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December 2, 1994

To: Members of the Executive Board

From: The Secretary

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

Attached for consideration by the Executive Directors is a report on preliminary considerations of Fund policies with regard to currency stabilization funds. A summary of possible modalities of currency stabilization funds appears on pages 17-19.

This subject, together with the Managing Director's statement on Fund policies with regard to currency stabilization funds (BUFF/94/111, 12/2/94), is tentatively scheduled for discussion on Wednesday, December 14, 1994.

Ms. McGuirk (ext. 38363), Mr. Hagan (ext. 37715), or Mr. Decarli (ext. 37627) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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

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

(In consultation with other Departments)

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

December 1, 1994

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I. Introduction

This paper considers possible Fund policies in support of currency stabilization funds (CSFs) used in the context of Fund arrangements. Interest in Fund financing for currency stabilization purposes has arisen in a number of different situations. As Executive Directors are aware, some countries in transition--for example, Russia and Ukraine--have expressed interest in CSFs as part of a bold strategy to rapidly reduce inflation on the basis of an exchange rate peg supported by a comprehensive economic stabilization and reform program. 1/ 2/

It is envisaged that CSFs could be used in certain circumstances to assist members wishing to pursue a fixed exchange rate regime in the context of a Fund arrangement. In such circumstances, the success of the exchange rate anchor would depend foremost on tight fiscal and monetary policies, together with adequate reserves to weather short-term exchange market pressures. In this context, CSFs could provide a supplement to reserves that would help foster confidence in the sustainability of the nominal anchor and the overall anti-inflationary strategy. CSFs may also have a role to play in supporting an exchange rate peg where exchange market reforms are adopted under a Fund arrangement, such as exchange rate unification or the establishment of current account convertibility.

Although the Fund's resources have often been used to help build members' international reserves, existing policies do not explicitly provide for dedication of Fund resources specifically to the financing of CSFs, i.e., resources that would be expected to be drawn upon only in the event of certain well-defined circumstances in the member's exchange markets. Fund support for such operations would need to be consistent with the purposes of the Fund and therefore limited to circumstances under which exchange rate policies are credible and could favorably influence the process of macroeconomic stabilization. Use of the resources of a CSF would be limited to very short-term intervention to help counter short-term exchange market pressures and would not constitute a source of general balance of payments financing. Sustained exchange market pressures or changing economic fundamentals would need to be addressed through a timely

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1/ Poland's 1990 program, which featured a $1 billion currency stabilization fund, is frequently cited as an example of such a strategy. The Polish stabilization fund was financed by 13 industrial countries. It was initially established to support the 1990 economic reform program and was subsequently extended for two further one-year periods; although the Fund did not contribute to the financing of the Polish fund, operations of the fund were closely linked to Poland's stand-by arrangement (Annex I).

2/ The possible contribution of a CSF has also been raised in several countries with Fund arrangements where short-term exchange market pressures have emerged and in countries where major exchange rate actions and reforms have been considered.

strengthening of financial and other policies, rather than continued exchange market intervention. 1/

CSFs would be an integral, albeit transitional, part of an overall strategy designed to assist a member undertaking a comprehensive stabilization and adjustment effort involving an exchange rate peg. The purpose of a CSF would be to enhance the credibility of a program that is appropriately framed and fully financed. By its nature, a successful CSF would serve its purpose best when it does not need to be used. It would be expected that once the member had established policy credibility and further increased the level of reserves it held there would no longer be a need for special CSF operations to be associated with any further financial assistance from the Fund.

Effective operation of a CSF in a manner that adequately protects Fund resources would require conditions that are not typically found in Fund arrangements--in particular, conditions for use would entail much more frequent reporting of key information needed to permit close monitoring of exchange market developments, including intervention operations, and more frequent assessments of economic developments and policies; relatively short repurchase or "reconstitution" periods; and revolving features to permit purchases of reconstituted amounts.

This paper examines the purpose and possible features of Fund support for CSFs. Section II discusses the basic purpose and features of CSFs and considers possible operational modalities of Fund support for CSFs. Section III provides a summary of the possible modalities of Fund support for CSFs as a basis for discussion. If there is support for the development of policies to provide Fund financing for the purpose of CSFs, the staff would prepare a formal proposal, taking into account the views of the Executive Board.

II. Possible Elements of Currency Stabilization Funds (CSFs)

1. Basic purpose, conditions, and main features

The basic purpose of CSFs would be to add credibility to an exchange rate peg adopted as part of a comprehensive strategy of economic stabilization and reform supported by a Fund arrangement. As discussed in the recent review of experience under stand-by and extended arrangements, a fixed exchange rate can be an effective component of an anti-inflation strategy, provided that it is backed by financial policies that are seen to be sufficiently tight to quickly change inflation expectations. 2/ In such

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1/ In particular, Fund resources could not be used to "meet a large or sustained outflow of capital" within the meaning of Article VI.

2/ See EBS/94/104 (5/19/94).

circumstances, adequate international reserves to cushion short-term exchange market pressures are also important. 1/

In most cases, members seeking to maintain a fixed exchange rate under a Fund arrangement will already have access to substantial reserves, and purchases under the Fund arrangement would permit a further strengthening of the member's reserve position. In some cases, however, the member's initial level of reserves--even when supplemented by potential purchases under an arrangement--may be viewed as inadequate to help counter short-term speculative pressures and market disorder and thus to foster confidence in the exchange rate peg. In such circumstances, which would not be expected to occur frequently, the prospects for successfully maintaining a nominal exchange rate anchor could be enhanced by access to a pool of supplementary intervention resources at the outset of the exchange rate peg. Resources of a Fund-financed currency stabilization fund established for this purpose would be oriented toward addressing short-term disturbances in the exchange market, rather than supporting the exchange rate in the face of sustained pressures.

