FOR AGENDA

EBS/98/214

CONFIDENTIAL

December 9, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Review of the Supplemental Reserve Facility and Preliminary Consideration of a Contingent Credit Line**

Attached for consideration by the Executive Directors is a paper on the review of the Supplemental Reserve Facility and preliminary consideration of a contingent credit line, which is tentatively scheduled for discussion on Monday, December 21, 1998. Issues for discussion appear on pages 16 and 17.

Mr. Bennett (ext. 38784), Mr. Elizalde (ext. 37796), or Mr. Kuhn (ext. 36555) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Review of the Supplemental Reserve Facility and Preliminary Consideration of a Contingent Credit Line

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

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December 9, 1998

I. INTRODUCTION

1. On December 17, 1997, the Executive Board established the Supplemental Reserve Facility (SRF).[1] This facility was intended to provide financial assistance to members experiencing exceptional balance of payments problems due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves. The SRF was designed to deal with crises that had already happened, i.e., were extant and underway. However, since the widespread contagion following the financial crises in Asia, and especially the fallout from the default and imposition of capital controls by Russia in August 1998, the crisis has touched almost all emerging markets, resulting for a time in a generalized market paralysis. This has led to a growing concern that, with the increasing globalization of international capital markets and the observed tendency for markets' taste for risk to swing from overoptimism to overpessimism regarding emerging market countries generally, some members may face severe capital market pressures less through flaws in their own policies than from "contagion" emanating from elsewhere. Reflecting this concern, a number of members have requested the Fund to consider the possibility of "an enhanced Facility which would provide a contingent short-term line of credit for countries pursuing strong IMF-approved policies".[2] This facility could be drawn upon in times of need and would entail appropriate interest rates along with shorter maturities. The facility could be accompanied by private sector involvement and complemented by bilateral contingent financing activated alongside the facility.

[1] Decision No. 11627-(97/123) SRF, December 17, 1997 (Selected Decisions, twenty-third Issue, June 30, 1998, pp.243-246.

[2] Declaration of G-7 Finance Ministers and Central Bank Governors, October 30, 1998.

2. The SRF was designed for members experiencing an actual crisis, and was not envisaged as a precautionary instrument to stem "possible" crises. The needs of a member whose objective is to fend off a possible crisis less of its own making and deriving more from the threat of contagion would be better served by the availability of Fund resources on an explicitly contingent basis. This paper reviews the operation of the SRF to date, and recommends some changes to the facility. The paper then considers how the Fund might support members seeking large scale resources on an explicitly contingent basis in the context of a "contingent credit line". It explores several options, each differing in respect of the nature of the commitment of resources and the nature of the arrangement during the precautionary period. Following activation of the contingent credit line, each of the three options presented would broadly conform and all would involve SRF type resources, with similar maturities, charges (as proposed to be amended), and phasing (as proposed to be implemented), but could differ possibly with respect to linkages with official bilateral and private financing. The paper concludes with some suggestions regarding the role that compliance with certain standards (data disclosure, banking system soundness, etc.) could play in allowing members to pre-qualify for use of such a contingent credit line as a pointer for future development.

II. Experience with The SRF to Date

3. The SRF was designed to assist members suffering a crisis 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 adequate financing. To this end, the SRF was conceived as a facility offering potentially large scale resources (without specified access limits) on a short term basis and with a significant surcharge over the basic rate of charge. The member's economic program, whose implementation and follow through would likely last for a longer period than the financial crisis itself, was to be supported by a stand-by (or extended) arrangement, under which the program would be monitored and subject to conditionality. Reflecting the presumption that the member requesting access to the SRF would be experiencing an actual crisis, a first purchase was to be made available upon approval. Key features of the SRF, as contained in the Decision, are shown in Box 1.

4. Consistent with the objective that the resources be short-term, each purchase under the SRF is subject to a repurchase expectation at 12 months (half) and 18 months (half) from the date of purchase, expectations which can be extended for up to one year at the request of the member and subject to Fund approval, at which point they become obligations. Outstanding use of Fund resources under the SRF is also subject to a surcharge over the basic (adjusted) rate of charge equal to 300 basis points, which surcharge applies for a period of twelve months from the date of approval of access to the facility. After twelve months the surcharge rises by 50 basis points, and rises by a further 50 basis points for each subsequent six monthly period until a maximum surcharge of 500 basis points is reached before final maturity. The SRF can be available to a member for a period of up to one year, under a stand-by or extended arrangement.

Box 1. Key features of the SRF [1]

1. SRF resources are available to "a member that is experiencing exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and the member's reserves, if there is a reasonable expectation that the implementation of strong adjustment policies and adequate financing will result, within a short period of time, in an early correction of such difficulties".

2. A member using SRF resources "will be encouraged to seek to maintain participation of other creditors, both official and private, until the pressure on the balance of payments ceases". The Fund will take into account the financing provided by other creditors when approving a request for use of SRF resources, and may make use of SRF resources conditional on the imposition of controls on the outflow of capital.

