fund procedures. It is generally recognized that the Board will need to be in a position to respond quickly to requests for the availability of resources under CSFs. In this connection, Directors may wish to comment on the appropriateness and feasibility of establishing the procedures suggested below.

The features of a CSF outlined above provide for the availability of the first tranche in advance of intervention needs, i.e., as a precautionary working balance. When these resources begin to be used, the member may request the availability of further resources under the CSF to replenish reserves used for intervention purposes. If reporting procedures are

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1/ For example, costs associated with the shipment of gold.

2/ Under the original Articles, there was no periodic charge for an initial period and the rate of periodic charges increased over time as long as the purchase was outstanding. On the possibility of a similar increase under the present Articles, see Article, Section 8(b), last sentence.

effective and timely--which would be a continuing condition for access to the CSF--the Fund should be aware of any significant use of intervention resources and the circumstances of such use. Where possible, the member country should give the Fund advance warning of when a request for the availability of resources is going to be made. This would permit a careful evaluation of the situation and the adequacy of policies through a staff visit or other communication. Nevertheless, the Board may need to consider requests for the availability of CSF resources at very short notice. Moreover, during periods of intense exchange market pressures, Board decisions could be needed on a relatively frequent basis.

Procedures for keeping abreast of developments and considering requests for the availability of CSF resources could include the following.

a. On establishment of a CSF, based on the additional data provided by the member, staff would circulate to the Board on a monthly basis a one-page summary of recent developments and prospects, a table of selected CSF-related economic indicators, 1/ and a brief assessment as to whether the member remains in compliance with all the terms and conditions of the CSF and the related arrangement. If called for, this could be supplemented on occasion by somewhat longer reports for discussion. CSF-related material would in any case be covered in staff reports for reviews under the arrangement.

b. As a rule, the minimum period required for the Board to act on a member's request to make CSF resources available would be one week (five working days). Under emergency circumstances this could be compressed to 48 hours.

c. After a request for the availability of resources was made, staff would circulate as soon as possible an updated summary of the economic situation and a staff assessment of compliance, to be supplemented as necessary by a briefing at a Board meeting.

d. Under normal circumstances, the period between circulation of the updated summary and the Board discussion of the request would be at least 48 hours. However, under exceptional circumstances, the circulation period could be abbreviated to allow afternoon Board discussion following morning circulation.

e. Disbursement procedures, as reflected in the Fund's Rules and Regulations and agreements with each member regarding the exchange of currency, normally require three business days from initiation of a purchase. Thus, if it normally took a minimum of five business days for the Board to act on a request for availability of CSF resources, and a purchase was initiated immediately thereafter, it would normally take eight working

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1/ Relevant data could be circulated more frequently, say, fortnightly, if needed.

days from receipt of the request for availability to disburse a drawing to the member.

f. All data and information circulated in the summary reports should be treated with the utmost confidentiality, and, under certain circumstances, may require limited or marked circulation.

IV. Issues for Discussion

In commenting on the issues and procedures regarding possible Fund policies on CSFs, Directors may wish to touch on the following points and provide guidance to the staff on whether to prepare recommendations on Fund policies regarding CSFs for Board consideration.

1. General considerations

a. Experience has shown that under certain circumstances a nominal exchange rate anchor can be a powerful instrument in bringing about a rapid decline in inflation. Within the context of a Fund arrangement, Fund financial support for the specific purpose of establishing a CSF could provide an important element of additional confidence in support of an exchange-rate-based stabilization strategy.

b. Fund support for CSFs could be considered in cases of high inflation countries with good prospects for achieving a rapid and substantial decline in inflation. It would be expected that a CSF would be activated at a relatively early stage in the process of reducing inflation, but only when the Fund could be confident that the member's policies were sufficiently strong and would be implemented and adapted as necessary; activation could take place at the outset of an arrangement or during the course of a review.

c. The most appropriate exchange rate policy to be supported by a CSF would be an exchange rate peg, or a preannounced crawl, that would limit the discretionary use of the exchange rate. However, it would not be the purpose to maintain a peg indefinitely.

d. Careful consideration would need to be given to establishing the appropriate level at which to fix the exchange rate peg, avoiding a peg at a real exchange rate that is excessively low or high relative to historical levels or other relevant indicators.

