FOR AGENDA

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CONFIDENTIAL

December 5, 1997

To: Members of the Executive Board

From: The Secretary

Subject: **Supplemental Reserve Facility**

Attached for consideration by the Executive Directors is a paper on the supplemental reserve facility, which will be brought to the agenda for discussion on a date to be announced. Conclusions appear on page 16.

Mr. Bennett (ext. 38784), Mr. Elizalde (ext. 37796), or Mr. Wittich (ext. 38307) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Supplemental Reserve Facility

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

(In consultation with other Departments)

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December 5, 1997

I. Introduction

1. The increasing globalization of international capital markets, combined with the growing volume of financial savings that these markets serve to allocate around the world, has brought considerable benefits and has substantially enhanced the growth potential of emerging market economies. As has become clear in recent years, however, this development has also brought with it important risks, as the flow of capital is crucially dependent upon the confidence that international investors have in the capacity of the recipient economies to make payments. The crises in Mexico in late 1994 and in the countries of Asia this year have clearly demonstrated both how vulnerabilities can increase rapidly in the financial sector and how large, sudden, and disruptive can be turnarounds in investor confidence. They have also revealed the scope for contagion: loss of confidence in one emerging market economy leads investors to look for similar signs of weakness elsewhere.

2. These reversals in market confidence and the disruptions they can create in financing for emerging markets have created a new kind of problem for the Fund—how to help contain these sharp reversals in private capital flows and bring about, through the member's adjustment program and the restoration of confidence, an early return to more normal market conditions. This paper considers the circumstances of recent crises of this type and the ways in which the Fund has responded to them. It then explores the possibility that the Fund's response to this type of situation could be usefully framed in the context of a new facility to provide resources on the exceptional scale required under a stand-by or extended arrangement, but with terms different from those applying to purchases in the credit tranches or the extended Fund facility.[1] [2] [3] While recent developments would suggest the need for such

[1] This would be in line with the request made by Asian Finance and central bank deputies in Manila on November 19 for the Fund "to constructively examine the establishment of a new mechanism to provide short-term financing to augment an exceptional stand-by or extended

(continued...)

a facility, they also raise important issues regarding prevention, including in the context of the Fund's surveillance, which need to be addressed as soon as possible. These are, however, beyond the scope of this paper.

II. TURNAROUNDS IN MARKET CONFIDENCE: THE CRISES OF 1995-97

3. In recent years, four Fund members have requested the use of Fund resources following massive turnarounds in market confidence: Mexico (late 1994), Thailand (1997), Indonesia (1997), and Korea (1997).[4] In all these cases, the Fund provided access to its resources which was heavily front loaded and well in excess of both the annual and cumulative access limits in the credit tranches and the extended facility.

The buildup to the crises

4. The crisis in Mexico in late 1994 had its origins in a consumption boom, an erosion of competitiveness, and a large and growing current account deficit. During the course of 1994, political and external developments triggered several episodes of capital outflows, and the

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[1](...continued)
arrangement in light of the globalization of financial markets and the increased scale of private capital flows."

[2] It is not the object of this paper to explore access policy more generally, or to reconsider the application of the annual and cumulative limits at this time. There will be a more general review of these issues, in light of proposals for capital account liberalization and the impending quota increases, at a later stage and, in any case, before October 31, 1998.

[3] The assistance under this facility would be provided under a stand-by or extended arrangement and thus would make it quite different from the "short term financing facility" that was discussed in 1994 (EBS/94/193). The latter was conceived as a very short term line of credit, which would be requested in the context of an Article IV consultation and would, at least initially, be subject to only limited conditionality. The facility envisaged in this paper would be requested at the same time as (or otherwise in the context of) assistance in the credit tranches or under the extended facility in the context of a stand-by or extended arrangement and would be subject to conditionality from that arrangement.

[4] The Philippines also suffered a reversal of confidence and loss of reserves following the breaking of the crisis in Thailand. However, the crisis in the Philippines was on a more modest scale, by comparison to the cases reviewed in this paper. This permitted the Fund to support the strengthened adjustment program, in the context of the existing extended arrangement, with an augmentation involving smaller resources, in relation to quota, than involved in the other cases. This support was cofinanced with resources from the Export-Import Bank of Japan.

authorities responded by running down their reserves and by refinancing high-interest, peso-denominated debt into low-interest dollar-indexed debt (Tesobonos). By December 1994, the authorities were forced first to devalue and then to let the exchange rate float. The resulting depreciation immediately raised questions about the government's capacity to service the Tesobonos and, at the same time, exposed a number of domestic banks to a risk of non-rollover of foreign credit lines. The crisis spilled over to markets elsewhere, principally in Latin America, with Argentina being the most seriously affected. It was only in the context of a strengthened set of adjustment policies and the commitment of a large volume of financial support, mostly from the US government and the Fund, that confidence was restored and Mexico regained access to private capital.

