FOR
AGENDA

EBS/99/49
Supplement 1

CONFIDENTIAL

May 19, 1999

To: Members of the Executive Board

From: The Acting Secretary

Subject: **The Fund's Liquidity and Financing Needs—Review**

The attached supplement to the paper reviewing the Fund's liquidity and financing needs (EBS/99/49, 3/29/99) discusses further the implications of the CCL on the Fund's liquidity position. This paper, together with EBS/99/49, is tentatively scheduled for discussion on Monday, May 24, 1999.

Mr. Corr (ext. 38774) 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

Fund's Liquidity and Financing Needs—Review
Supplementary Information

Prepared by the Treasurer's Department

(In consultation with other departments)

Approved by David Williams

May 19, 1999

1. This supplement extends the discussion of the potential implications of the CCL on the Fund's liquidity position in "The Fund's Liquidity and Financing Needs—Review" (EBS/99/49, 3/29/99), which was issued before the Executive Board concluded the discussions on the CCL. The paper places the issues in the context of the decision establishing the CCL and the understandings on its operation, with a particular focus on the methodological issue of how to account for commitments and potential future purchases under the CCL.

2. In EBS/99/49, the staff suggested that "the Fund's commitment to provide resources under precautionary arrangements, including under CCLs.... be fully taken into account when calculating the Fund's uncommitted resources" (paragraph 16). It was also suggested "to assume that no purchases would be made under such arrangements when projecting the Fund's future liquid liabilities" (paragraph 17). The first suggestion represented a departure from the traditional approach to precautionary arrangements under which commitments have been weighted at 50 percent— a rule-of-thumb that sought to strike a balance between the right of the member to draw resources and its stated intention not to do so.

Weighting of commitments

3. The traditional weighting of commitments under precautionary arrangements, together with the assumption that no future purchases would be made, significantly understates the potential impact on the Fund's liquidity position in the event a precautionary arrangement is drawn upon. But this seemed to pose little risk as long as (i) such arrangements were relatively few; (ii) the amounts were relatively small; and (iii) the probability of activation in an individual case was by and large independent of an activation of precautionary arrangements by other countries. As noted in EBS/99/49, these conditions no longer hold for recent precautionary arrangements and for the CCL.

4. The staff suggestion to increase the weight applied to commitments under precautionary arrangements and under the CCL was based on two broad considerations. First, the number and amount of commitments under precautionary arrangements have been growing in recent years, and their nature appears to have changed with the changes in the international environment. Precautionary arrangements have become an increasingly important element in members' crisis prevention strategy as a ready source of financial support. While most arrangements that began as or became precautionary in the period through 1996 retained that status thereafter, several relatively large precautionary arrangements—Philippines, Uruguay, Kazakhstan—were activated in the context of the financial market turbulence of 1997–98.[1]

5. Second, and more specific to the CCL, was the concern that the presentation of the Fund's uncommitted usable resources available for further commitments should meet the objectives of accuracy and full disclosure. The Fund's ability to provide the committed financing must be beyond doubt in order to be fully convincing to markets as any doubts about the Fund's capacity to provide the contingent financing, when needed, could undermine the role of the CCL. Moreover, with greater public attention being paid to the Fund's financial position, it has become increasingly important to provide clarity in the presentation of that position, and in particular with regard to the level of resources available for lending. From this perspective, commitments under CCLs should be fully taken into account when calculating uncommitted usable resources.

Impact on the liquidity ratio

6. While the suggested methodology would provide a straightforward and unambiguous indicator of the Fund's uncommitted usable resources, it may be seen as a very conservative approach to the more general assessment of the Fund's current and prospective liquidity as summarized by the liquidity ratio (the ratio of net uncommitted resources to liquid liabilities). A commitment under the CCL would have the same immediate impact on the numerator of the liquidity ratio as any other commitment of Fund resources. However, since CCL commitments would not affect the denominator, the total impact on the projected liquidity ratio would be significantly lower than with ordinary arrangements.[2]

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[1]The Philippines' first precautionary arrangement (approved in June 1994) was activated in July 1997 as the Asian crisis began; a subsequent precautionary arrangement for the Philippines (approved in April 1998) was drawn upon in November 1998. The arrangements for Kazakhstan and Uruguay (approved in July 1996 and June 1997, respectively) were activated almost simultaneously in December 1998.