3. The SRF is "likely to be utilized in cases where the magnitude of the outflows may create a risk of contagion that could pose a potential threat to the international monetary system".

4. A member would resort to the SRF only if "the projected access in the credit tranches or under the extended Fund facility, taking into account outstanding purchases, would otherwise exceed either the annual or cumulative limit".

5. Access under the SRF is determined "taking into account the financing needs of the member, its capacity to repay, including in particular the strength of its program, its outstanding use of Fund credit, and its record in using Fund resources in the past and in cooperating with the Fund in surveillance, as well as the Fund's liquidity.

6. SRF resources are made available under a stand-by or extended arrangement, and SRF purchases are available subject to the conditions specified in the arrangement.

7. SRF resources can be committed for a period of up to one year.

8. SRF resources will generally be available in two or more purchases.

9. The first SRF purchase is made available at the time of approval of SRF financing.

10. Repurchase expectations arise in two equal semiannual installments 1-1 ½ years from the date of purchase. The Fund may extend each such repurchase expectation by up to one year. Repurchase obligations arise in two equal semiannual installments 2-2 ½ years from the date of purchase.

11. During the first year from the date of approval of SRF financing, the rate of charge on SRF resources is 300 basis points above the basic rate of charge. The surcharge increases by 50 basis points at the end of that period and every six months thereafter, up to a maximum of 500 basis points.

[1] This Box is based on Decision No. 11627-(97/123) and all quotes are taken from that Decision.

5. Access to the credit tranches or the Extended Fund Facility (EFF) simultaneously with access to the SRF was based in part on the assumption that the member would, in the context of its adjustment effort, face both a medium term financing need, for which longer maturities would be appropriate, and a shorter term financing need, suitable to the terms of the SRF. Because it would be difficult to distinguish between these needs with precision, members using the SRF are allowed to use resources from the credit tranches or the EFF up to either the annual or cumulative limit, whichever is applicable, for projected access under the arrangement, before recourse to the SRF.[3] In any case, since access in the credit tranches is available for all types of balance of payments problems, members are entitled to have access to these resources rather than more expensive resources that may be available under special policies for a specific balance of payments problem.

6. Since its establishment on December 17, 1997, the SRF has been used three times.[4] Its first use was for Korea's conversion of remaining access for the first year of its three-year stand-by arrangement from the credit tranches to the SRF on December 18. This stand-by arrangement was negotiated on the understanding that part of the resources available under it would be converted to the terms of the SRF as soon as the latter was established. The arrangement was approved on December 4, two weeks before the inception of the SRF, and Korea made its first purchase of 513 percent of quota in the credit tranches under the stand-by arrangement. Additional purchases of 325 percent and 188 percent of quota, respectively, were to become available on December 18 and January 8.[5] Following the amendment of the stand-by arrangement to include financing from the SRF, purchases scheduled for the twelve months following December 17, 1997 (equivalent to 1,244 percent of quota) were switched from the credit tranches to the SRF, with the consequent shortening of maturities and higher rate of charge. Since the first purchase under the stand-by arrangement was already in excess of the prevailing annual and cumulative access limit of 100 percent of quota and 300 percent of quota respectively, access for the ensuing twelve-month period of the stand-by arrangement was to be provided entirely from the SRF. With reserve losses continuing, the schedule of

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[3] In other words, one or both limits must be reached over the twelve month period of the arrangement that overlaps with the SRF. It is not necessary that access under the relevant limit be used up in the first purchase or before purchases of SRF resources can be made. There is therefore flexibility in phasing within-year purchases from the credit tranches or EFF and from the SRF: EBS/97/225 ¶15 states that "the availability of resources provided under the arrangement to deal with the two types of financing need can [...] be phased according to the assumed pattern of needs...".

[4] Additional details on these three cases can be found in a forthcoming background paper both for this review and for the review of access policy and limits under the credit tranches and the EFF.

[5] The arrangement initially involved biweekly reviews.

purchases was modified on December 29 to increase the degree of frontloading (and the program's financing was also strengthened through a concerted rollover of interbank debt).

7. The second use was for the augmentation of Russia's extended arrangement in July 1998, under which the arrangement was augmented by 146 percent of quota, of which 54 percent of quota was from the EFF and 93 percent of quota was from the SRF. The first purchase upon approval of the augmentation was 33 percent of quota, of which 16 percent of quota was from the SRF. Additionally, 50 percent of quota was made available from the CCFF simultaneously with the approval of the augmentation. The total amount available under the SRF was determined by the envisaged balance of payments need, taking into account access under the EFF and CCFF, subject to the constraint that projected access from the EFF had to total up to either the annual or cumulative access limits. In this instance, the annual limit was the applicable limit.