5. The more recent crises in Thailand and, to a lesser extent, in Indonesia and Korea, were also based on unsustainable economic booms, although in these cases it was as much investment as consumption that drove demand. Years of spectacular growth, earning these countries, along with their neighbors, the epithet of "Asian Tigers", had encouraged substantial inflows of capital seeking continued high returns. These resources went variously into the stock market, through direct investment, or—often in the form of short-term, dollar-denominated debt—were intermediated through the banking system. The latter, insufficiently regulated or supervised, and taking on unsustainable maturity and exchange rate risks, began channeling funds into the property market and into other investments with dubious rates of returns. The strength of demand, meanwhile, pushed up the real exchange rate and led to a deterioration in the current account, especially in Thailand.

6. As market confidence began to ebb (in Indonesia and Korea somewhat later and, in part, as a result of spillover effects from the Thai crisis), pressures began to mount on the exchange rates of these countries. Thailand's initial response was to intervene heavily, although the full extent of this intervention was initially hidden from the market because most of it was undertaken in the forward market. Eventually, in the summer of this year, first Thailand and then Indonesia succumbed to the loss of market confidence and allowed their exchange rates to float and thereby depreciate. Korea, likewise, was forced to allow its exchange rate to depreciate beyond the limits of its crawling band. As with Mexico, these depreciations immediately raised questions in financial markets about the ability of Thailand, Indonesia and Korea to service their short term external obligations. Market participants also raised questions about the ability of banks and the corporate sector to survive the losses resulting from the large depreciations and the associated high short term rates of interest. Contagion effects proved much more extensive than with Mexico, with all the countries in the region and some beyond subjected to severe exchange rate and stock market pressures.

The nature of the Fund's response

7. As with most members seeking the use of Fund resources, all four countries suffered to varying degrees and in varying proportions from underlying macroeconomic imbalances and structural problems and, reflecting this, the drying up of medium and long term capital inflows. With the onset of their crises, however, they now faced another kind of problem: a

large stock of maturing short term, dollar denominated or dollar linked debt and a lack of confidence on the part of the market in the ability of banks or the corporate sector to service these debts. In these circumstances, there was a risk that a significant proportion of these debts would not be rolled over. In the absence of recourse to exceptional finance, the consequence of this would be a further weakening of the exchange rate and a scramble for credit domestically, with resulting higher real interest rates (and bankruptcies) and/or inflation, depending on the monetary stance of the authorities. The risk was that the erosion of market confidence would then continue and become much more difficult to reverse, raising the risk of default. The task of the Fund, to which these countries turned with requests for the use of Fund resources, was therefore to provide, both directly and with the assistance of partners, a sufficient package of financing to promote a restoration of confidence in the framework of an adjustment program. The latter would need to justify this confidence by ensuring that the authorities were taking the steps necessary to correct the problems that had caused the loss of confidence and adopting policies that would permit a return to a sustainable growth path.

8. In all four cases, the Fund provided resources in the credit tranches under stand-by arrangements with very large and heavily frontloaded access (Table 1). The size of the arrangement, and the degree of front loading, reflected judgements regarding the amount necessary—given forceful adjustment measures and combined with resources made available by other participants in the packages—to restore confidence (see Box 1). In making such judgements, a view had to be taken of the amount of short term exposure (public or private) for which there was a significant risk of non-rollover.[5] In order to provide confidence to the markets that resources were available to meet this eventuality, without further weakening the country's external reserve position, packages were generally set at levels sufficiently large to give confidence to the markets that the member would be able to meet that part of its short term exposure that was deemed most at risk of non-rollover, as well as other net claims from the balance of payments as might be expected to occur. The expectation was that, if the package, combined with the adjustment program, was successful in restoring confidence and stopping further outflows, then the resources would not need to be fully drawn.[6] The provision of these packages was not, however, intended to interfere with the normal process of bankruptcy and investor losses if banks and enterprises were insolvent. The experience of these and other cases, however, reveals that there is a general and widespread need for countries with emerging markets to establish or to enhance their mechanisms for orderly bankruptcy procedures to deal with arrears to private creditors.

[5] Including debt and forward exchange market positions.