For CSFs to play their intended role, certain conditions would need to be met: economic and financial policies would need to be sufficiently tight to deliver an inflation path compatible with the targeted exchange rate peg (that is, the exchange rate peg would need to be realistic and sustainable); economic policies would need to be adapted promptly as necessary in response to changing conditions so as to ensure maintenance of the nominal exchange rate objective; and the underlying program would need to be fully financed (i.e., without taking into account the resources of the stabilization fund). Under these conditions a substantial reflow of flight capital would be expected.

When a member seeks to establish a CSF in the context of a Fund arrangement, the operations of the CSF would need to be consistent with the objectives and design of the Fund program. In particular, the CSF would not substitute for the planned accumulation of foreign exchange reserves targeted under the underlying program; the program would continue to provide for an adequate accumulation of reserves, relative to the level and volatility of international transactions.

In addition, where Fund resources are made available through the CSF, special features would be required to help ensure that, if drawn upon, the CSF would be used in a manner consistent with its intended purpose. In particular, close and continuous monitoring by the member and the Fund of

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1/ Members that chose to pursue nominal exchange rate anchors in the context of Fund arrangements between mid-1988 and mid-1991 tended to have higher initial levels of reserve cover than those without such anchors. At the same time, several members successfully adopted exchange rate pegs notwithstanding a low level of reserve cover (e.g., Argentina, Honduras, and Morocco). See EBS/94/84 (4/15/94).

exchange market conditions, intervention operations, and program performance would be required. The release of Fund resources for CSF operations should, within certain bounds, be dependent upon a judgment by the Fund that all of the above conditions had been met and that intervention rather than, or in addition to, policy adaptation was appropriate. A provision for reconstitution of resources within a relatively short period following use would help assure that resources were not transformed into general balance of payments support and that, where necessary to permit such reconstitution, intervention is accompanied by an appropriate modification of policies.

Following the establishment of a CSF, activation (which would permit the member to make purchases) should occur at a stage when the Fund is confident that the member's program is fully supportive of a fixed exchange rate policy. In some cases this may be at the outset of a Fund arrangement; however, in other cases, where there has been a poor track record of policy implementation and/or there is considerable uncertainty about the appropriate level of the exchange rate, some period of policy performance may be necessary before it can reasonably be judged that the exchange rate has settled at (or been adjusted to) a level that could be maintained by sufficiently tight financial policies. In any event, a CSF would be regarded as a transitional, confidence building instrument. To the extent that the positive effects on confidence are related to the availability of the CSF, limited, if any, recourse to the stabilization fund would be wholly consistent with its objectives (as was the case in Poland). In brief, a CSF is most likely to succeed when it is unlikely to be drawn upon. By the same token, resources of the CSF that are used for intervention and subsequently reconstituted should again become potentially available for use under appropriate conditions--i.e., it would be desirable that the CSF revolve, so long as the Fund arrangement remained in place and the confidence-building effects of the stabilization fund were regarded as important to the member's ongoing adjustment efforts.

2. General approach

There are two ways in which the Fund could establish general policies to provide financing for CSFs. 1/ First, a separate policy (or "window") could be established for support of currency stabilization within a stand-by or extended arrangement as was done in the case of the policy on Fund support for commercial bank debt and debt service reduction operations. Incorporating CSFs into arrangements would underscore their special, transitional character and help ensure that such operations would be limited

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1/ A CSF with the features described in this paper could be incorporated into a stand-by or extended arrangement approved by the Board on an ad hoc basis for an individual member country. Nevertheless, in this case, in accordance with the principle of uniformity of treatment, the Fund would need to be prepared to finance CSFs for other member countries in similar circumstances, and would thus need to consider the same general policy issues discussed here.

to circumstances where a fixed exchange rate could contribute importantly to economic stabilization in the context of a comprehensive Fund arrangement. In this connection, there may be a need to invoke the exceptional circumstances clause to accommodate a CSF within the annual and cumulative access limits under stand-by and extended arrangements. Such a policy ("window") could be established by a simple majority in the form of guidelines contained in a summing up.

Alternatively, a special facility for CSFs could be established since CSFs would be intended to finance special balance of payments problems. Under a special facility, it could be provided that CSFs could be used only in association with Fund arrangements (similar to the contingency element of the CCFF). Also, a short repurchase period could be established and resources made available under the facility could be fully additional to those provided under an associated arrangement, obviating the need to invoke the exceptional circumstances clause. 1/ An 85 percent majority of the Board would be required to establish such a new facility.

As will be discussed in the relevant sections of this paper, while the choice between these two alternatives will, to some extent, affect the features of CSFs, in practice, the same operational characteristics could be achieved under either approach. To illustrate how the special features needed to effectively operate a CSF within an arrangement could be established, the following discussion assumes that CSFs would be incorporated into arrangements as a window. 2/

Under the window approach, resources would be made available under an upper credit tranche stand-by or extended arrangement and would be segmented into two elements. The first would provide general balance of payments support, subject to the typical conditions of Fund arrangements regarding phasing, performance criteria, reviews, and repurchase periods. The second element would be dedicated specifically to providing short-term financing for CSF operations. As has been the case in the context of Fund support of debt and debt service reduction operations, the Fund may attach special conditions to the use of an identified portion of purchases under an arrangement. Accordingly, the conditions and phasing for purchases under the stabilization fund element would be distinct from and in addition to

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1/ Another consideration is that under certain conditions GAB resources might be called upon to finance the operations of CSFs (see Section II.5). For a nonparticipant, if these conditions are met, GAB resources may be used only to finance transactions in the upper credit tranches, under an upper credit tranche stand-by or an extended arrangement, or in the first credit tranche in conjunction with such arrangements; GAB resources could not be drawn upon to finance transactions under a special facility.

