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April 15, 1999

To: Members of the Executive Board

From: The Secretary

Subject: **Further Considerations Toward a Contingent Credit Line—Further Follow Up**

Attached for consideration by the Executive Directors is a further follow up paper on further considerations toward a contingent credit line, which will be brought to the agenda for discussion on a date to be announced. A draft decision with explanatory text will be circulated shortly.

Mr. Bennett (ext. 38784), Mr. Corr (ext. 38774), or Mr. Leckow (ext. 34799) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Further Considerations Toward a Contingent Credit Line: Further Follow Up

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

Approved by Jack Boorman, François Gianviti and David Williams

April 15, 1999

I. Introduction

1. On April 2 the Executive Board resumed discussions regarding a possible role for the Fund in providing contingent credit lines (CCLs), and on April 5 met again to further consider this matter. In light of these discussions and the Acting Chairman's concluding remarks as well as the discussions that took place on this issue at the Preparatory Meeting of Deputies on April 13, this paper reviews several outstanding issues for consideration by the Executive Board.[1]

II. Outstanding Issues

2. Motivated by the overall objective of crisis prevention, including by creating further incentives for the adoption of strong policies and encouraging precautionary arrangements with the private sector and thereby reducing the risks of contagion, there is wide support in the Board for the concept of a Fund-financed CCL. With these critical objectives in mind, and considering the potential implications for the Fund's liquidity, the Board has devoted considerable efforts towards shaping the criteria and factors relevant for members' eligibility for the CCL.

3. Directors were generally agreed on three of the four criteria for eligibility proposed by the staff in their earlier paper.[2] These were (i) a positive assessment of the member's policies by the Executive Board, reflected in the last Article IV consultation and thereafter; in assessing whether a member met this criterion, the Fund would take into account progress towards adherence to relevant internationally accepted standards; (ii) constructive relations

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[1] See the Chairman's concluding remarks (BUFF/99/46, 4/6/99)

[2] *Further Considerations Toward a Contingent Credit Line—Follow Up* (SM/99/81, 3/29/99).

with private creditors and satisfactory progress in limiting external vulnerability through management of the level and structure of external debt; and (iii) a program, including a quantified macroeconomic framework, which meets the approval of the Executive Board and which the member would be ready to adjust, as needed, in the event of contagion (perhaps in ways formulated ahead of time in consultation with the Fund).

4. There was less agreement on the remaining criterion posed in the earlier staff paper, that an eligible member's policies should be such that it would not be expected to use Fund resources. At the meeting on April 5, the staff had clarified that it was not meant that this criterion should exclude members that had arrangements in place that were intended to be precautionary as long as this position was supported by a plausible balance of payments projection. Nor was it intended to exclude members that might be expected to need to use Fund resources for externally caused reasons, such as contagion. The more controversial question, however, was whether members should be eligible if they were undertaking an adjustment program for reasons other than contagion, and drawing under an arrangement in support of this program. The staff had earlier expressed the view that a member undergoing an adjustment program and that expected to draw under its arrangement would, by implication, not have a balance of payments position which was viable without exceptional support. Some risk would thereby remain that there could be a loss of market confidence related to this balance of payments position and/or to the implementation of the adjustment program aimed at its eventual equilibrium. While there could be some cases where this risk was considered to be very slight, in practice it would be difficult to draw the line between such situations and those of other members where the risk was clearly higher. In such circumstances, there would be a danger that the signal of fundamental soundness that the CCL was intended to convey could become compromised by too wide an eligibility criterion. In view of the need to draw a reasonably objective line, the staff recommend that, to safeguard the signal associated with the CCL, members drawing under their arrangements be considered eligible only if it can be established that they meet all the other eligibility criteria and that these drawings under the arrangement have been made necessary largely by externally caused events. Where there is doubt, the avenue of augmentation of the existing arrangement would be open and would seem more appropriate.

5. Regarding the various factors which would be taken into account in judging compliance with the other criteria described above (in particular (i) and (ii) above), most Directors agreed that it would not be reasonable, at this stage, to treat any of these factors as absolute requirements, and that the Board should exercise its judgement in assessing whether there was a sufficient "critical mass" of factors in place to determine satisfaction of each of the relevant criteria. The factors discussed and the way they would be taken into account will be elaborated in the text explaining the draft decision. This text will discuss, in particular, the factors regarding a member's progress towards adherence to internationally accepted standards, private sector involvement, and external vulnerability.

6. A second issue concerns the conditions associated with the availability of resources at the time of activation of the CCL in the event of contagion. Several Directors felt that at least some part of the resources committed under the CCL should be released subject only to the member's compliance with its program to date and to the onset of contagion. These Directors stressed the importance of ensuring that (some part of) the resources committed should be readily available in the event of contagion if the CCL was to be of value to the member (beyond the positive signaling effect). Other Directors, however, were concerned that the absence of an opportunity to review the member's program and possibly require adjustments in light of the member's changed situation, if appropriate, could impair the Fund's ability to safeguard its resources.