8. The third use of the SRF was by Brazil, under a three year stand-by arrangement approved on December 2, 1998. Under this arrangement, 420 percent of quota was available in four purchases under the SRF (with a first purchase of 150 percent of quota) and 180 percent of quota under the credit tranches (of which 100 percent of quota was available in four equal purchases in the first year). This arrangement introduced flexibly timed reviews related to the second, third and fourth SRF purchases, according to which Brazil could request Executive Board consideration of these reviews at a date earlier than scheduled (up to specified dates in each case). Subject to completion of the respective reviews, the related SRF purchase could then also be made earlier than scheduled.

9. The limited experience so far with the SRF, both in terms of time elapsed and number of countries, precludes more than a limited assessment of the practical implications and appropriateness of its features. Had it not been for the expansion of the global financial crisis following developments in Russia in August, Korea would have been able to make its first SRF repurchase within the one year "expectation" period without hesitation.[6] That it plans to make the repurchase, with no request for an extension of the expectation, despite the spreading crisis, suggests that the repurchase periods of the SRF were, in the event, appropriate for Korea. Nevertheless, the scope for extending repurchase expectations is a valuable feature of the SRF and should help members avoid awkwardly timed repurchases when it takes longer than expected to restore the confidence of markets in the country's policies or for markets more generally to fully settle down. The rate of charge, inclusive of the surcharge, was quite close to what Korea contracted on its two foreign bond issues in April 1998, and, had markets settled down further, might have been well above relevant market

[6] Korea was able to tap the capital markets as early as April 1998, four months into the arrangement, for US$3 billion in ten year bonds and US$1 billion in one year bonds—issues that were heavily oversubscribed.

rates (although this is not yet the case).[7] As for Russia, no expectations for repurchase have yet arisen.

10. Two features of the SRF deserve reconsideration. The first is the mechanism by which the rate of charge escalates. As currently structured the rate of charge increases by 50 basis points one year from the date of approval of the member's use of the facility, irrespective of when purchases are actually made. It would seem more appropriate to have the escalation of the rate of charge run from the date purchases are actually made, so that the member is charged on the basis of the time credit under the SRF is actually outstanding, rather than the time the member's potential access to the SRF is approved. This would seem particularly important for members which choose to treat all or part of the SRF access as precautionary. As it stands, with the base for escalation at the date of approval, such members have an incentive to purchase early, in order to obtain a longer period at the lower rates of charge, which would not exist if the base for escalation were from the date of the purchase itself.

11. The second feature for review, which has less to do with the structure of the SRF than the practice, relates to the phasing of purchases. Until the Brazil program was conceived, purchases under the SRF were phased according to the expected balance of payments need and conditional on actions, targets and reviews as of given dates. The inherent difficulty in predicting balance of payments need relating to pressures in the capital account and the need to reassure markets of the genuine and early availability of resources that are committed under these arrangements suggests that some flexibility should be introduced into the timing of purchases. Accordingly, as with the arrangement for Brazil, which includes use of the SRF, it is proposed that the second and later purchases under the SRF be subject to flexibly timed reviews by the Executive Board, which can be brought for Board consideration on dates earlier than the deadline for such reviews, at the request of the member.[8] Board consideration of the program's implementation under the arrangement in the context of such flexibly timed reviews would be assisted by monthly indicative targets and prior actions identified for particular reviews, thereby ensuring that progress under the program can be readily assessed at the time the review is held, whenever that may be.

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[7] The ten year and one year bond issues launched in April, 1998, were priced at 355 and 345 basis points above the equivalent market rate for US Treasury securities. Since then, market spreads for Korea have widened again, in line with emerging market spreads elsewhere. However, the escalation of charges, were SRF resources to remain outstanding, would bring the applicable surcharge up to 500 basis points in due course—well above the spreads observed in April.

[8] When a review has a deadline, this means that no purchase beyond this date can be made without completing the review. This includes purchases to which a member may have become entitled earlier (including on approval of the arrangement) but which it had not made because the member had treated the arrangement as precautionary. Prior to this date, earlier purchases remain available (subject to other relevant conditions such a performance criteria).

12. The staff recommends that, whatever the outcome of the following discussion on a possible contingent credit line, the amendments to the SRF suggested in this section relating to charges should be adopted. If the Executive Board accepts the recommendation regarding charges, the staff will circulate a draft decision accordingly. The staff also recommends that, in future, flexibility in the timing of reviews and the related phasing of SRF purchases (as in the arrangement for Brazil) should be a feature of the SRF to be introduced, as appropriate, in other cases.