[6] The inclusion of coverage of "at risk" short term exposure meant that access to Fund resources tended to be much higher, in relation to projected gross financing needs as customarily defined (current account deficit, plus amortization of medium and long term debt, plus repayment of arrears and planned build up of reserves) than for other cases. The ratio for the first year of the arrangements for Mexico, Thailand and Indonesia ranged from 31 to 56 percent, by comparison to the more usual ratio of about 10 percent.

Table 1: Phasing of Purchases, in percent of Quota

Phasing of purchases and repurchases during arrangement

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Total
Mexico									
Scheduled purchases	500	189	...	...	...	...	...	...	688
Scheduled repurchases 1/	25	42	33	129	297	214	48	...	788
Actual purchases	500	...	...	...	...	...	...	...	500
Actual repurchases 1/ 2/	43	81	143	61	163	109	...	...	600
Thailand									
Scheduled purchases	366	70	70	...	...	...	...	...	505
Scheduled repurchases	...	...	...	109	196	122	57	22	505
Indonesia									
Scheduled purchases	371	69	50	...	...	...	...	...	490
Scheduled repurchases	...	...	...	143	213	93	33	9	490
Korea									
Scheduled purchases	1,758	91	91	...	...	...	...	...	1,939
Scheduled repurchases	...	...	...	574	896	367	74	28	1,939

Phasing of purchases in the first year of arrangement

	1	2	3	4	5	6	7	Total
Mexico	300	73	63	63	...	...	...	500
Thailand	209	105	35	17	...	...	...	366
Indonesia	147	147	39	39	...	...	...	371
Korea	513	325	188	325	225	91	91	1,758

1/ Outstanding obligations of SDR 1.8 billion (about 100 percent of quota) were due between 1995 and 1997 from the 1992 SBA.

2/ Advance pruchases of SDR 2.6 billion (148 percent of quota) made so far, SDR 0.7 billion in 1996 and SDR 1.9 billion in early 1997. The repurchase schedule for 1998 and 1999 assumes that the early repurchase amounts are with respect to payments falling due in those years.

Box 1. Financing Features of Fund Arrangements for Mexico (1995), Thailand (1997) and Indonesia (1997)

In Mexico in 1995 the authorities faced the risk that some $29 billion in Tesobonos and $18 billion in banks' foreign currency-denominated credit lines would not be rolled over. The package that was put together, at $53 billion, was in excess of these amounts deemed at risk, in order to give confidence to the markets that all these amounts could be honored if needed. The Fund's contribution of $18 billion was about one third of the total initial package. Other participants included the US ($20 billion), other bilaterals ($2 billion), the BIS ($10 billion) and commercial banks ($3 billion). The BIS component did not, in the event, materialize, so that the Fund's share of the final package was closer to half.

In Thailand, some $38 billion in bank and non-bank short term foreign currency debt was projected to fall due during 1997 and 1998. In addition, the Bank of Thailand had forward foreign currency obligations of $25 billion. It was assumed that, in the context of the program and a sufficiently large financial package, all but $5 billion in private sector external obligations could be rolled over, and that the effect of unwinding forward obligations on the Bank of Thailand's spot reserves would be limited to $17 billion. On balance, and taking into account other inflows and outflows, the financing needs for 1997 and 1998 were estimated at $14 billion. The package that was assembled amounted to $17 billion. The Fund's share of this, at $4 billion, was about one quarter. Other participants included Japan ($4 billion), other bilaterals ($6½ billion) and other multilateral institutions ($2½ billion).

For Indonesia, the estimated amount of short term debt owed by banks and non-banks was about $33 billion. Of this, some $23 billion was thought to be at risk of non-rollover. The package that was put together amounted to $18 billion, with a further $5 billion from Indonesia's own external reserves (which were at much more comfortable levels than those of Mexico and Thailand at this juncture). Excluding the use of Indonesia's own resources, the Fund financed slightly over half of the package, with the rest provided by multilateral development banks. In addition to this package, a number of countries pledged their willingness to consider supplementary support, totaling some $20 billion, should adverse external circumstances create the need for further resources.

For Korea, the stock of short term debt owed by banks and non-banks was estimated to be of the order of $66 billion. Some $25 billion of this was related to trade finance, much of which was expected to be rolled over as trade continued, but the rest was considered to be at risk of non-rollover. The package that was assembled amounted to a total of some $55 billion, towards which the Fund provided $21 billion and other multilateral banks provided $14 billion. The rest represented supplementary support from bilaterals on a similar basis as for that provided for Indonesia.