7. A possible compromise between the desires to signal the ready availability of resources for members with access to the CCL and the need to safeguard Fund resources would be for there to be an approach that, in view of the member's satisfaction of the eligibility criteria, the member would generally be given the benefit of the doubt regarding access to a specified portion of the resources at time of activation. The availability of this portion would then generally be based only on (i) a finding by the Executive Board that contagion had occurred; (ii) that the member had successfully implemented its program in the period preceding the request for activation; and (iii) that the member was committed to adjusting policies to deal with the real economic impact stemming from the contagion. This portion could be set at, for example, up to 100 percent of quota (including the (small) amount made available upon approval).[3] If, nevertheless, in the view of the Board, the member's situation had changed substantively, requiring policy adjustments (including, possibly, a review of exchange rate policy)[4], the Board would still have the discretion to make this portion available only after the Board had reviewed the member's specific commitments to policy adjustment—but this would be expected to be the exception rather than the rule. The availability of the remaining amount committed would, on the other hand, always be subject to the Board's satisfaction that the member's program (as adjusted if necessary) was appropriate to the circumstances and these remaining amounts could either be released at that time or be phased through the remainder, or extension, of the arrangement.

8. Such an approach would help give the member reasonable assurances regarding the likely availability of some of the committed resources in the event of contagion; at the same time, the Board would retain the ability to require additional policy adjustments if it felt that these were necessary in the new circumstances confronting the member. If such an approach is favored, it is suggested that the resources to be made available immediately upon activation

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[3] The amount available at activation would be agreed at the time of approval of the CCL.

[4] In the wake of the recent crises in Asia, Russia and Latin America, questions have been raised about the appropriateness of different exchange rate regimes. This issue will be examined further in the forthcoming Board seminar and conference on systemic issues including appropriate exchange rate arrangements.

should comprise only resources from the CCL. The resources from the credit tranches (if any) and remaining resources from the CCL would be made available subsequently.[5]

9. A third issue concerns the cost of CCL resources. The earlier staff paper had suggested that Directors might wish to consider making the surcharge on use of CCL resources somewhat lower than that for SRF resources. Most Directors considered that the surcharge should be the same. Several Directors, however, were sympathetic to the idea of some moderation of the cost of the CCL in light of its contingent nature and to this end suggested the alternatives of reducing the commitment fee or refunding it in the event the CCL was not activated.[6] The commitment fee is intended to recognize that a stand-by or extended arrangement from the Fund is a service provided by the Fund, which entails administrative costs for the Fund, and for which members should pay a small amount. If the arrangement is not utilized, or not fully utilized, the Fund would retain a modest fee not only to cover such costs but also to compensate it for having maintained sufficient liquidity during the period of the commitment. While the costs to the Fund in committing resources for a member under a CCL could be lower than for other arrangements involving the use of the Fund's resources, the staff considers that in the case of commitments under the CCL, even if it were not activated, the administrative costs involved should not be borne by the membership as a whole and, in particular, by other members using Fund resources. Furthermore, the cost of being able to access the contingent resources is, at 25 basis points, modest by international standards and, as some Directors have noted, would seem amply justified if it reduces the risk of contagion (with the possibly larger financial benefit of reduced borrowing costs for such members that would be associated with a Fund "seal of approval"). Finally, a reduction or elimination of the commitment fee could well serve as a precedent for other arrangements, such as those regarded as "precautionary," under which the member announces its intention not to make purchases. Therefore, and given the refundability of the commitment fee if the

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[5] Including only CCL resources in the first purchase after activation would enable the associated Board review (without requiring policy adjustments) to ensure that the release of this purchase would be related to contagion and not to the member's own policy errors. Resources from the credit tranches are, by contrast, available for any kind of balance of payments problem .

[6] Under Article V, Section 8(c)(ii), the Fund "may levy a charge for stand-by or similar arrangements" at the beginning of each 12-month period of an arrangement. This charge, frequently referred to as a commitment fee, amounts to the equivalent of 1/4 of 1 percent per annum of the amount that could be drawn under the arrangement over the following twelve months. Under Section 8(c)(i) of the same Article the Fund has decided that the charge for an arrangement shall be refunded *pro rata* at the time the arrangement is drawn upon and is effectively offset against the service charge levied on purchases under the arrangement. The commitment fee, which accrues to the Fund upon expiration of the arrangement, is refunded in proportion to the amount of resources actually drawn.

arrangement is drawn upon, the staff recommends that the structure of charges and fees for the CCL be the same as those which apply to the SRF.