e. Policy conditions necessary to ensure the success of an exchange-rate-based stabilization include: 1) fiscal adjustment and credit creation consistent with targeted inflation; 2) appropriate measures to deal with backward-looking automatic wage and other indexation schemes; 3) establishment of a high degree of current account convertibility and an open trade regime, and other measures to encourage a return of flight capital; 4) contingency plans for dealing with large capital outflows or inflows which would depend on full interest rate flexibility; and 5) establishment of integrated operational management of foreign exchange reserves and intervention policy. More specific conditions would depend on the particular circumstances of each country.

f. A CSF would not be a substitute for sufficiently strong policies to achieve an exchange-rate-based stabilization. The program underlying the request for a CSF would have to be fully financed, and the CSF would foreseeably not have to be drawn upon.

g. It would be possible to consider co-financing of CSF under the conditions discussed. If co-financing was judged to be feasible and beneficial for a particular case, specific features would need to be determined at that stage.

2. <u>Operational features</u>

a. The Board will need to decide whether it would be preferable to establish CSFs as a "window" under arrangements or through establishment of a separate special facility. In either case, ESAF-eligible member countries would be able to use CSFs through operations parallel to an ESAF arrangement.

b. An access limit of 100 percent of quota would enable the Fund to contribute substantially to the credibility of a member's exchange-rate-based stabilization efforts. The determination of access levels for individual cases would be guided by the usual criteria of need, strength of policies, and capacity to repay the Fund, taking into account the adequacy of precautionary reserves to instill confidence in the member's exchange rate regime. In practice, access under CSFs would be likely to vary considerably on a case-by-case basis, depending on the degree to which the expected need for reserves was already met through other sources.

c. Normally, a CSF would have four equal tranches but with flexibility to raise access under the first tranche to a maximum of 35 percent of the size of the CSF with offsetting reductions in the third and fourth tranches (i.e., 25/25/25/25 or 35/25/20/20 or other variations in between) depending on the particular circumstances of each case. There would also be flexibility, where warranted by the circumstances, to vary the number and size of tranches within a range of 3 to 6 tranches.

d. Activation and use of CSFs would be based on continuing compliance with the conditions of integrated foreign exchange management, reporting requirements, adherence to the Fund arrangement, and any other conditions set out at the establishment of the CSF. To enable close contact and monitoring, it would be desirable for a Resident Representative to be in place. On activation, access to the first tranche of a CSF would become available; availability of resources beyond the first tranche, which would be for more limited periods, would require Board approval. The appropriateness of the nominal exchange rate anchor would need to be kept under continuous review by the authorities and the Fund.

e. Drawings beyond the first tranche would normally be for the purpose of replenishing some pre-fixed proportion of the member's own reserves used in intervention.

f. To the extent possible, all CSF purchases would be subject to a one-year repurchase obligation, 1/ and any purchase beyond the first tranche would be subject to a three-month early repurchase expectation; for stand-by arrangements longer that 12 months, the repurchase obligation for purchases in the first tranche could coincide with the expiration of the arrangement. Up to three requests for a three-month extension of a repurchase expectation would be permitted. Failure to comply with a CSF repurchase expectation would stop further access to the Fund's resources under all Fund facilities. Failure to meet an early repurchase obligation would result in an overdue obligation to the Fund with all the usual consequences.

g. Charges associated with the operations of CSFs would be the same as those that pertain to arrangements in the General Resources Account.

h. Procedures for handling Fund operations under CSFs as described in section III.7 would be envisaged, including normally a minimum of five working days for the Board to act on requests for the availability of CSF resources.

1/ Under a "window," in cases where a waiver under Article V, Section 4 is not necessary, CSF purchases in the first tranche would be subject to a one-year early repurchase expectation; all other CSF purchases would be subject to a three-month early repurchase expectation.