9. The financing package for each country was based on an associated adjustment program carried out in the context of a stand-by arrangement. These adjustment programs varied in emphasis, depending on the source of the macro imbalances and the nature of the structural problems confronting the country—and affecting market confidence. For Mexico, the emphasis, at least initially, was primarily on macroeconomic adjustment, with measures sufficient to bring the fiscal accounts towards balance, and a tight monetary policy designed to cool domestic demand and ease pressure on the exchange rate. Reflecting this, the stand-by arrangement was initially approved for an eighteen month period. Thailand also required a significant degree of current account and fiscal adjustment. For Indonesia and Korea, where the macroeconomic imbalances were less pronounced, as well as for Thailand, there was also important emphasis on structural reform, especially in the financial sector, since concern about the state of bank/finance company portfolios was one of the main factors undermining market confidence. Given this objective, the arrangements were approved for a rather longer period of three years. Notwithstanding the length of these later arrangements, however, the recognition that the financing associated with them did not need to be long term led to the recommendation that these arrangements take the form of a stand-by arrangement rather than an extended arrangement

10. The bulk of the resources available under each of the three stand-by arrangements for Mexico, Thailand, and Indonesia was provided in the first two purchases. In Korea, with biweekly monitoring for the initial period of the arrangement, there was a higher number of "large" purchases. While the respective members each made the first purchase, all four included statements in their Letters of Intent that, in the event that the situation stabilized, as was expected, they would not request some of the subsequent purchases and would make advance repurchases as conditions permitted. Consistent with the principles elaborated above, there was a recognition that the resources were valuable as much for their availability as for their use, and that the needed maturity was probably significantly less than the three and a quarter to five years provided for in the credit tranches. While it is too early to know what will happen in Thailand, Indonesia and Korea, it is worth noting that the intent expressed in Mexico's Letter was carried out broadly as envisaged. The markets began to stabilize three months after the arrangement's approval (following a tightening of the program at the time of the first review), permitting the authorities not to request the fifth and subsequent purchases and treat the arrangement thereon as precautionary, and with the sustained reflow of capital the following year, significant advance repurchases were made.

III. UNDERLYING VERSUS SHORT TERM FINANCING NEEDS

11. The experience of these four countries suggests that financial crises in emerging market economies may increasingly comprise two components: an underlying balance of payments need, of the type more typically characterizing a request for the use of Fund resources, and an additional, and often very much larger, *short term* financing need resulting from a loss of market confidence and reflected in actual or potential pressure on the capital account. The contribution of these two components of need will vary from case to case, and in some cases, albeit probably very few, the former may even be absent. Both of these

needs—related as they are to changes in investors' willingness to incur exposure to the country—generally emanate from the same underlying macroeconomic and/or structural imbalances.[7] In view of their common source, but different characteristics, it would appear appropriate to separate the financing of the large but likely short term needs from that of the other component of balance of payments need, but to keep both in the context of a common adjustment program. This could be achieved through the creation of a new facility, designed specifically to address these potentially large but short term needs that emanate chiefly from the capital account, reflecting the loss of market confidence, but which should, with appropriate supporting policies, be contained and reversed within a relatively short period of time. Such a facility would augment the resources provided under a stand-by or extended arrangement (but be separate from resources in the credit tranches or extended facility, also provided under the same arrangement). Conditionality under the facility would be shared with the conditionality associated with the other resources provided by the overall arrangement. Policy conditionality would be appropriate to the member's capacity to repay, given the exceptionally large volume of resources that may be committed.

12. Resources in the credit tranches under stand-by arrangements are well suited to the financing needs that characterize the majority of members with arrangements supported by resources in the General Resources Account (GRA) . These are typically members that, following a change in circumstances or as a result of previously imprudent policies, must adjust absorption and the current account to the possibly reduced level of the resources available to them. Such programs are cast in a way that, provided they are carried out as envisaged, will permit the member to repay the Fund within the three and a quarter to five year period stipulated for the credit tranches. Financing needs associated with broader, but perhaps longer-gestation, programs of structural reform can be accommodated within the extended Fund facility under extended arrangements, where the repayment is scheduled over a four and a half to ten year period. However, repayment schedules of these lengths are not well suited to the circumstances of short term needs, where the member should be able to repay—again with the firm implementation of supporting policies and restoration of market confidence—within a much shorter period of time. Nor is the Fund's policy on early repurchases well-suited to the task of eliciting large and rapid repurchases in the event that a member's balance of payments and reserve position improves rapidly—as is intended in these cases.[8] A new facility could be designed so as to provide for repayment at shorter maturities

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[7] Even if the large but short term need (perhaps caused by speculative attack) were not *caused* by underlying imbalances, it is likely to *create or uncover* underlying imbalances and structural problems that will have to be addressed in the context of the corrective program, i.e., sharp changes in the amount or direction of capital flows are likely to impact the exchange rate, the financial system, corporate balance sheets, and, ultimately, the real economy.