III. TOWARDS A CONTINGENT CREDIT LINE

13. As noted earlier, the SRF was designed on the assumption that the member would have an actual need at the outset. This was based on the premise that the member was facing a real and present crisis and an immediate need to draw. Since such a crisis was expected to have resulted, at least partly, from the market's judgment about and reactions to macroeconomic imbalances or structural weaknesses, the member was also expected to undertake an (immediate) adjustment program. This adjustment program could be expected, in turn, to be associated with a medium term financing need, for which financing from the credit tranches (or the EFF), with longer repayment terms and lower charges, would be more appropriate than financing from the SRF. In any event, access in the credit tranches is available for all types of balance of payments problems. The special terms of the SRF are considered appropriate for the exceptional balance of payments needs resulting from a sudden and disruptive loss of market confidence that would otherwise take access beyond the annual or cumulative access limits in the credit tranches or the EFF, whichever is first applicable.

14. The situation of members whose economies are fundamentally sound, but which are concerned with the potential effects of contagion on their access to capital markets, could be expected to be different from that described above. There might not be a real and present funding crisis, but rather only the threat or possibility of one. There might therefore be no immediate balance of payments need. Such a member might also not have a pressing need for adjustment or reform, at least not in advance of the timetables it has already set for itself. In the normal course of events, therefore, the member may be able to rely on a continued flow of capital from abroad.[9] In such circumstances, a member concerned about the threat of contagion leading to an interruption in that flow of capital might find it appropriate to seek access to Fund resources on a contingent basis, to deal with the consequences of contagion, should this occur.

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[9] In practice, it would be difficult to draw such a clear line between members requiring policy adjustment *ex ante* (for which the SRF would be appropriate) and those not (for which a contingent credit line would be appropriate). Nonetheless, it would be important to confine the use of a contingent credit line to members for which the threat of an exogenous disturbance to capital flows is clearly the dominant consideration and for which policy shortcomings can confidently be judged unlikely to be the trigger for the crisis.

15. The availability of large scale resources on a contingent basis for members concerned about the possibility of speculative attack raises important issues for the operation of international capital markets. The presence of such contingent credit lines may well help prevent the spread of contagion, but the difficulty in completely distinguishing between members requiring policy adjustment *ex ante* and those whose policies are basically sound means that such contingent credit lines could well exacerbate moral hazard—encouraging overlending by private creditors to borrowers whose financial health may not be all that it seems—and may do as much to destabilize the international financial system—on this score—as stabilize it. It is important, therefore, that such contingent credit lines be structured in such a way as to minimize these risks.

16. Such considerations underline the importance of the integral involvement of the private sector in any system of contingent credit lines that the Fund might establish for members. In addition to the private sector, the potentially very large scale of the resources that may be needed to substantiate such contingent credit lines suggests that a more systematic involvement will also be required of official bilateral creditors. The precise modalities of the involvement of the private sector can be expected to evolve as case experience is gained and in the course of the ongoing work on the international architecture; that of official bilateral creditors will need to be discussed with possible participants. In both cases, however, there are established mechanisms (the recent private credit lines for Argentina and Mexico, and the BIS arrangements for Brazil) that could provide relevant bases on which to build.

17. From the point of view of a member concerned about the possibility of a speculative attack in the capital markets resulting from financial market contagion, a contingent credit line could serve a number of purposes (i) to avoid such an attack by securing IMF endorsement of its economic program, (ii) to forestall such an attack by underlining the ready availability of resources, and (iii) to enable the member to help meet such an attack, should it occur, by supplying the resources in a timely way. From the point of view of the Fund, a contingent credit line would need to (i) be structured so that it could be expected to be repaid relatively quickly if it were drawn, (ii) be subject to appropriate conditionality so as to ensure adequate safeguards for Fund resources, and (iii) involve the participation of official bilateral and private creditors, as appropriate. Three possible modalities according to which the Fund could provide a contingent credit line that satisfies these various desiderata might be considered.[10]

18. The first would be for the member to agree on a program which would be monitored by the Fund and on the basis of which the Executive Board would endorse the member's policies and indicate its willingness to consider, in appropriate circumstances, use of Fund

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[10] This paper does not give consideration to a "pure" credit line for which there is no conditionality attached to drawings (such as reviews). While this might satisfy the desires of the member, as listed above, it would put at clear risk the Fund's ability to safeguard its resources. However, paragraphs 34-37 below consider means by which less reliance could be placed on the traditional modalities of Fund conditionality.

resources. This could be called the Fund monitored program (FMP) option. In order for this to go beyond the entitlement that is already enshrined in the Articles, the Board's willingness to consider use of Fund resources if certain circumstances emerge and a need arises could be expressed in a Board decision including reference to the specific amount of resources that could, in principle, be available.[11] Should circumstances subsequently arise where the member requests the use of Fund resources, the Executive Board would review the member's performance under the FMP, its current policy stance and the prevailing circumstances, and subject to this review—and any appropriate strengthening of the policy package, approve an arrangement (either a stand-by or a new kind of arrangement under a special facility) with the appropriate level of resources.