Factors Relevant to the Determination of an Access Limit Under CSFs

This annex considers factors relevant to the determination of an access limit under CSFs. In particular, it considers the actual reserve levels of members with fixed or managed exchange rate regimes in relation to three common measures of reserve adequacy. The first considers the variance of transactions or observed turnover in the foreign exchange market; the second considers the level of reserves relative to imports; and the third considers the level of reserves in terms of the country's domestic monetary base.

a. Variance of transactions or turnover in exchange markets

The idea that reserve holdings should be related to the variability and/or volume of foreign exchange transactions is well established. The variance of external transactions can be measured historically, although measurements of this type may be of little relevance for a country about to convert from a floating to a fixed exchange rate regime. 1/ Another guide might be the turnover in foreign exchange markets. While this, on its own, would not give a precise indicator of reserve adequacy, it could be useful in calibrating relative reserve needs for countries with mature financial systems. The problem in using such a measure for economies in transition (and other countries undergoing major liberalization) is that turnover in foreign exchange markets has grown rapidly, reflecting the liberalization of the exchange regime and the increasing importance of external economic transactions: in practice, such growth has been unpredictable. 2/ More generally, the types of stable relationships upon which such calibrations depend may not exist in countries experiencing high and erratic rates of inflation.

b. Reserves in relation to imports

An alternative approach to assessing reserve adequacy compares a country's gross reserves with its monthly import bill. Under this approach, a general rule of thumb often used as a broad indicator of reserve adequacy under Fund programs has been that reserves should be equal to at least 3 months of imports, while reserves in excess of six months of imports have usually been viewed as relatively comfortable. This practice for assessing reserve adequacy evolved during a period in which controls on the international movement of capital were much more extensive than today.

1/ Where the exchange rate was previously freely-floating with little or no support from official intervention, the move to a fixed rate regime may be associated with an increase in intervention needs. On the other hand, where the previous regime was a managed float, the adoption of tight macroeconomic policies in support of an exchange rate peg could lead to a reduction in intervention needs.

2/ For example, the annual turnover in the Moscow foreign exchange market rose from under US$3 billion in 1992, to US$13 billion in 1993, and nearly US$25 billion in 1994.

Also, the measure is no more than a rule of thumb and is often supplemented in a judgmental way by considering other factors such as the openness of the capital account, the stock of highly liquid liabilities, and the country's access to short-term borrowing facilities. Nonetheless, the level of import cover provided by reserves has the benefit of being a readily quantifiable fact. 1/

Table 1 shows the actual reserve levels in terms of months of imports for a sample of countries that maintained pegged or managed exchange rate regimes at end-1993. 2/ The average level of reserves for these countries was 4.5 months of imports, appreciably above the 3-month rule of thumb. However, there is considerable variation, with reserves ranging from 0.7 months of imports (Papua New Guinea) to 18.7 months of imports (Botswana), with the median of the distribution falling just below 3.5 months of imports.

Among possible early cases likely to come up for consideration for CSFs may be some countries of the FSU aiming to sharply reduce inflation. Table 2 summarizes reserve-import ratios for the Baltics, Russia, and the other FSU countries. The Baltic countries--which have each moved to full or virtual currency pegs in the process of stabilizing their economies--have reserves averaging 3.5 months of imports. However, the average for Russia and the other FSU countries is half this level--i.e., 1.8 months of imports. Of these 12 countries, only two have reserves equivalent to three months or more of imports.

c. Reserves in relation to the monetary base

Both of the above approaches consider reserve adequacy from the point of view of external flows. The problem can also be looked at from another perspective: the amount of reserves needed to operate a currency board. Under a currency board-type arrangement, the central bank does not engage in sterilization to offset the monetary effects of foreign exchange intervention. Under these operating rules, reserves sufficient to cover base money would provide another benchmark against which to measure the adequacy of reserves to defend a fixed exchange rate. In the event of a speculative attack, unsterilized intervention would automatically tighten

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1/ In principle, rules of thumb might also be developed that compare reserve levels with, say, Fund quota, or nominal GDP. However, in practice, indicators such as these have not commonly been used.

2/ The sample was drawn from the group of countries that maintained pegged or managed exchange rate regimes by excluding those countries with Fund arrangements that had gone off track or where the external position was considered to be difficult.