[8] The Guidelines for Early Repurchase, which date back to 1978, are due to be reviewed in the near future. However, the staff is not confident that it will be in a position to recommend an

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than those of the credit tranches or extended facility. As noted in section II, the Letters of Intent of Mexico, Thailand, Indonesia and Korea all contained statements of intentions to make advance repurchases as conditions permitted. There are, however, no formal mechanisms available to the Fund to enforce these intentions.[9]

13. Access under the credit tranches and the extended Fund facility is also subject to annual and cumulative limits on the amount of resources (access) that can be made available. These limits are, however, conceived with more normal financing needs in mind, and in meeting the recent requests of members facing severe pressures in the capital markets, the Fund has had to appeal to the "exceptional circumstances clause"—both as regards the amount of resources committed and their phasing—to meet the members' needs. If resources for the relevant short term financing needs were instead provided under a new facility, the access limits under the credit tranches and extended Fund facility would be better-placed to continue to play their traditional roles of constraining and anchoring access to Fund resources.[10] The exceptional circumstances clause in particular would no longer need to cover occasions of sudden losses of market confidence; access to Fund resources to assist members facing such problems would be provided under the new facility in conjunction with resources within the limits under the credit tranches or extended Fund facility, also to be provided under stand-by or extended arrangements.

14. Purchases in the credit tranches and the extended Fund facility are subject to a rate of charge, based on the SDR rate of interest, that is low by comparison to the rate of interest that might be payable on international capital markets—especially by a member that has just suffered a loss of confidence.[11] In responding to the potentially large but short term needs, it may be necessary for the Fund to make large sums of financing available up-front, which the member may, or may not, need to draw on depending on whether or not there is, as intended

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[8](...continued)
operational mechanism under which a member that regains or strengthens its access to capital markets will have to make repurchases commensurate with that improvement.

[9]An undertaking to make advance repurchases would constitute a legal obligation only if the member had been specifically required to undertake an early repurchase obligation as a condition for a waiver under Article V, Section 4—a requirement that was not included in these arrangements (nor in any others to date).

[10] Other questions have been raised regarding the continued relevance of the current access limits, but these will be addressed in a later paper.

[11] The SDR rate of interest is a basket of interest rates on short-term financial instruments in five major currencies (largely Treasury bills).

under the program, a rapid return of confidence.[12] In these circumstances, there is a case for applying higher charges to the use of these resources, in order to provide an *incentive* to the member to purchase only when necessary, and to repurchase as soon as feasible. Higher charges could be applied to resources provided under a new facility. For higher charges to be effective as an incentive to purchase only when necessary, and to repurchase as soon as feasible, they would likely need to be set substantially above the basic rate of charge applicable under other Fund facilities and policies, which has recently been around 4.5 percent per annum.[13] Higher charges would also be justified by the risks to the Fund associated with very large and frontloaded access, and by the possible need for larger precautionary balances that could be financed through higher charges.[14]

15. Because both types of financing need, whether of a short term or medium term nature, will generally derive from the same underlying macroeconomic and/or structural imbalances, they should both be addressed in the context of a common adjustment program. A new facility aimed at the short term financing needs should therefore be available to members *only* under a stand-by or extended arrangement designed to deal with these underlying imbalances, and the availability of resources provided through such a facility should be linked to the conditionality of the associated arrangement and other resources provided under it.[15] The availability of resources provided under the arrangement to deal with the two types of financing need can then be phased according to the assumed pattern of needs (potential, large, and short term

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[12] As noted in section II, the recent large arrangements for Mexico, Thailand, Indonesia and Korea all included undertakings in the Letter of Intent to forego purchases in the event that the situation stabilized. These undertakings reflect the rule in the Articles that Fund resources should be used only if there is a balance of payments need, but, with respect to purchases under an arrangement, this assessment can only be made "ex post", i.e. after the purchase has been made.

[13] With burden sharing, the rate of charge has been closer to 4.7 percent in the first half of financial year 1998.

[14] The role of higher charges in safeguarding the Fund's resources was discussed in Safeguards for the Fund in Cases of Very High Access -- Preliminary Considerations, EBS/96/82.