19. The second approach would be for the member to agree with the Fund on a program, and for this to be endorsed and monitored in the context of a low access precautionary arrangement. In approving such an arrangement, the Board could, in its decision approving the arrangement, indicate that it would be willing to consider augmenting the arrangement by up to a specified amount should the member be subjected to financial market contagion. This could be called the Augmentation option.[12]

20. Finally, the third option would be for the member to agree with the Fund on a program which would be endorsed and monitored in the context of an arrangement, with the full amount that would be available in circumstances of contagion committed from the date of its approval. This could be called the Commitment option. As with the second option, such an arrangement could be phased with low access until such time as the contingent element is activated at the time of a request and upon the completion of a review by the Board.

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[11] Such a Board decision, even if it specified the amount of resources the Board would be ready to consider, would not represent a commitment, which, as a legal matter, requires some part of the resources to be available up front.Under the FMP approach, the Fund could decide not to provide resources when the actual request to use Fund resources was made, on considerations other than compliance with the member's program, for example, based on a changed assessment of the policy requirements or balance of payments need or even on adverse trends in the Fund's own liquidity position. The FMP approach would therefore be a necessarily far less certain contingent credit line than is a commitment (as in an arrangement).

[12] Mexico's 1989 extended arrangement in connection with its envisaged a debt service reduction operation represents a precedent in this regard, where a pre-specified amount under a possible augmentation was noted in the decision approving the arrangement. Decision No. 9162-(89/65), adopted May 26, 1989, which approved the extended arrangement, also stated that "[t]he Fund notes the intention of the authorities of Mexico to request augmentation ... by an amount up to the equivalent of forty (40) percent of .. quota ...The Fund will be prepared to consider an augmentation ... in the event that the arrangements for financing .. to provide for appropriate debt service reduction and upon the determination by the Fund that such arrangements are consistent with the objectives of the program ..."

21. The FMP and Augmentation options are broadly similar in terms of the assurance they would give the member, and the markets, that the potentially large scale resources will be available when needed. The Commitment option offers the strongest assurance in this regard, but the release of the bulk of the resources would still be contingent on completing a Board review and thereby involve some uncertainty regarding the actual availability of these resources. The FMP and Augmentation options, neither of which involve a commitment, as such, of *large scale* resources, leave some scope for the Fund to decline or provide less access should its liquidity or other considerations recommend this, whereas under the Commitment option the Fund would be bound by its undertakings while the member's program was on track, if the circumstances triggering the request for the resources were satisfied, and if any necessary further adjustments were made or agreed.[13]

22. Prior to the actual commitment of resources under the FMP option, the member would be following a "Fund monitored" program—no resources would be available and benchmarks under this program could serve as (part of) the basis for judging the possible request for use of Fund resources. Under the Augmentation or Commitment options, monitoring could be in the form of either performance criteria or benchmarks. In view of the precautionary nature of the arrangement and the low level of available access during this stage, however, and the assumption that the member does not need to undertake fundamental adjustment, it might be reasonable to monitor the program solely through benchmarks and a mid-term review. Under all three options it might also be reasonable to seek, as a precondition for a member's qualification for the contingent credit line, the member's compliance with certain applicable disclosure standards, such the Special Data Dissemination Standards (SDDS), as well as other standards (relating to banking system soundness, etc.) as these standards are developed over time. Upon provision or activation of large scale resources, on the other hand, conditionality would be strengthened accordingly—under all three options the resources would be provided in the context of an arrangement, and appropriate conditionality in the form of performance criteria, reviews, and possibly monthly monitoring could be applied. The Fund would thereby be in a position to safeguard its resources under all three options.[14]

23. From the point of view of the Fund, the FMP option differs from the Augmentation and Commitment options mainly by virtue of the fact that it would endorse a member's

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[13] Under current policies, the existence or not of a commitment would be reflected in the differing application of a commitment fee at the moment a contingent credit line was established—this would apply on the full amount in the case of the Commitment option and on the original amount (until augmentation) in the case of the Augmentation option, but would not apply for the FMP option.

[14] In view of the possible involvement of the private sector (e.g., through separate credit lines) and/or official bilateral creditors, it might be appropriate for the member's program and its compliance to be conveyed to these creditors, and possibly to the markets generally, depending on the modalities of these parallel arrangements.

policies without committing any resources. While such an endorsement without financial commitment is possible, Executive Directors have expressed a number of reservations about comparable suggestions in the past.[15] These have included concerns that without having, in effect, to "put its money where its mouth is", the Fund's standards in judging members' policies might tend to erode or be perceived to erode; that the approach could lead to harmful and incorrect distinctions between members that receive Fund endorsement and those that do not (and may well not seek it); that withdrawal of an endorsement once provided could cause serious problems for the Fund and members; and that the Fund could tend to become more akin to a "rating agency" than a cooperative financial institution.[16] [17] These considerations would tend to argue in favor of either the Augmentation or Commitment option. From the point of view of the member, on the other hand, some may see disadvantages in being perceived as having to request a Fund arrangement (whether in the form of a stand-by or a new kind of arrangement) and prefer to be in a less formal relationship in the period prior to possible activation of the contingent credit line. This argument might favor the FMP option.