Table 1. Reserves Coverage for Selected Countries Maintaining Pegged or Managed Exchange Rate Regimes, End-1993

Country	Gross Reserves (US$ bn.)	Reserves Coverage (Months) 1/	Base Money (US$ bn.)	Reserves in Percent of Base Money 2/	Three Months of Imports in Percent of Base Money
Argentina	17.3	8.3	15.0	115.2	41.6
Bahamas, The	0.2	1.0	0.2	86.3	263.0
Bahrain	1.3	4.5	0.4	300.5	198.8
Bhutan 2/	0.1	7.0	0.0	160.5	68.8
Bangladesh	2.4	6.1	2.2	108.7	53.5
Barbados	0.2	2.0	0.2	92.9	142.5
Botswana	3.9	18.7	0.4	912.6	146.3
Chile	9.6	7.7	14.0	68.5	26.8
China	22.5	2.7	216.2	10.4	11.6
Colombia	7.3	6.5	4.9	147.8	68.3
Cyprus	*1.0*	*2.9*	*1.5*	*67.0*	*70.4*
Czech Republic	3.9	2.9	5.5	71.3	73.1
Ecuador	1.1	2.9	1.1	97.0	99.2
Egypt	12.9	10.2	12.6	102.2	29.3
Fiji	0.3	3.5	0.1	185.7	159.4
Hungary 2/	5.6	5.6	10.5	53.6	28.5
Indonesia 2/	11.3	3.2	7.5	150.2	139.3
Israel	6.4	2.8	9.4	68.1	72.1
Korea	20.2	2.5	28.6	70.7	86.4
Kuwait	4.2	4.5	1.7	249.0	166.0
Malaysia	27.2	6.4	10.5	260.1	122.6
Malta	1.4	5.9	1.1	122.2	62.4
Mauritius	0.8	4.3	0.5	147.1	103.0
Mexico	22.7	3.7	16.2	140.2	112.9
Morocco	3.7	5.8	4.8	76.9	39.9
Pakistan	1.2	1.3	8.1	14.8	33.8
Papua New Guinea	0.1	0.7	0.2	69.0	301.7
Poland	4.1	2.9	7.5	54.7	57.4
Quatar	0.7	4.2	0.6	115.8	81.8
Seychelles	0.0	1.3	0.1	45.2	102.8
Singapore	48.4	6.2	9.1	530.6	255.4
Solomon Islands	0.0	1.4	0.0	166.0	345.7
Sri Lanka	1.6	5.6	1.2	140.4	75.4
Thailand	24.5	5.1	11.3	217.2	127.2
Tonga	0.0	5.2	0.0	250.2	143.7
Tunisia	0.9	1.5	1.4	63.5	125.0
Turkey	8.9	2.9	8.9	99.9	103.0
United Arab Emirates	6.1	3.2	3.6	170.6	160.1
Uruguay	0.8	3.4	0.7	105.2	92.3
Vanuatu	0.0	3.7	0.0	180.9	145.7
Average (unweighted)		4.5		152.2	113.4
Average (weighted)		4.3		68.1	47.4
Average (weighted), excl. China		4.5		130.0	85.8

Sources: WEO; IFS data; and other data provided by the authorities.

1/ Gross reserves, measured in months of imports of goods and nonfactor services.
2/ Data for 1992.

Table 2. Reserves Coverage for the Baltics, Russia, and the Other FSU Countries, End-September 1994

Country	Fund Quota 1/ (US$ mn.)	Gross Reserves (US$ mn.)	Gross Reserves (Months of imports)		Base Money (US$ mn.)	Gross Reserves in Percent of Base Money		Three Months of Imports in Percent of Base Money
			Own Reserves	+100% Fund Quota		Own Reserves	+100% Fund Quota	
Baltic states								
Estonia	68	429.5	3.0	3.5	316.5	135.7	157.2	136.5
Latvia	135	582.5	4.6	5.6	465.3	125.2	154.2	82.4
Lithuania	152	636.3	2.8	3.5	423.3	150.3	186.2	158.3
Other FSU countries								
Armenia	99	7.0	0.2	2.7	27.7	25.3	382.7	424.2
Azerbaijan 2/	172	0.4	0.0	2.2	111.4	0.4	154.8	210.9
Belarus	412	165.7	0.6	2.2	126.0	131.5	458.5	620.1
Georgia	163	2.3	0.0	2.5	8.7	26.4	1,900.0	2,284.5
Kazakhstan	364	890.0	2.6	3.6	431.3	206.4	290.8	241.4
Kyrgyz Republic	95	82.3	2.8	6.0	121.9	67.5	145.4	72.5
Moldova	132	118.0	2.3	4.9	106.6	110.7	234.5	142.8
Russia	6,340	6,745.0	1.1	2.2	15,139.4	44.6	86.4	116.6
Tajikistan 3/	88	4.0	0.1	1.5	182.1	2.2	50.5	102.1
Turkmenistan	71	816.0	6.6	7.2	71.4	1,142.9	1,242.3	516.8
Uzbekistan	293	1,298.0	4.9	6.0	391.8	331.3	406.1	201.5
Ukraine 4/	1,466	260.0	0.2	1.4	1,708.7	15.2	101.0	210.7
Average (unweighted)			2.1	3.7		167.7	396.7	368.1
Baltic states			3.5	4.2		137.1	165.9	125.7
Other FSU countries			1.8	3.5		175.4	454.4	428.7
Average (weighted)			1.4	2.5		61.3	112.5	136.0
Baltic states			3.3	4.0		136.8	166.2	123.3
Other FSU countries			1.2	2.4		56.4	109.0	136.8