2/ CSFs could not be incorporated into ESAF arrangements under the structure of the ESAF Trust as reflected in the present instrument; a parallel stand-by or extended arrangement would need to be established for this purpose.

those for purchases available under the "traditional" element of the arrangement. Transactions under both elements would take the form of purchases and repurchases vis-à-vis the General Resources Account.

In order to give the stabilization fund element a revolving character, provision would need to be made to allow repurchases under the CSF element to be purchased again for stabilization operations, subject to the agreed conditions, as long as the stabilization fund was operative. Under current rules, an early repurchase while an arrangement remains in place does not have the effect of restoring the amount available under the arrangement. However, a revolving feature could be achieved through a provision that the CSF element of the arrangement would be augmented automatically as repurchases are made for reconstitution purposes within the time frame of the arrangement.

Access under the arrangement, including the CSF element, would be determined within the existing guidelines for access policy, taking into account specific policies established for CSFs. Where appropriate, appeal would be made to the exceptional circumstances clause to accommodate the stabilization fund element. 1/ Access under the CSF element would be determined, inter alia, taking into account the desirability, in the circumstances envisaged, of a special form of precautionary reserve. The need for CSF resources would depend on possible exchange market pressures, the actual and programmed level of reserves, alternative sources of short-term financing, and the scope for policy adjustments. A ceiling could be placed on the amount by which an arrangement could be augmented for the CSF element. An upper limit of, say, 100 percent of Fund quota over the term of the associated arrangement should enable the Fund to contribute very substantially to most members' currency stabilization efforts. However, the limit would not be regarded as a target and in many cases a lower level of access would likely be sufficient depending on the circumstances. Although additional to the resources available under the traditional element, the limit would operate within the overall (annual and cumulative) access limits under stand-by and extended arrangements. 2/

3. Operational features

Purchases under a CSF would be subject to the policy conditionality associated with an upper credit tranche stand-by or extended arrangement and to further conditions tailored specifically to the operation of the CSF. The latter provisions would be intended to ensure that CSFs are established

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1/ Approval of access to Fund resources under the exceptional circumstances clause requires a simple majority of the votes cast.

2/ As discussed earlier, under the alternative of establishing a special facility to provide financing for CSF purposes, access under a special facility could be additional to access provided under stand-by or extended arrangements, and this would avoid recourse to the exceptional circumstances clause.

under appropriate circumstances and resources are used for the intended purposes of short-term intervention and subject to early reconstitution. The general provisions on CSFs would be contained in policy guidelines. Specific provisions for a CSF would be set out in the text of an individual Fund arrangement together with the traditional elements of the arrangement (i.e., phasing, performance criteria, and reviews). These would specify the commitment of Fund resources for the stabilization fund element; 1/ provide for the first and subsequent tranches and reviews of requests for purchases within the upper tranches by the Executive Board; provide for early repurchase for reconstitution purposes and augmentation of access to reconstituted resources of the CSF; provide for possible collateral requirements; establish requirements for reserve management and data reporting related to CSF operations; and provide for terminating CSF operations.

Notwithstanding the special features and conditions that could be associated with the establishment and use of CSFs, Fund financing for CSF operations could entail unusually high risks for the Fund. In particular, on a day-to-day basis it is inherently difficult to determine whether changing conditions are related to short-term or longer lasting developments that would require a policy response. In designing the operational features of Fund financing for a CSF, which are discussed below, the risks associated with such financing need to be balanced against the effectiveness of such an instrument in providing greater confidence to an exchange rate anchor.

a. Activation of a currency stabilization fund

The CSF element of the arrangement would be activated by the Executive Board following a determination that the conditions were appropriate; this could be at the time an arrangement is approved, or at the time of a review under the arrangement. In assessing whether to activate the CSF element, the Executive Board would consider whether the exchange rate and exchange rate policy were realistic and sustainable; whether the exchange rate policy was (and would be) firmly supported by fiscal and monetary policies, which would be adapted rapidly, as necessary; and whether the program was fully

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1/ If activation of a CSF does not occur at the outset of the arrangement, it would be possible to proceed with a "traditional" arrangement and to activate the stabilization fund element at a later stage, at which point the member would be able to request CSF purchases. Although this would not constitute a commitment of Fund resources for a CSF at the outset, the Executive Board could indicate, in approving the arrangement, that it would be prepared to give consideration to a later request for augmentation of the arrangement for CSF purposes; in this case, the amount of the CSF and its features and conditions could be established in the stand-by documents and come into effect when the CSF is activated (by a Board decision). Alternatively, the features of a CSF (amount and conditions) could be specified at the time a CSF was activated; e.g., at the time of a review of performance under the arrangement.

financed. On activation of the stabilization fund element of the arrangement, access would become available to a specified amount of resources (a first tranche), subject to the member remaining in compliance with the Fund arrangement and to the further conditions noted below.

b. Tranching of access

To facilitate close Fund monitoring of CSF operations, CSF resources would be made available in tranches. The first tranche would become available on activation of the CSF, and the member would be free to draw on resources in this tranche to replenish reserves that have been drawn down for intervention purposes or to supplement reserves on a precautionary basis. The first tranche would thus represent a form of working balance, which could be purchased and held for the duration of the CSF or drawn, repaid, and drawn again without the need for further review by the Executive Board so long as the member remained in compliance with the arrangement and other conditions such as reporting requirements, as might be required by the Board in connection with the CSF element. 1/ Access under the first tranche would provide the member with supplemental resources to respond immediately to currency market pressures, and, as these resources are used, the member could request to replenish its working balance if needed through purchases in the upper tranches of the CSF.