24. Under the Augmentation and Commitment options, but not under the FMP option, there would need to be some (possibly small amount of) resources made available upon approval of the arrangement incorporating the contingent credit line. If the arrangement were a stand-by arrangement (rather than a new kind of arrangement under a special facility) and the member had not used up the first credit tranche, then the resources available on approval would have to be the first credit tranche, or that part thereof that it had not already drawn. And as with the SRF, under a stand-by arrangement, resources beyond the first credit tranche would also need to be made available—should activation of the main part of the contingent credit line occur—up to either the prevailing annual or cumulative access limit, whichever should be applicable.[18] Thereafter, resources could be on SRF-like terms.

25. Projections of the Fund's liquidity reflect the impact of future purchases under current and projected arrangements. These projections are based on the staff's assessment of probabilities concerning possible arrangements with members, ranging from zero to one (for

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[15] There are many parallels in this matter with the issue of a possible short-term financing facility, discussed by the Executive Board on November 30, 1994. See the Concluding Remarks by the Chairman (BUFF/94/112) and the staff paper (EBS/94/193).

[16] The FMP option may also create some confusion with staff-monitored programs (SMPs), which do not involve Board endorsement.

[17] The consequences of the withdrawal of Fund endorsement may bear some parallels with the consequences of a program being off-track in the context of an arrangement. The impact of the former on the markets may, however, be strengthened if withdrawal were to involve a decision on the part of the Executive Board (which a program's going off-track does not).

[18] See paragraph 26.

arrangements already in place). In the past, the commitments under precautionary arrangements have been weighted at 50 percent probability.[19] Under the contingent credit line proposal discussed here, the treatment of the amounts involved under the FMP, Augmentation, or Commitment options in assessing their impact on the Fund's liquidity will need to be considered carefully. While the FMP option involves no immediate commitment, for example, the potential demand created as a result and its impact on the Fund's liquidity could still be substantial. Moreover, since these options for Fund financing are meant to address balance of payments crises arising from contagion, probabilities would not adequately reflect the expected use of Fund resources for members on an average basis because the crisis in one country is not independent of a crisis in another country. Depending on Directors' views on the approaches discussed in this paper, the staff would return to the implications for the Fund's liquidity in a follow up paper.

26. Notwithstanding the above, in view of the large scale of resources that the Fund might be expected to commit for a contingent credit line under any of the three options, it would be important for the Fund to have potential access to the General and New Arrangements to Borrow (GAB and NAB), which both require that (for nonparticipants) resources be provided under either an upper credit tranche stand-by arrangement or an extended arrangement.[20] The latter, which were designed for members with medium term financing needs and structural problems, would not seem appropriate for members requiring only a short term contingent credit line. Thus, if use of the GAB/NAB for contingent credit lines is to be a possibility, such credit could not be provided in the form of a free standing facility. It must be provided under an upper credit tranche stand-by arrangement.

27. Apart from the availability of a (possibly very small) purchase on approval, there need be no further resource availability during the precautionary period of an arrangement under the Augmentation or Commitment options. If and when the crisis hits, however, and the member requests or anticipates a need to draw substantial amounts, the question arises as to how and whether these resources should be phased. It would be appropriate for the Executive Board to decide on the phasing at the time the request for a drawing is made, rather than at the time the contingent credit line is approved, since the uncertainties involved would make it very difficult to determine the proper phasing prior to a crisis having unfolded. At this point, the Executive Board would conduct a review, taking into account the member's track record under its program to date, the circumstances it now faces, and the program it intends to adopt

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[19] For details, see "Methodology Used in Reviews of the Fund's Liquidity and Financing Needs, " EBS/97/60, 4/2/97.

[20] The NAB (and GAB) may be activated for nonparticipants if "the exchange transactions are (i) transactions in the upper credit tranches, (ii) transactions under stand-by arrangements extending beyond the first credit tranche, (iii) transactions under extended arrangements, or (iv) transactions in the first credit tranche in conjunction with a stand-by arrangement or an extended arrangement."

following the onset of the crisis. In light of this, the Board would decide on whether to allow the member access to the contingent credit line and how to phase the resources. Following the first substantial purchase, which could be made available upon approval of the contingent credit line's activation, the remaining purchases could be made available according to flexibly timed reviews as recommended for the SRF above, and as to be utilized for Brazil's 1998 stand-by arrangement with SRF financing.