[15] Tight linkage of the facility to stand-by or extended arrangements would, if necessary, permit activation of the General Arrangements to Borrow (and , when effective, the New Arrangements to Borrow) to finance purchases under the facility. The potential for activation of these borrowing arrangements will be important given the scale of resources that may be involved in cases of this type. The Fund's liquidity ratio stood at about 51 percent in early December (following the approval of Korea's arrangement) and is expected to fall to about 33 percent in mid-1999. Roughly speaking, the ratio will fall by 10 percentage points for every additional SDR 5 billion that is committed.

under a separate facility, and more modest but medium term under the credit tranches or extended Fund facility) within the same arrangement.

IV. Supplemental Reserve Facility

16. Reflecting the above considerations it is recommended that a new special facility, to be called the Supplemental Reserve Facility, be established to deal exclusively with short term crises.[16] [17] [18] Such a facility would be available to members for the provision of exceptional access to Fund resources in the relevant circumstances, i.e. where a crisis of confidence has developed with the risk of significant outflows of capital developing. The purpose of the facility would not, however, be to finance such outflows, but rather to stop further outflows and rebuild reserves, with the implementation of an adjustment program and the assembly of a financial package that would justify a return of confidence, and thereby limit the real costs of the excessive exchange rate depreciation, undue correction in the current account, and unnecessary insolvencies that might otherwise occur. It is intended that this facility would be used only in circumstances where there is a good chance of a rapid turnaround in confidence

[16] The establishment of a new special facility with the features described below would require a majority of 85 percent of the total voting power.

[17] Many, but not all, of the elements of such a facility could be achieved through a "window" within an arrangement, as with Currency Stabilization Funds, through conditions attached to waivers granted under Article V, Section 4 for arrangements which take the Fund's holdings of a member's currency above 200 percent of quota. The creation of such a "window" or "element" within an arrangement would require only a simple majority of the Board. A key feature—higher charges—would not, however, be available except in a refundable (collateralized) form which would largely deprive them of their effectiveness. Large scale use of Fund resources through such a window would also still require appeal to the exceptional circumstances clause. Use of a facility, on the other hand, would serve to formalize circumstances which are becoming less rare as emerging markets grow in size and number. Separation of these circumstances would permit stand-by and extended arrangements to respect the annual and cumulative access limits applicable to purchases in the credit tranches and the extended Fund facility in all but truly exceptional circumstances.

[18] In principle this facility would be available to the whole of the Fund's membership, including ESAF eligible countries. It is not, however, envisaged that any of the latter would likely qualify for use of the facility, given that it would only be expected to be used by members who have achieved large scale access to international capital markets. Nor would such a facility seem appropriate, in view of its nonconcessional terms. Should a financing need of the relevant type arise for an ESAF eligible member, this could normally be addressed in the context of available resources on appropriate terms.

and that it not be used as a means of bailing out private creditors.[19] Given the scale of the resources that may be expected to be required, it is assumed that the Fund would provide resources through such a facility only in the context of an overall financial package involving other lenders. It is not intended that this facility would be used in the absence of evident pressures in the exchange rate and other financial markets, i.e. where a crisis of confidence has not actually developed. Members concerned about the possibility of a crisis of confidence arising should instead implement policies designed to prevent such an eventuality and do so in the context of access in the credit tranches or under the extended Fund facility, under a stand-by or extended arrangement, without access under the facility. In this way they will be able to suffice with more modest levels of access, and in doing so incur charges only at the basic rather than a higher rate. The specific features proposed for the facility are summarized in Box 2.

17. Access to resources under the facility would be available to a member for up to one year following approval of its request, although the arrangement, under which other resources would also be made available, would typically be for a longer duration. Conditionality under this facility would be linked to the conditionality of the associated stand-by or extended arrangement, and the (limited) phasing of purchases. The conditionality under the arrangement would be set in cognizance of the additional financing to be provided under the facility.[20] An important element of these programs would be to bring the standards of the country's financial system up to the best practice required of market access countries and to ensure that transparency and disclosure meet these same standards. Developments in the program, and the success or otherwise in containing outflows would be monitored in the context of the first substantive review, at which time corrective policies, if needed, would be sought as a condition for the release of further purchases. Should capital outflows persist, the possibility of debt restructuring or controls would have to be considered.[21] If the negotiations were undertaken according to the Emergency Financing Mechanism, there would also be an interim

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[19] Nor should the existence of such facility be interpreted as an "automatic bailout" of governments. The facility would be available only to a member willing to implement the necessary corrective measures and for which there was a realistic prospects of a return of market confidence.

[20] Amongst other things, there should be an enhanced level and continuity of policy dialogue, a high intensity of monitoring and data provision, and a focus on debt management. Papers presenting requests for use of the facility would be expected to provide a full description of how private sector creditors are being dealt with, including in the context of financial sector restructuring.