All purchases in tranches above the first tranche, either for initial use of resources in the upper tranches or following reconstitution and re-use of resources in the upper tranches, would require Board approval subject to appropriate conditions. 2/ In general, it would be expected that drawings beyond the first tranche would be to replenish all or some proportion of reserves used in intervention so that a member could continue to maintain an adequate level of precautionary reserves throughout the life of the CSF.

All tranches would be defined as a percent of the total CSF. In order to provide for progressively tighter Board monitoring as Fund exposure under the CSF rises, consideration could be given to reducing progressively the size of successive tranches. As an example, a series of tranches could be as follows: 20 percent of the total CSF for the first two tranches; 15 percent for the third and fourth tranches; and 10 percent for the remaining tranches. However, there could be some flexibility in determining

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1/ During the course of an arrangement, if it appears that the conditions for use of the CSF are no longer met, management would consult with the Board on the appropriate course of action.

2/ Given the possibility of rapidly changing circumstances in foreign exchange markets, it would seem appropriate that Board approval of a purchase in the upper tranches of the CSF would provide for only a limited amount of time within which to make an approved purchase. Beyond that period, the member would have to approach the Board with a new request, even if it had not drawn on the previously approved amounts.

the size of the tranches, depending on the particular circumstances of the member country (e.g., the initial level of reserves and the size and variability of flows in the foreign exchange market).

Above the first tranche, the maximum size of a purchase that could be requested under the CSF would depend on the level of outstanding credit under the CSF. Specifically, at a given point in time, if the member's outstanding credit under the CSF fell into a particular tranche, the maximum size of a purchase request under the CSF would be equal to the size of the subsequent tranche. Annex II illustrates how such a scheme might work.

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

Resources that are reconstituted to the CSF (i.e., repurchased) would again become available for drawing, subject to conditions for purchases in each tranche. Conditions for access to reconstituted drawings would be equivalent to those for earlier drawings, including requiring Board approval of each drawing of reconstituted funds beyond the first CSF tranche.

c. Reconstitution (i.e., early repurchase)

To assure that resources made available under a CSF specifically for intervention purposes are used for short-term reversible operations and not transformed into general balance of payments support, CSF drawings would be subject to an early repurchase "expectation" that would provide for repurchase within a period of, say, three to six months. Such a period should normally provide adequate time for the reversal of exchange market

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

pressures, including reversals that are in response to such financial policy measures (e.g., interest rate increases) as may be necessary. However, in light of possible uncertainties regarding the speed and strength of changes in market sentiment, consideration could also be given to a provision whereby the member might seek Executive Board approval for an extension of the repurchase expectation period by up to three months. 1/ Since there would be a trade-off between requesting an extension of a repurchase expectation and requesting a new purchase under a CSF, the criteria for granting an extension would involve essentially the same considerations as those taken into account at the time of a request for a purchase.

A repurchase expectation would not constitute an obligation and, therefore, failure to observe such an expectation would not constitute a breach of the member's obligations under the Articles. However, it could be established under policies pertaining to CSFs that failure to meet a repurchase expectation would interrupt further purchases under the arrangement (or other Fund facilities), and this could ultimately lead to a declaration of ineligibility under Article V, Section 5. 2/ It would seem appropriate that, in addition to such expectations, a one-year repurchase obligation be established for all purchases so as to avoid having to rely on the standard three-to-five year maturity period in the event that a member fails to repurchase in accordance with the expectation. Moreover, so as to avoid excessive revolving of drawings, consideration could be given to subjecting purchases under the first tranche of a CSF only to such a one-year obligation rather than the shorter repurchase expectation periods. 3/

If, as assumed here, a special "window" were utilized, the repurchase expectation could be adopted under the general decision establishing the "window." However, under this alternative, a special repurchase obligation could only be imposed under Article V, Section 4 as a condition for a

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1/ Where purchases under a CSF are bunched (e.g., at weekly intervals), repurchase expectations would also be bunched. To avoid excessively frequent Board consideration of requests for extension of repurchase periods, the Board might address, on a combined basis, requests in respect of a number of forthcoming repurchases (e.g., those falling due over the following month or quarter).

2/ A more complete description of the effects of nonobservance of an early repurchase expectation is contained in "Debt and Debt Service Reduction Operations - Early Repurchase Expectations" (EBS/89/224, 11/22/89).

3/ For arrangements that exceed one year, the repurchase obligations could be set to coincide with the expiration date of the arrangement.

waiver. 1/ Such waivers are required at the time of commitment of resources if the amount committed under the arrangement would, if purchased in full, increase the Fund's holdings of a member's currency above 200 percent of quota. 2/ 3/

Under either a "window" or a special facility, early repurchase expectations and obligations could be utilized in combination as described above. Such a combination could provide some scope for avoidance of unintended rigidities during the period when the CSF was in operation, while assuring that once stabilization operations cease, repurchases within an established period would constitute a financial obligation to the Fund.

d. Foreign exchange management and reporting provisions

Access to the currency stabilization element of the arrangement would be conditioned on prior establishment of integrated operational management of foreign exchange reserves and intervention policy and subject to continuing compliance with specific reporting provisions intended to enable the Executive Board to assess the appropriateness of (i) activating a stabilization fund element; (ii) requests for drawings under a CSF; and (iii) requests for extension of repurchase expectations relating to CSF drawings. Conformance with reporting requirements would be a prior condition and a continuing requirement for use of CSF resources.