[2]An effect on the liquidity ratio that would be broadly similar to scoring commitments at 100 percent could be achieved by adjusting both the numerator and the denominator at 50 percent. A lower adjustment on both sides could, however, raise the methodological issue

(continued...)

7. Table 1 illustrates and compares the effects on the liquidity ratio of a hypothetical commitment of SDR 10 billion under the CCL, accounted for at 50 percent and 100 percent, and a commitment combined with a purchase of the same amount (as might be the case under the SRF). The illustration is based on an initial liquidity ratio of 100, which is broadly in line with the expected ratio for the coming year in the baseline scenario presented in EBS/99/49. In the case of CCLs, the liquidity ratio would decline by 8 points to 92 percent with a 50 percent weighting of commitments and by 17 points to 83 percent if commitments were taken into account in full. This compares with a drop in the liquidity ratio by 29 points to 71 percent for a non-precautionary commitment with associated drawings, or, equivalently, a CCL commitment following activation. This comparison highlights the potentially higher volatility in available resources if commitments are not fully taken into account when they are made.

Table 1. Illustrative Impact of the CCL on the Fund's Liquidity Position
(in billions of SDRs unless otherwise indicated)

		SDR 10 billion			
		After Commitment			
	Baseline projection	100% Weighting	50% Weighting	After Activation	After Repurchase
Net uncommitted resources	60	50	55	50	60
Liquid liabilities	60	60	60	70	60
Liquidity ratio (in percent)	100.0%	83.3%	91.7%	71.4%	100.0%

Probability-weighted approaches

8. CCLs could be considered as a form of insurance provided by the Fund to members in case of unexpected balance of payments pressures arising from events outside their control. From this perspective, it could be argued that the Fund should account for CCLs in the same way insurance companies deal with possible claims by considering the expected, i.e., probability-weighted, payouts rather than the full amount of all contingent payments. The viability of this probability-based approach hinges critically on an accurate statistical and

[2](...continued)
of time-series consistency between the actual and projected ratios. The denominator—liquid liabilities (reserve tranche positions and outstanding borrowing)—is taken directly from the Fund's balance sheet. Adjustments to this figure might thus create further difficulties in explaining and interpreting the Fund's liquidity position.

actuarial assessment of the probabilities of individual claims and of the covariance of claims. It is for this reason that low probability but high-loss events with high correlations, such as earthquakes or floods, are typically not insurable in private markets.[3] Inaccurate assessments of the underlying probabilities and correlations can quickly lead to illiquidity or insolvency on the part of the insurer.

9. An approach based on probabilities would be difficult to implement in the case of CCLs. First, as the experience of the past two years has shown, the emergence, spread, and intensity of financial crises are very difficult to forecast. As activation of a CCL is conditional upon exceptional financing needs arising from financial contagion, projections of the timing and extent of actual use of CCL resources are subject to great uncertainty. With no experience, the assessment of probabilities of activation would, at this stage, be largely arbitrary.[4] Stress simulations for individual countries may, in due course, provide a basis for a quantitative assessment, but these approaches are yet to be developed.[5]

10. The second, and more serious, difficulty with probability-adjusted projections is the high degree of correlation of possible activations that may be associated with the CCL. Given the possibility of high correlation, an approach that uses some probability-weighted expected outcome would likely offer poor guidance for the Fund's liquidity management, which cannot be based on average outcomes. Moreover, in contrast to traditional precautionary arrangements, the CCL allows for relatively large access. The possibility of a simultaneous activation of CCLs by several members thus poses the risk of a sudden, heavy drain on the Fund's resources. This risk is further compounded by the possibility, and even likelihood, that the Fund would be faced with additional demands in the case of a crisis that triggered activation of CCLs.