28. By assumption, the event that the member is preparing itself for is a crisis of confidence in financial markets. If confidence is lost purely as a result of contagion, it would be reasonable to expect that market access will be regained when markets settle down , so long as the loss of access itself does not begin a self aggravating series of events to a new, less desirable, equilibrium. In such circumstances, a member availing itself of a contingent credit line to fend off the speculative attack should be in a position to repay the credit relatively quickly. The SRF incorporated repurchase expectations of 12 and 18 months and obligations of 24 and 30 months. Since the SRF was intended for members of whom some adjustment—over an uncertain length of time—was expected, with related financing needs, it might seem that the repurchase periods for a credit line for members less in need of adjustment could be even shorter. However, contagion, by definition, is a multiple phenomenon involving more than one country, and possibly many, whereas a self generated crisis could, in principle, be singular with no necessary consequences for world capital markets generally. In circumstances where there is a generalized reduction in the appetite of financial markets for risk, it may take longer to regain access to capital markets, even for members with basically sound economies. At any rate, the speed with which members could be expected to return to the capital markets will be a function of uncertain global market conditions in the aftermath of the crisis. On balance, therefore, with arguments for both shorter and longer repurchase periods than those applicable for the SRF, it would seem reasonable for the contingent credit line to operate with the same maturities as those for the SRF.

29. Incentives to repurchase and disincentives to draw, unless needed, would also be provided by an appropriate rate of charge. For a member facing a crisis of confidence in international capital markets, market rates for new sovereign borrowing are likely to be well above the basic rate of charge, perhaps by several hundred or even thousand basis points. It would, of course, defeat the purpose of a credit line designed to meet such a speculative attack if the rate of charge were to be set equal to or above such levels upon activation. On the other hand, it would be reasonable to set the rate of charge at a level where the member would only seek activation at time of crisis, i.e., above the rate of interest it might expect to pay in more normal times. These were considerations in setting the surcharge for the SRF, whose activation is expected to coincide with a similar tightening of capital market terms for the member concerned. The SRF also included an escalation clause for the surcharge. The escalation of the rate of charge was designed to ensure an early cross-over between the cost of Fund resources and the cost of market resources, providing an incentive to the member to make repurchases before, rather than at, the obligation date. It would seem appropriate to include a similar feature into a surcharge as applied to the contingent credit line. As with the proposed amendment to the SRF, the base for the escalation should be the date of purchase

(not the date of approval of the member's access to the facility, as per the original design of the SRF).

30. For a member seeking *ex ante* protection from contagion to qualify for a contingent credit line from the Fund, it would be appropriate that such a member should be able to demonstrate that it retains normal access to capital markets and is in good standing with creditors. Such a member would strengthen its case further if it were to secure a more active role for the private sector in preparing for contingencies through the establishment of parallel credit lines from commercial banks (along the lines of those recently established by Argentina and Mexico). The involvement of the private sector in this manner should help add a market endorsement of the member's policies, in addition to that of the Fund, and this, in turn, should lessen the risk that such a member would suffer from a loss of market confidence. The involvement of the private sector in this context, however, raises many questions. Such questions include, *inter alia*, whether private credit lines are yet sufficiently well defined for the purpose at hand, whether other forms of private sector involvement would be appropriate, and whether private sector involvement should be mandatory or optional. The precise modalities of private sector involvement should become clearer in light of practical experience and the ongoing work on the architecture of the international financial system.

31. In addition to the involvement of the private sector, the G-7 Declaration called for the involvement, in individual cases, of the official bilateral sector. This would seem important, not least because of the scale of resources that may be required to calm the markets, but also to ensure appropriate burden sharing. The recent package for Brazil provides an instructive example of how such official bilateral creditors could play a role, and represents an improvement over the structure of bilateral assistance in some of the Asian programs in 1997. As with private sector involvement, there are many questions surrounding the possible role of official bilateral creditors, such as the nature and scale of burden sharing, the nature and timing of bilateral commitments, whether the credits should be parallel to only the first purchase or to all, and whether official bilateral involvement should be routine or optional.

32. With flexible phasing, similar repurchase periods and rates of charge, the activated contingent credit line would be very similar to the SRF. But there would be important differences. The first difference would be the precautionary stage, which would be low access or without an arrangement in place at all and would involve Fund endorsement of a member's policies in a situation in which no immediate balance of payments problem or need exists. The second is the more integral involvement that is envisaged for the private sector and official bilateral creditors, although, at this stage practical arrangements to secure such involvement remain to be developed.

33. Of the three options for a Fund "contingent credit line" considered in this paper, the somewhat greater reliability of resource availability when an arrangement is in place, as would be the case when the resources are anticipated in the context of a possible augmentation or fully committed, would seem to favor these options from the point of view of the member, although some members might prefer the appearances of a looser relationship in the

precautionary phase. The framework of an arrangement would also seem preferable from the Fund's point of view, in avoiding the difficulties that have arisen in past discussions of Fund endorsement without financial commitment. Assistance under a *stand-by* arrangement is recommended by the need to allow for the possible use of resources from the GAB/NAB (activation of which would, in turn, require that the stand-by arrangement be in the upper credit tranches).