1/ Article V, Section 4 provides that as a condition for waiver of the 200 percent of quota limit on holdings of a member's currency, the Fund may establish terms that safeguard its interests. In the present context, a repurchase obligation, designed to help assure that a stabilization fund is used for the purposes intended, would represent such a safeguard. Also under Article V, Section 4, it is possible to request collateral for any purchases that would raise holdings above the 200 percent of quota threshold.

2/ Accordingly, a waiver would be required in all instances where combined access under the arrangement and the CSF exceeded 100 percent of quota (assuming that the member has drawn its reserve tranche) and for smaller levels of combined access where a member has outstanding purchases under prior arrangements, the CCFF, or the STF. Obligations so established would apply from the outset, that is, before holdings actually exceed 200 percent of quota. In most cases where an arrangement would include a CSF, it would be expected that a waiver would be required. If, as outlined above, the commitment is made at the time of activation subsequent to the approval of an arrangement, a waiver may be required when the commitment is made.

3/ If CSFs were established under a special facility, both the expectation and repurchase obligation provisions would be set forth in the decision establishing the facility. The basis for the establishment of a special period for the repurchase obligation would be Article V, Section 7(d) and, accordingly, an eighty-five percent majority of the total voting power would be required.

Reporting would generally need to include data on both the foreign exchange market and economic policy variables. 1/ Data on exchange market operations would include exchange market intervention, exchange market quotations and analysis of developments, official foreign exchange and other reserve balances, official foreign exchange receipts and payments, foreign exchange balances of the banking system, exchange rates, and interest rates. Given the nature of the operations, such reporting should be frequent and with minimum lags; for the majority of data, reporting would be on a daily basis and it would be necessary to make a distinction between "intervention" related to autonomous transactions, such as debt service payments, and exchange market intervention aimed specifically at counteracting exchange market disturbances. In addition, more frequent and timely data would be needed on economic policy developments such as the budget and monetary accounts. Precise details of the information subject to the reporting requirement would be specified by the Board in the context of the activation of a CSF, and it could be provided that they may modified or supplemented during the operation of the CSF as conditions for approving CSF purchases or completing reviews under the arrangement. These reporting requirements would require very close cooperation and consultation of the authorities with staff on request, with the assistance of Resident Representatives as needed.

In addition, where possible, member countries should give the Fund advance warning when a purchase is likely to be requested. As feasible, a prior staff visit or other communication would permit careful evaluation of the situation and the adequacy of policies.

Nonetheless, the Board may need to consider requests for drawings on CSF resources at very short notice, possibly during the course of a day. Moreover, during periods of intense exchange market pressures, the Board may need to meet on a relatively frequent basis. Meetings and all relevant background information would need to be treated with utmost confidentiality. Board procedures for handling requests to draw under a CSF would need to be developed and included in the general guidelines. Such procedures would take into consideration issues such as confidentiality of data and Board meetings, the circulation period for reports, possible lapse-of-time procedures, and the lead time needed to schedule Board meetings.

Once a CSF has been established for a Fund member, the Board could be kept regularly informed of developments through the periodic circulation of a brief description of the current economic situation and prospects, supported by a table of selected CSF-related economic indicators. At the time a drawing under a CSF was requested, an updated description and data could be circulated immediately to the Board and supplemented by a staff

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1/ Data reporting requirements could vary between members depending, inter alia, upon the format within which information is compiled, the expected sources of pressures on exchange markets, and the policy instruments available to the authorities.

presentation at the Board meeting to consider the request. Under the best circumstances, the period between circulation of the updated summary and the Board discussion of the purchase request would be at least 24 hours. However, under exceptional circumstances, the circulation period could need to be abbreviated (for example to allow afternoon Board discussion following morning circulation), or lapse of time decisions may be considered necessary.

e. Termination of currency stabilization fund operations

Access to financing under CSFs would be terminated on expiration of the associated Fund arrangement. Residual operations would be confined to repurchase of balances outstanding at the end of the arrangement. In the event that an arrangement lapses in advance of its expiration date, drawings from the CSF would cease at that point. In addition, outstanding drawings under the CSF would be repurchased in accordance with the repurchase expectation/obligation relevant to each drawing; requests for an extension of a repurchase expectation would not be considered after the lapse of the associated arrangement. The possibility would exist for the member to request a CSF as part of a successor arrangement. Such a request would be considered on its own merits; access to resources under a new CSF would be determined taking into account the member's policies and prospective need for intervention resources from the Fund as well as credit outstanding and performance under previous CSF operations.

4. Cost considerations

Commitment and use of Fund resources in the context of currency stabilization fund operations would entail certain financial costs to the member.

First, there is a charge of 1/4 of 1 percent per annum payable at the beginning of each twelve-month period of an arrangement on the total amount of the arrangement that could be purchased during that period. 1/ This commitment fee would apply to the CSF element as well as the "traditional" element of an arrangement. 2/ If an arrangement were drawn upon, the member would recoup the commitment fee in direct proportion to the amounts drawn relative to the total size of the annual segment of the arrangement. Should a CSF drawing be repurchased and access under the CSF augmented to establish a revolving pool of intervention resources, the augmentation would give rise to a new commitment fee of 1/4 of 1 percent per annum of the resources made available under the augmentation, prorated based on the remaining period of availability of the CSF element. The member would

1/ Rule I-8. See pages 34/35 of By-Laws, Rules and Regulations, Fiftieth Issue, January 7, 1994.