[21] Related to this is the question of the Fund's and members' policies towards orderly workouts. Responding, in part, to a request from G10 Deputies on this subject, a paper will soon be brought to the Board discussing Fund policy towards sovereign arrears to private creditors, and there will be a subsequent paper with regard to arrears of private borrowers.

review of developments , at which time the authorities could be informed of the need to make adjustments, if necessary.[22]

18. The facility could generally enable two or more purchases, with phasing geared to the member's situation and subject to close monitoring, continued compliance with the program, and completion of Board reviews. Such phasing of purchases would strengthen the facility's conditionality. The second and subsequent purchases could be treated as precautionary by the member, which would have the incentive to do so by virtue of the application of the higher rate of charge. The availability of such undrawn balances would, however, depend upon compliance with remaining performance criteria at subsequent test dates and completion of reviews.

19. Repurchases could begin after 2 years and be completed in four equal quarterly installments. They would initially comprise an "expectation" which could, subject to review by the Board, be extended for a specified period of time (up to one year), before being replaced by an "obligation". While the short term financial crisis might be expected to have reversed itself within one year, uncertainty about the timing of the return of confidence, and the possibility of accumulating reserves that may have been used during the crisis, would recommend some flexibility for the date of repurchases which could be accomplished by such a structure. A repurchase schedule of this nature would also largely eliminate the overlap of repurchases under the facility with repurchases of purchases in the credit tranches under the same arrangement (and eliminate any overlap completely with respect to an extended Fund facility).

20. The rate of charge would be set (uniformly) in the range of, say, two to four hundred basis points higher than the (adjusted) basic rate of charge applicable to the use of GRA resources under other facilities and policies.[23] [24]A higher rate of charge can be justified by the incentive it creates for the member to treat available resources as precautionary and to make

[22] Given the speed with which the negotiations may have proceeded, there may be some elements of the program which require further specification at the time of these reviews.

[23] Incorporation of a higher rate of charge would require a majority of 70 percent of the total voting power.

[24] The spread on Mexican government bonds issued during the 1995 crisis was 445 basis points. The spread on the tranched resources from the U.S. Treasury Exchange Stabilization Fund ranged from 225 to 375 basis points. As noted in Safeguards for the Fund in Cases of Very High Access--Preliminary Considerations (EBS/96/82), "when market rates of interest are above the generally applicable rate of charge, members have little financial incentive to make early repurchases, notwithstanding that normal access to private capital markets may have been regained. Especially in cases of large Fund exposure, this lack of incentive may need to be addressed."

early repurchases when conditions warrant, and by the disincentive it creates for members to seek use of this facility as an inexpensive way of topping up credit tranche or extended Fund facility resources under an existing arrangement. A higher rate of charge may also be considered appropriate in light of the Fund's additional exposure to risk, that would accompany large scale and frontloaded use of Fund resources. Higher charges would be applicable to all purchases under the facility (i.e., not based on a credit or currency holding threshold).[25] Access under the facility would also be subject to a commitment fee and service charge, in the same way as access under the credit tranches or extended Fund facility.

21. A higher rate of charge on purchases under the facility will generate a potentially large amount of net income, which would raise a number of issues regarding additions to the Fund's precautionary balances, the determination of the basic rate of charge, and possibly burden sharing.[26] The additional net income could be collected in a new contingent account, and the conditions for its possible use and disposition when no longer needed would need to be considered. These issues, which arise both for the current financial year and for subsequent financial years, will be discussed more fully in another staff paper to be issued shortly.

22. Access under the facility would not be subject to the annual and cumulative limits applied to purchases in the credit tranches or the extended Fund facility. As under the exceptional circumstances clause, access would be judged on a case by case basis depending on the financing needs, the strength of the program and the Fund's liquidity. Access to other resources made available under the arrangement (i.e., credit tranches or extended Fund facility) would remain subject to the usual annual and cumulative limits. Access to the facility would, in effect, replace activation of the exceptional circumstances clause in cases where the member faces the type of balance of payments problem for which the facility was established and where projected access in the credit tranches or under the extended Fund facility would otherwise exceed either the annual or cumulative limit.

23. Negotiations on use of the facility and use of other resources under an arrangement should normally be conducted simultaneously. The Emergency Financing Mechanism could be used to accelerate the process. If use of the facility should be requested during the course of an arrangement in the credit tranches or under the extended Fund facility approved earlier, its approval should be subject to a strengthening of the program and inclusion of additional reviews.