34. As outlined in paragraph 17, all three of the options for a contingent credit line considered in this paper reflect a tension between one of the key interests of the member—surety regarding the availability of resources, and the operational requirements of the Fund—the traditional safeguards that need to be applied in the provision of these resources. These apparently conflicting interests might be reconciled if the member could somehow pre-qualify for the use of Fund resources, and do so in a way that satisfies the Fund's need to safeguard its resources, i.e., for the Fund to be confident that the resources drawn would be used appropriately and that the conditions would be created for their timely repurchase.

35. Beyond the three options described above, therefore, the Executive Board might wish to begin to consider the development of more novel criteria for qualification for a contingent credit line, according to which, for example, a member would pre-qualify for all or part of such a credit line provided it satisfied certain "health checks". These health checks would be represented, *inter alia*, by the member's compliance with Fund-endorsed standards in areas such as (i) banking system capital adequacy, supervisory and regulatory standards, and other indicators of banking system soundness, (ii) data disclosure and dissemination, both by the authorities to the Fund and to markets, and by institutions and corporations to the authorities and to markets, (iii) bankruptcy legislation and procedures, and (iv) codes of fiscal and monetary policies. In addition to these standards the member would, of course, be expected to have established a track record of sound macroeconomic policy implementation. These criteria are not intended as exhaustive; moreover, many of the required standards are not yet established and will need to be developed in the context of the ongoing work on the architecture of the international financial system. But, subject to an appropriate list being identified and criteria established to determine compliance, members deemed by the Fund to satisfy these standards could be qualified to draw on the contingent credit line, or at least on a large part of it, subject only to the relevant circumstances occurring, i.e., capital flight induced by financial market contagion.

36. Such an approach would not yet be a practical one for the Fund to implement, since the appropriateness and adequacy of the relevant standards are still unclear at this time and their application to the membership would require expertise with which the Fund is not yet sufficiently equipped. Many of the problems noted in the discussion of the FMP option above (paragraph 23) would also be relevant to this approach. But in the course of the work on international financial architecture, it should become possible to identify with greater confidence the indicators of financial system health, and the level of disclosure required of the member to establish compliance with the required standards.

37. It has already been suggested above that members should be required to satisfy certain minimal criteria by way of standards, such as the SDDS, as a necessary but not sufficient condition to qualify for access to a contingent credit line. Additional standards could be applied as and when appropriate yardsticks can be identified and defined in the course of work on architecture. These standards would be additional to the monitoring that would still be applied to the member in the various forms discussed above for the three individual options. But under the Augmentation and Commitment options, the member's compliance with such standards might enable the Fund to make available in the first purchase rather more than the token amount envisaged above. The development of these standards and their inclusion in, and progressive substitution for, the initial (or pre-crisis) conditionality associated with the contingent credit line would serve to move the concept of the contingent credit line closer towards the ultimate goal of pre-qualification. When a comprehensive list of standards is eventually developed, and the Fund is able to apply them to its membership, compliance with the full set might be deemed a sufficient condition for a member's qualification for the contingent credit line. It would remain the case that the member's activation of the main body of the contingent credit line (i.e., beyond the first purchase that would be available upon approval under the Augmentation or Commitment options) would still be associated with the conditionality and phasing described above for the three options. The establishment of an appropriate set of standards and the development of the Fund's expertise in applying them is likely to take some time, but if this is the direction in which the Fund should be going, then it would be appropriate to begin now the process of equipping the Fund for this role.

IV. Issues for Discussion

38. This paper has raised a number of issues on which the staff would appreciate the guidance of the Board.

39. First, regarding the operation of the SRF, staff seek the Board's approval for the proposed amendment to the base for the escalation of the rate of charge, i.e., that it should run from the date of purchase, and not the date of approval of a member's access to the SRF. Staff also seek Board's guidance on whether the practice of introducing flexibility into the phasing SRF purchases, as in the arrangement for Brazil should be generalized.

40. Second, staff would appreciate the Board's reactions to the concept of a "contingent credit line" and the three possible approaches outlined for establishing such a contingent credit line. The staff's preference is for either the Augmentation or Commitment options, with the member's program monitored in the context of an arrangement throughout. As well as the Board's guidance on the desirable features of a contingent credit line, including on the nature of conditionality under the three variants, including adherence to the SDDS, in the pre- and post activation stage, and on charges and maturities, the staff would also like to receive the Board's guidance regarding the appropriate role for the private and/or official bilateral creditors and possible modalities for their involvement.

41. Third, the staff would appreciate the Board's guidance on the future direction of such a contingent credit line, and on the role of standards in determining a member's qualification for access to it.

42. Following the Board discussion, staff will prepare a follow up paper, proposing the relevant amendment to the SRF (if the Board concurs) and bringing to the Board a specific proposal for the contingent credit line and with more specific suggestions for the role of private and official bilateral creditors and the implications for the Fund's liquidity.