2/ The commitment fee for the CSF part of an arrangement would be payable at the time of the actual commitment of these resources.

recoup that fee in the same manner as described above if reconstituted resources were purchased again.

Second, purchases of the Fund's general resources are subject to a service charge of 1/2 of 1 percent. There would be service charges for each purchase transaction, including for resources that have been purchased and reconstituted and are subsequently purchased again under the revolving feature of a CSF.

Third, the rate of charge on the use of Fund resources would apply to outstanding balances drawn under a CSF.

The overall costs to a member of Fund support for CSF operations would therefore depend on the size of the approved level of access under the CSF (which determines the applicable commitment fee), the degree to which resources revolve (and bear commitment and service charges), and the degree to which resources remain outstanding (thereby bearing standard Fund charges). Cost considerations may deter members from seeking approval of excessively large, precautionary stabilization funds; this would be appropriate. They may also encourage rapid policy adjustment in the face of currency market pressures so that intervention resources could be quickly reconstituted. However, in some circumstances, cost considerations, particularly with respect to the service charges, could lead members to keep purchases outstanding as long as possible, or request an extension of a repurchase expectation, because of the potential transactions costs associated with a new purchase.

The staff has examined the possibility of minimizing multiple commitment and service charges arising through the reconstitution and subsequent drawing of CSF resources by establishing a Fund-administered account into which reconstituted resources would be deposited and could be reused, subject to the same conditions and Board approval discussed above for the GRA. 1/ Under this mode of operation, the CSF element of the arrangement would not be augmented (avoiding the further commitment fee) after the reconstitution of CSF resources to an administered account, since the resources would continue to be available through drawings from the account, and drawings on the account need not incur a service charge. However, while service charges and commitment fees could be reduced by the use of an administered account, the member could bear costs on account of the difference between earnings on the administered account's invested

1/ From the member's perspective, there would be no difference in procedures for use of a CSF with or without an administered account.

balances and the Fund charges accruing on the same resources. 1/ In addition, provision could be made in the instrument establishing the administered account for an administrative charge which would cover the cost to the Fund of administering the account.

Under a range of scenarios examined by the staff, the cost savings to members of this approach would not appear to be significant. For this reason, and for simplicity of design and Fund operations, it is not proposed to operate CSFs in the context of administered accounts.

5. Financing modalities

Commitments and disbursements of resources under a CSF would be financed from the Fund's ordinary resources. The Fund's current liquidity position is relatively strong, with uncommitted usable resources totaling some SDR 53 billion at end-October 1994. As indicated in the paper prepared for the Executive Board's recent consideration on access policy, the Fund would seem well positioned at present to meet expected demands on its resources over the next few years. 2/ Furthermore, the Fund's present and prospective liquidity would be adequate to support a relatively substantial increase in demand for the Fund's resources, including additional demand arising from the recent increase in the annual access limit for outright purchases and purchases under stand-by and extended arrangements from 68 percent of quota to 100 percent of quota. 3/ Nevertheless, a relatively sharp decline in the Fund's liquidity ratio by end-1997 seems likely. 4/ An increase in demand, which at present is difficult to estimate, arising from the introduction of Fund financing for CSFs together with a possible further increase in projected demand if access under the STF is extended and augmented and a Short-Term Financing Facility (STFF) established, could exert considerable downward pressure on the Fund's liquidity position over the next few years. This and the uncertainties inherent in projections of the demand for and supply of usable resources in

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1/ Currently the rate of charge, including burden sharing adjustment, is about 5½ percent per annum, while the investment yield that the Fund could obtain on very short-term SDR-denominated deposits is around 4 percent per annum. With this differential, the cost of holding Fund resources for four months would be equivalent to the cost of an early repurchase followed by a new purchase within the four-month period.

2/ See "Review of Access Policy and Limits Under the Credit Tranches and Extended Fund Facility" (EBS/94/201, 10/14/94).

3/ See "The Fund's Liquidity and Financing Needs--Review" (EBS/94/198, 9/29/94).

4/ Simulations prepared for EBS/94/201 show that the liquidity ratio could decline from 166 percent at present to around 70-80 percent by end-1997.

the Fund imply that the Fund's liquidity would need to be kept under close review. 1/

The possibility exists that other organizations or countries might wish to "co-finance" CSF operations in the context of a stand-by or extended arrangement. Contributions to CSF operations could be made, for example, by countries which have an interest in the contribution that an exchange rate peg could make to more stable bilateral financial relations and, indirectly, to the growth of regional trade and investment. In such circumstances, co-financing for a Fund-supported CSF could enable members to develop institutional arrangements for future bilateral financial support, while currently benefitting from the safeguards regarding the appropriate use of intervention resources that would come from Fund involvement.

Where Fund resources are made available through a co-financed CSF, the Board would retain sole authority regarding the use of Fund resources. Co-financing from non-Fund sources could be available for the duration of the operations of the CSF with the understanding that such resources would be disbursed to the member in parallel with, and in proportion to, purchases from the Fund (though possibly after consultation between the Managing Director and the co-financing governments or institutions). In such circumstances, co-financing might be provided on similar terms as Fund resources with respect to short-term repayment, reconstitution and reuse, and the termination of CSF operations.