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[25] Purchases in the credit tranches or under the extended Fund facility, that would accompany purchases under the facility, would remain subject to the adjusted basic rate of charge.

[26] For FY 1998, under the existing decision on charges for FY 1998, net income in excess of the target amount, including the proceeds of higher charges, would be used retroactively to reduce charges. Executive Board Decision No. 11482-(97/42), adopted April 21, 1997.

Box 2. SUMMARY FEATURES OF THE FACILITY

1. The facility would be available to deal with crises of market confidence affecting the capital account, for which there was a reasonable expectation of an early correction with the implementation of appropriate supporting policies and an adequate financing package.

2. Conditionality under a facility would derive from the linkage with the conditionality of the associated resources under the stand-by or extended arrangement, and some (limited) phasing of purchases.

3. Access to resources under the facility would be available to a member for up to one year following approval of its request.

4. The facility would generally enable two or more purchases—one on approval, and subsequent ones subject to compliance with the program and substantive Board reviews.

5. Repurchases could begin after 2 years and be completed in four equal quarterly installments. They would initially comprise an "expectation" which could, subject to review by the Board, be extended for a specified period of time (up to one year), before becoming an "obligation".

6. The rate of charge would be 200-400 hundred basis points higher than the basic rate of charge applicable under other Fund policies and facilities.

7. Access would be judged on a case by case basis depending on the financing needs, the strength of the program, the Fund's liquidity, and judgments regarding capacity to repay the Fund.

8. In circumstances befitting the use of the facility, a member seeking use of Fund resources would be expected to use the facility only if access under the other policies financing the stand-by or extended arrangement would otherwise exceed either the prevailing annual access limit or cumulative limit.

9. Negotiations on use of the facility and the other resources to be made available under the arrangement should normally be conducted simultaneously. The Emergency Financing Mechanism could be used to accelerate the process.

24. Access to such a facility would be available to a member only in combination with a stand-by or extended arrangement and where the associated financing needs (i) relate to a member's reserve position and developments in its reserves, (ii) emanate chiefly from the capital account reflecting swings in market confidence, and (iii) are expected—with the implementation of appropriate supporting policies—(if not much diminished or forestalled) to be reversed within a short period of time with a restoration of market confidence.

25. The linkage of the use of Fund resources through such a facility to financing needs arising from a loss of investor confidence raises questions regarding the applicability of Article VI, Section 1, which provides that Fund resources may not be used to finance "a large or sustained outflow of capital". Resources under the facility would not, however, be intended to be used to finance a large or sustained outflow but rather to forestall further outflows, and encourage a reversal, through the implementation of a strong adjustment program and the establishment of an adequate cushion of reserves. Consistent with the approach that has been followed in recent cases, it would be intended that the establishment of this cushion would, in and of itself, contribute to the restoration of confidence.

26. To the extent, however, that confidence were not restored within a reasonable period of time and reserves were being used to finance a continuing withdrawal of capital, at that stage the issue could indeed arise as to whether Fund resources were being used to finance large or sustained outflows. As has been discussed on previous occasions, this determination would involve, inter alia, a determination as to whether the resources were being used in a manner consistent with the Fund's purposes (see Annex). If a determination were made that the Fund's resources were being used to finance such outflows, the question (among others) would arise as to whether, in accordance with Article VI, Section 1, the Fund should request a member to impose capital controls as a means of preventing the Fund's resources from being used for this purpose.

V. CONCLUSIONS

27. Crises of confidence in international capital markets may increasingly come to characterize the financial problems of members that the Fund will be asked to address through the provision of Fund resources. The manifestation of these financial crises is different from those that have been the traditional concern of Fund supported programs in the past. The terms of access in the credit tranches and under the extended Fund facility were designed with these more traditional balance of payments needs in mind. In order to better address the potentially larger, yet shorter term financial crises that result from loss of market confidence, this paper recommends the creation of a new facility. Such a facility would allow access to resources in the credit tranches and the extended Fund facility provided under arrangements to remain geared to members' fundamental imbalances, both in focus and in their terms and conditions. It would also serve to formalize the *intended* phasing and maturity of Fund resources as they have been made available in the four examples of these crises that the Fund has addressed with access in the credit tranches under stand-by arrangements to date. The application of higher charges for the use of Fund resources through a facility would help provide appropriate incentives to the member using the facility, and compensate the Fund for the risks that may be involved in providing large and front loaded access to its resources.

The Role of the Fund and Article VI[27]

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

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[27] This annex has been excerpted from Fund Policies with Regard to Currency Stabilization Funds -- Further Considerations, EBS/95/109, pp. 9-11.

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.