Overall impact of the CCL on liquidity

11. At the same time, it is worth noting that the overall volatility of the Fund's liquidity may well be reduced by the existence of the CCL. The Fund's commitment of contingent financing, and the improved policy framework required under the eligibility conditions as approved by the Board, could be expected to reduce the risks of contagion and thus help

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[3]Unless the risks can be spread over a wide number of insurers through re-insurance or government guarantees.

[4]Probability-based approaches to projections of the liquidity ratio would require adjustments not only to the level of usable resources (numerator) but would also involve an equivalent adjustment to the level of liquid liabilities (denominator) reflecting expected drawings. This would raise the methodological issues discussed in Footnote 2.

[5]See Buff/99/46: Concluding Remarks by the Acting Chairman "Further Considerations Toward a Contingent Credit Line (CCL)-Follow-up," EBM 99/38, 4/5/1999.

reduce the actual demand for Fund resources during a crisis. However, this observation does not lead to a clear operational conclusion regarding the assessment of commitments during the pre-crisis period.

12. The staff papers on the CCL had noted the difficulties in estimating the potential demand for the Fund's resources under the CCL. It remains to be seen which countries might seek and qualify for access under the CCL. The eligibility criteria agreed by the Board may tend to limit the number of candidates in the near term, though the number of countries that might be interested in and qualify for a CCL could grow over time as they achieve progress in meeting the conditions.

13. As the number of countries with potential access to the CCL grows, so will the potential volatility of the Fund's liquidity position between extreme outcomes—zero use of CCL resources in the absence of a financial crisis and contagion, and large use of resources if contagion strikes. In this context, it should be noted that the impact of the different approaches varies with the level of overall demand for CCLs. The larger the demand, the greater the risk that a 50 percent weighting could give rise to a false sense of "comfort" as regards the Fund's liquidity position. For example, if CCL commitments rose to, say, SDR 50 billion, a 50 percent weighting would, taking into account commitments of SDR 25 billion, show the uncommitted resources declining to a still adequate level of SDR 35 billion at end-2000. However, if these commitments were activated, the purchases would virtually exhaust the Fund's available uncommitted resources, reducing them to some SDR 10 billion. This further underscores the need for a prudent accounting for commitments.

Concluding observations

14. In light of the characteristics of the CCL facility, for some of which there is no prior experience (e.g., the preventive purpose, the contingent nature, the separate decisions for commitment and activation), the staff recognizes that it is difficult to come to definitive conclusions regarding the appropriate method of taking CCLs into account in the liquidity analysis. Perhaps the paramount consideration should be that the Fund not be seen to commit more resources than it has available, albeit there exists the possibility of supplementary support from the GAB/NAB. The staff is of the view that to weight commitments under CCLs at 100 percent for liquidity purposes would strike a reasonable balance at this early stage of the CCL; zero weight would be given to purchases. It is recognized, however, that in the absence of experience with the CCL, the weighting is in large part a matter of judgement and that a somewhat lower weight may also be consistent with a prudent approach at this early stage of the CCL. Also, it should be noted that, irrespective of the weighting for CCLs that ultimately may be agreed for presenting the Fund's liquidity position, the question how best to interpret this information and what guidance to derive from it will likely continue to be of more immediate importance for the Fund's liquidity management.

15. Given the lack of experience in this area and taking into account that the CCL will be reviewed after a year, the staff would keep the Fund's liquidity position under continuing review, as reflected in the Chairman's Summing Up at the conclusion of the CCL discussions,[6] and the Board would be informed if potential commitments risk reaching a level that could call into question the Fund's capacity to provide adequate support to members in need. In this context, the staff would undertake further analysis of possible alternative approaches, including "stress simulations" of the impact of CCLs on liquidity in the paper for the next regular review of the Fund's liquidity position. In the meantime, the staff would propose to score commitments under the CCL at 100 percent, with no presumption of purchases.

[6]See SM/99/91, Supplement 2 (4/24/99).