The possibility also exists that third-party countries or organizations would be willing to finance CSF operations in full (as in the case of the Polish currency stabilization fund). To the extent that Fund resources would not be made available through a Fund-supported CSF, Fund policies regarding the triggering of the CSF, the tranching of resources, the approval of drawings, and the reconstitution of resources need not apply. Nevertheless, the exchange rate policies supported by such a CSF and the intervention activities conducted in the context of the operations of the

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1/ Under certain conditions, the Fund can supplement its quota-based resources by borrowing under the General Arrangements to Borrow (GAB). For Fund members that are not participants in the GAB, the Managing Director may initiate the procedure for making calls on the GAB "if, after consultations, he considers that the Fund faces an inadequacy of resources to meet actual and expected requests for financing that reflect the existence of an exceptional situation associated with balance of payments problems of members of a character or aggregate size that could threaten the stability of the international monetary system." In addition, use of GAB resources by non-participants is only permitted for transactions in the upper credit tranches, under an upper credit tranche standby or extended arrangement, or for first credit tranche transactions in conjunction with such arrangements. Although the possible use of the GAB is not currently under consideration for financing CSF, if the specific conditions for use of the GAB were met, this source of additional financing could be considered.

fund would need to be consistent with the member's arrangement with the Fund. 1/ For this reason, the terms of any externally-financed CSF would need to be clarified in advance of Board approval of the associated stand-by or extended arrangement. In addition, the Fund would need to monitor closely intervention activities to ensure that they remained compatible with the objectives of the Fund-supported program. In the event of inconsistencies, the Board could deny approval of further purchases under the Fund arrangement.

III. Summary of Possible Modalities of CSFs for Discussion

This paper has outlined broad elements that might form the basis for the establishment and operation of CSFs to be used in the context of Fund arrangements. CSFs would be intended to lend added confidence to members' exchange rate and supporting policies undertaken in the context of an arrangement with the Fund, and would be directed exclusively to short-term intervention to counter short-term exchange market disorders; they would not be used as a source of general balance of payments support. Fund financing for CSFs could be provided by establishing a special facility for this purpose (requiring a majority of 85 percent) or by establishing a "window" within a stand-by or extended arrangement (requiring a simple majority). In view of the special, transitional character of such operations and the central role of exchange rate policy in Fund arrangements, it would be essential for the operations of CSFs to be fully integrated with a stand-by or extended arrangement. This could be achieved under either of the approaches considered. Conditions for activating a stabilization fund would include a judgment by the Executive Board that, as part of a comprehensive strategy of stabilization and reform, the member's exchange rate and exchange rate policy were realistic, sustainable, and firmly supported by strong economic and financial policies. The member's program would need to be fully financed (excluding CSF resources), and the member would need to be in compliance with its arrangement in order to draw on a CSF.

To ensure that these objectives and conditions--which would be important safeguards for the Fund's resources--are met, close monitoring by the member and the Fund of exchange market conditions and operations would be needed; release of funds for stabilization fund purposes should, within bounds, be subject to continuing Executive Board judgments that the conditions for use of CSF resources are met and that Fund support for intervention is warranted; and amounts drawn should be reconstituted within a fixed and relatively short period. To serve the confidence-building purposes of the CSF, resources made available through the CSF should be

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1/ The same consistency would be required in the event that a member had access to short-term financing for intervention purposes other than through the Fund-supported CSF. The utilization of such resources would need to be consistent with the Fund program and the intervention operations financed through the CSF.

available in a revolving manner during the period of the Fund arrangement, so that repurchases would automatically replenish the amount of intervention resources potentially available to the member.

Executive Directors may wish to comment on the general objectives and conditions for CSFs as set out in this paper and on the specific modalities and features discussed. For ease of reference, there follows a checklist of specific points and questions on which Directors may wish to comment:

1. The two approaches discussed to establish CSFs in support of an exchange rate peg: (i) a special facility with access on top of that under the associated arrangement; or (ii) a window within a stand-by or extended arrangement with access subject to present guidelines (appealing, if necessary, to the exceptional circumstances clause) .

2. The provision to activate a stabilization fund element on approval of a stand-by or extended arrangement or on completion of a review under such an arrangement.

3. Maximum access under a CSF of, say, 100 percent of quota and revolving features to permit recurrent use of the CSF.

4. The provisions for "tranching," including:

(a) A first tranche that would become available upon activation of the stabilization fund element, which could be used and reused without further review by the Board, so long as the total amount outstanding under the stabilization fund element does not exceed the first tranche and the member remains in conformance with the arrangement, reporting provisions, and other conditions established by the Board; the Board would be consulted on how to proceed in the event that the conditions for use of the CSF may no longer be met.

(b) Purchases in tranches beyond the first would require Board approval on the basis of an assessment of existing conditions. Approval would require Board judgement on whether intervention is appropriately accompanied by financial policy tightening. Such approval would be on a one-off basis, so that access to resources in the second and subsequent tranches that were drawn and reconstituted would be subject to further approval and time bound;

(c) Limits on drawings under CSF tranches with progressively smaller amounts available for purchases in upper tranches.

5. The need for accelerated Board procedures for documentation and meetings to handle requests for activation and use of a CSF.

6. The provision for reconstitution of CSF drawings within a short period. Whether reconstitution provisions should take the form of early repurchase expectations, early repurchase obligations, or a combination of the two as suggested in the paper. The proposed twelve-month repurchase obligations for all purchases under the CSF (or coincident with the term of the associated arrangement). The proposed period of three to six months for the repurchase expectation; the provision for Board approval of extensions of the repurchase expectation period by up to three months (but not beyond the repurchase obligation period); and, for purchases in the first tranche, the possibilities of not applying a repurchase expectation and of establishing a repurchase obligation that coincides with the end of the arrangement.