Source: Staff estimates.

1/ Assumes SDR=US$1.47.
2/ Data for August 1994.
3/ Data for March 1994.
4/ Data for October 1994.

monetary conditions and help to stem the attack. 1/ This is the basic principle that underlies the operation of a currency board; in fact, it has been found that currency boards can operate successfully with only two-thirds backing. 2/ For prudential reasons, central banks operating currency board type arrangements typically hold reserves in excess of the required backing.

In practice, this benchmark for reserve adequacy also appears relevant for countries without currency boards that are maintaining a fixed or managed exchange rate. Thus, only 6 of the 40 countries included in Table 1 had gross reserve levels equivalent to less than two-thirds of the domestic monetary base. 3/ The average level of reserves for these countries was 152 percent of the monetary base; however, as with the import measure, there is a wide variance.

Table 2 presents the same measure of reserve cover for the Baltics, Russia, and the other FSU countries. Estonia and Lithuania, which have currency boards, and Latvia, which has (de facto) pegged its exchange rate, all have reserve levels in excess of the monetary base: on average, reserves exceed the monetary base by almost 40 percent. For other FSU countries, the averages are distorted by Russia (weighted average) and Turkmenistan (unweighted average), but of these 12 countries, six had reserves that were greater than two-thirds of the monetary base.

The measures of reserve adequacy reviewed above are relevant to the assessment of the appropriate level of access under CSFs. First, it is noteworthy that the three-month import rule of thumb and the monetary base coverage rule tend, on average, to indicate broadly similar levels of reserve cover for countries that have pegged or managed exchange rate regimes. For the countries shown in Table 1, three months of imports is equal, on average, to around 113 percent of the domestic monetary base. However, for the countries shown in Table 2, the three-month import rule tends to be much more demanding than a rule based on the monetary base, largely reflecting the disequilibria in their economies and--in particular--the highly depreciated level of the real exchange rate. For the Baltic countries, three months of imports is equivalent, on average, to around 126 percent of the domestic monetary base. For other FSU countries, the same

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1/ The assumption that reserve changes are not sterilized is crucial to the base money approach to measuring reserve adequacy. If reserve changes are sterilized, the potential for reserve use in defending the exchange rate is virtually unlimited. For this reason, clear understandings concerning the extent of any sterilized intervention will be essential to the effective operation of CSFs.

2/ See "Currency Boards: Issues and Experiences" by Adam G.G. Bennett (PPAA/94/18, September 1994).

3/ China distorts the weighted average because it has by far the largest weight in the sample and a large monetary base in relation to foreign exchange reserves reflecting its underdeveloped financial system.

level of imports is equivalent to over 400 percent of the domestic monetary base, or 260 percent excluding Georgia.

Second, with regard to a possible upper limit of 100 percent of Fund quota on Fund support for CSFs, some illustrative calculations are presented in Table 2. These illustrative calculations show the impact of supplementing members' existing reserves with a CSF equivalent to 100 percent of Fund quota. 1/ On this basis, maximum access under CSFs for Russia and the other FSU countries would increase reserve levels, on average, from 1.8 to 3.5 months of imports during the period of availability of the CSF. The number of countries with reserves less than 3 months of imports would be reduced from 10 to 7. Similarly, maximum CSF access of 100 percent of quota would reduce the number of countries with reserve cover of less than two-thirds of the monetary base from 6 to 1.

1/ No account is taken in these calculations of possibly lower levels of access under CSFs on a case-by-case basis, or the possibility of increases in reserves that might be programmed under associated Fund arrangements.