10. Fourth, a number of Directors remained concerned about the resource implications of the CCL for the Fund's liquidity including, for some Directors, the impact of the CCL on the availability of resources under the Fund's existing facilities. Given the nature of the CCL, it is difficult to estimate, on a traditional country-by-country probability-weighted basis, the potential demand for the Fund's resources that might be called upon under the CCL. It would be very hard, at this stage, to judge which countries might be interested and would be able to qualify for the CCL, let alone which qualifying countries would actually draw under the arrangement. As indicated earlier, however, while there might be only a few countries in this category at the present time, the number of eligible countries could grow over time as countries achieve the requisite standards and relations with the private sector.

11. The recent paper for the review of the Fund's liquidity concluded that the Fund had adequate resources over the period ending 2000, even with relatively high demand, and projected net uncommitted usable resources at SDR 60 billion and liquid liabilities at SDR 57 billion, resulting in a liquidity ratio of 105 percent at end-2000.[7] The paper also showed the sensitivity of the Fund's liquidity position to considerably higher levels of demand, which could include possible demand under the CCL. An increase in demand of, say, SDR 20 billion over and above the "baseline" projection would result in a lower liquidity position, but the extent of the deterioration in the Fund's liquidity would depend on the type of additional demand. For example, if SDR 20 billion was committed under the CCL, but no purchases took place because the arrangements were not activated, then the liquidity ratio at end-2000, on the basis of the current methodology of scoring precautionary arrangements, would decline to 87 percent due to the higher level of commitments.[8] While consideration could be given to scoring precautionary arrangements, including CCLs, on a probability-weighted basis, the possibility of virtually simultaneous activations of a number of CCLs would suggest the need to stress-test this approach. The staff is currently examining this issue and will revert to the Board in the context of its upcoming review of the Fund's liquidity position. If the additional demand resulted in an increase not only in CCL commitments but also in purchases by SDR 20 billion, the net uncommitted usable resources would decline to SDR 40 billion and liquid

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[7] The liquidity ratio is defined as the ratio of net uncommitted usable resources (i.e., resources available to meet reserve tranche purchases and new commitments) to liquid liabilities (i.e., reserve tranche positions and any outstanding borrowing by the Fund) Thus, assumptions about commitments affect the numerator and assumptions about purchases affect the denominator. See "The Fund's Liquidity and Financing Needs—Review," EBS/99/49 (3/29/99). At the request of Executive Directors this paper is to be taken up after the Spring Meetings.

[8] In EBS/99/49 the staff has proposed that commitments under precautionary arrangements, including CCLs, be taken fully into account in estimating the Fund's uncommitted resources.

liabilities would rise to SDR 77 billion, resulting in a liquidity ratio of 52 percent.[9] Other scenarios, depending on the extent purchases are made, their timing, and the extent they are repurchased before the end of 2000, would produce liquidity ratios that would fall within the 50-87 percent range (instead of 105 percent as currently projected).[10] If the CCL were to expire two years from now, all amounts purchased under the facility would be expected to be repurchased by the end of three and one-half years, thereby allowing a fast recovery of the Fund's usable resources.

12. To pinpoint the precise effect of the CCL on the demand for Fund resources one would need to consider the impact of a contagion episode with and without the CCL in place. As some Directors remarked, absent the establishment of a CCL, a contagion episode would in any event likely lead to an increase in demand for Fund resources under various facilities, which would in all probability exceed the "baseline demand" projected in EBS/99/49. However, the greater the CCL's effectiveness as a prevention tool, the greater the likelihood that the actual use of Fund resources would not be as large as demand in the absence of the CCL. Thus, the potential impact of the CCL on the demand for Fund resources may, on the one hand, partly substitute for possible use of resources under other facilities, and, on the other hand, complement, to some degree, existing demand. In either case, the resources available to meet the projected demand under the CCL would not seem likely to impinge to any material extent on the availability of resources under the regular facilities. These considerations, as well as the staff's estimates of prospective demand over the near term, suggest that the Fund's current and projected liquidity position would enable the Fund to provide substantial financing under the CCL, if needed, and to maintain its traditional balance of payments support under existing facilities.

13. Some Directors felt that the potentially adverse implications for the Fund's liquidity could be addressed, in part, through the application of an access limit. Most Directors were opposed to the idea of an access limit, arguing that it would be contrary to the intent of the CCL. Augmentation would always remain a possibility, and in view of this, the initial commitment would not need to be so large as to encompass the most difficult scenario that could face individual members but could, perhaps, be presumed to operate within a range around, say, 300 percent of new quota, absent good reasons for doing otherwise. Access policy for the CCL should be one of the areas of focus of the proposed review of the CCL.

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[9] Assuming, as broadly agreed, that repurchase terms of CCLs would parallel those under the SRF, the possibility would exist that repurchases could be postponed by up to a year, at the request of a member. This adds to the uncertainty of any forecasts.

[10] The Fund's own net uncommitted usable resources can also be augmented by borrowing under the NAB and GAB, with currently a total capacity of up to SDR 32 billion in usable currencies.