7. The provisions for additional reporting requirements, including daily reporting of relevant financial variables.

8. The provision for termination of the operations of the CSF with termination of the arrangement.

9. On balance, whether the operational features of the CSF outlined here would provide sufficient flexibility for use by the member country as precautionary reserves while at the same time maintain adequate safeguards against risk for Fund resources.

10. The benefits of co-financing for Fund-supported CSFs, and the likelihood that such financing might be available.

11. Possible ways to reduce or offset the transactions costs of revolving CSF operations, including by establishing a Fund-administered account for reconstitution and reuse of CSF resources.

Provisions of the Currency Stabilization Fund Established for Poland in 1990-91

Poland provides an example of a currency stabilization fund (CSF) established in the context of a Fund arrangement. Poland's CSF was established in late 1989 by thirteen industrial countries. Its objectives were to underpin the exchange rate peg and disinflation strategy adopted by the authorities as part of Poland's 1990 stand-by arrangement. The CSF provided access to intervention resources of up to US$995 million (then around 110 percent of Poland's Fund quota). 1/ The availability of the CSF was extended for two additional one-year periods (until end-1992). However, the CSF remained precautionary in nature; at no time did the Polish authorities seek to draw on the resources available under the CSF.

The provisions of Poland's CSF included many features comparable to those discussed in the main paper above. In particular, the CSF was designed to operate exclusively in the context of an upper credit tranche Fund arrangement (access to CSF resources was dependent on agreement by Poland on a stand-by program); operations of the CSF were to be subject to close oversight (in the case of Poland, by an operating committee comprising representatives of countries contributing resources to the CSF); drawings under the CSF were conditional on continued compliance with the terms of the associated stand-by arrangement; 2/ and access was dependent upon compliance with information reporting requirements specific to the CSF. 3/

Furthermore, to permit oversight of CSF operations, resources were tranched, with access to tranches beyond the first tranche requiring the approval of the operating committee. In the case of Poland, the first tranche provided access to intervention resources of up to US$300 million; the second to an additional US$200 million; and the third to the remaining resources available under the CSF. Approval of the operating committee was

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1/ Contributions to the CSF were made by grants or loans, to be held in a separate account at the Federal Reserve Bank of New York, or through lines of credit. Interest on CSF drawings were payable by Poland, as specified under the bilateral contribution agreements. Liabilities were to be recorded in the currency originally contributed.

2/ Notwithstanding this general intention, the CSF operating committee could, after prior consultation by the Polish authorities, and after consultations with the Fund, approve drawings on the CSF in the absence of Poland's compliance with the Fund arrangement.

3/ Poland was to provide the operating committee with the following data on a timely basis: initial level of foreign currency reserves; foreign exchange reserves (daily); net foreign exchange operations (daily); quotations of exchange rates (daily); short- and long-term interest rates (when changed); debt service payments on medium- and long-term debts (when made); and other data reported to the Fund under the stand-by arrangement (when reported to Fund).

required on the first occasion on which drawings under the CSF would provide access to resources in the second and third tranches. Under the provisions of the CSF, the operating committee was required to consult with the Fund before granting such approval.

With a view to ensuring that the risk to CSF resources was shared by the authorities, drawings under the CSF were to be limited to one-half of Poland's net intervention activities in any given period. CSF resources were to be made available only for purposes of replenishing reserves after intervention; drawings could not be used to supplement convertible foreign currency reserves on a precautionary basis in the absence of intervention.

CSF resources available to Poland were subject to early repurchase, as a safeguard against the diversion of such resources to general balance of payments financing. Specifically, drawings under the CSF were subject to reconstitution on termination of the one-year period of operations of the CSF. As a result, CSF resources would have been available for an outside maturity of 12 months. The Polish CSF also included an early repurchase clause requiring the authorities to reconstitute to the CSF an amount equal to one-half of net purchases of foreign exchange in any calendar quarter in which the National Bank of Poland was a net purchaser of foreign exchange.

The Polish CSF provided for the possible extension of CSF operations in the context of a successor Fund arrangement. In the case of Poland, this required the consent of all contributing countries.

Illustration of Possible Tranching Provisions of a Currency Stabilization Fund

The following table illustrates possible tranche ranges and the maximum purchase in each range.

Example of Tranche Ranges and Purchase Limits

Outstanding Purchases under the CSF Tranche	Percent of CSF	Maximum Purchase (In percent of CSF)
1	$0 < t \leq 20$	20
2	$20 < t \leq 40$	15
3	$40 < t \leq 55$	15
4	$55 < t \leq 70$	10
5	$70 < t \leq 80$	10
6	$80 < t \leq 90$	10
7	$90 < t \leq 100$	Remaining amount

Using as an example the tranche ranges suggested above, if after several purchases (and, possibly, repurchases) outstanding credit under the CSF was 50 percent of the CSF, a request for another purchase could be for a maximum of 15 percent of the CSF. Such a purchase would increase the member's outstanding CSF purchases to 65 percent, or into the fourth tranche of the CSF, and the next purchase could be for a maximum of 10 percent of the CSF.

Regarding unwinding purchases, any repurchase would reduce the outstanding amount of drawings under the CSF, possibly shifting the member down in the tranche structure. Using the same example, if the member had outstanding purchases under the CSF within the range of the fourth tranche (e.g., 65 percent of the CSF), and then made a repurchase equivalent to 20 percent of the CSF, when it would fall back into the third tranche (45 percent of the CSF). The maximum size of the next purchase the member could request would then be 15 percent of the CSF.