SM/09/35
Correction 2

March 20, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Review of Fund Facilities—Analytical Basis for Fund Lending and Reform Options**

The attached corrections to SM/09/35 (2/6/09) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 19, Box 4, last paragraph, line 3. Add "GRA financing of" at the beginning of the language in parenthesis, so as to read: "(GRA financing of this would also require a change in the Articles of Agreement);" This is to clarify that the reference that there would be a need to change the Articles is made specifically in the context of GRA financing, and does not address other possible forms of financing from the Fund.

Page 20, Paragraph 28, second bullet, first sentence. Replace "since" with "unless" and delete "not", so as to read: "Withdrawals of foreign currency deposits by residents would not, strictly speaking, create a BOP deficit unless they would involve transactions between residents and nonresidents." This is to clarify the situation when withdrawals of foreign currency deposits by residents could create a BOP deficit (the existing language might lead to confusion).

Questions may be referred to Mr. Ogada, LEG (ext. 37886).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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Box 4. Targeting Fund Lending?

While Fund financing may be economically useful in a wide variety of circumstances, the modality of its delivery is nearly always the same—once the Fund has provided financial support to the borrowing country, the member can use the foreign exchange reserves to optimize their effectiveness within the program context. Typically, central banks would sell the FX in the open market, but the question arises whether more direct *targeting* of Fund financing could make it more effective. For example, in the face of an incipient FX-deposit run, Fund financing could be used to support an explicit deposit insurance fund, thus giving confidence to depositors and helping to avert the run, or to support capital injections to troubled banks.

A systematic approach ensuring more direct and targeted use of the FX provided by the Fund could have three advantages: (i) ensuring that the resources are used for the targeted purpose (e.g., providing confidence to depositors) could avoid cumbersome conditionality; (ii) transparently directing the resources to where they are needed could enhance confidence; and (iii) differentiation from more standard Fund-supported programs could alleviate domestic political stigma associated with seeking the Fund's support.[1] However, through effective program design and public communications (on how the Fund's money is being "used" to support program objectives), much of the same results could be achieved through traditional modalities of Fund support.

Some other proposals for altering more fundamentally the modality and nature of Fund support have also been made. One such proposal, which would require changes to the Articles of Agreement, involves the Fund buying sovereign bonds in secondary markets as a financing (rather than investment) device. This has been variously suggested as a means of achieving a market-based debt restructuring, and as a means of stabilizing debt markets in a crisis. It may be also considered as a way to support countries with existing high public debt burdens without adding to the debt (Lerrick and Meltzer, 2001; and Calvo, 2002). But doing so may only indirectly alleviate BOP pressures (purchases would have to reduce spreads, and the lower spreads would need to translate into lower borrowing costs), and there would be issues such as whether to purchase domestic currency instruments; whether the Fund should accept the lack of preferred creditor status or instead should require government guarantees; and how the Fund would manage a bond portfolio.

Other innovative ideas on the modality of lending include (i) the Fund providing guarantees of external debt issued by sovereigns with good fundamentals that are temporarily unable to roll over their debt because of global market conditions (GRA financing of this would also require a change in the Articles of Agreement);[2] and (ii) the Fund issuing paper in local markets, both as a means of adding to available lending resources and as a means of providing the domestic private sector with a "risk-free" asset (if sovereign debt is not perceived as such).

[1] In the case of Uruguay in 2002, stopping the withdrawal of dollar-denominated deposits was critical to restore financial sector stability. To achieve this, the central bank deposited a portion of the corresponding gross reserves received under the Fund arrangement into an escrow account that was excluded from the central bank's reserves, and earmarked it to cover all unrestricted dollar deposits. The rationale was to send a clear signal that unrestricted dollar deposits would be fully repaid, with the expectation that deposit runs would cease, which was ultimately the case (Box 4 in *Review of Exceptional Access Policy*, SM/04/99, 3/23/04).

[2] The effectiveness of such guarantees would likely require them to cover the full maturity of the bonds in question, which could involve tying up Fund resources for a prolonged period. The guarantees would also tend to fragment the bond market, with the guaranteed bonds trading at spreads reflecting the Fund's credit status, while the effects on the other (now de facto junior) bonds would be hard to predict, depending on their maturity and expectations as to the continuance of the guarantee program.

- A member's need based on "***developments in its reserves***" may exist if there is an unfavorable development (e.g., an impending discharge of liabilities), even though the member does not have a BOP deficit or inadequate reserves.[16]

1. As noted, these three conditions are exclusive and alternative; the requirement of need will be satisfied if any one of the three conditions is met (e.g., where, notwithstanding a strong reserve position, a member has a deficit in its overall BOP). Moreover, it is not necessary for a BOP need to exist when an arrangement is approved, as distinct from when a purchase is made, for which a need is required. Accordingly, a Fund arrangement may be approved on the basis of a prospective need, as with precautionary arrangements.[17]

A. Potential Causes of BOP Need

2. The different categories of "need" specified in the Articles of Agreement can be caused by a variety of circumstances and, thus, the BOP need requirement is unlikely to be a constraint on the Fund's ability to meet the evolving needs of its members. In addition to problems arising in the current account (e.g., terms of trade shocks) and the need to bolster reserves in the context of capital account crises, countries could also face BOP needs in other circumstances, including the following:

- ***Budget financing***. Financing expansive fiscal policies through, for example, monetary expansion could lead to a current account deficit that needs to be financed from external sources. The country could then experience a BOP need if such flows are not available, and foreign reserves provided by the Fund could be used to meet that need. If no current account deficit would occur, the central bank could have expanded domestic credit without having the reserves; in that case, there would be no BOP need and no use (or justification for the use) of Fund resources.

- ***Deposit run in dollarized economy***. Withdrawals of foreign currency deposits by residents would not, strictly speaking, create a BOP deficit unless ~~since~~ they would ~~not~~ involve transactions between residents and nonresidents. Nevertheless, meeting such withdrawals would require foreign exchange reserves, thereby weakening the authorities' reserves, and this could give rise to a BOP need.

Deposit run in local currency. If depositors are willing to hold local currency cash (and not substitute into FX), then the central bank can provide liquidity without requiring

[16] The legislative history shows that this concept was included in the Articles mainly to address concerns regarding the availability of Fund financing to reserve currency members that were part of the EEC "snake" currency arrangement. *Id.*

[17] Regardless of whether or not it has an actual BOP need, a member may simply choose to treat its Fund arrangement as precautionary by not drawing under it. For purposes of this paper, precautionary arrangements do not include this latter category of cases, but rather include only those for which the member does not have an actual BOP need when at the time of approval of the arrangement.