FOR AGENDA

SM/95/216

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August 22, 1995

To: Members of the Executive Board

From: The Acting Secretary

Subject: An Emergency Financing Mechanism

Attached for consideration by the Executive Directors is a paper on an emergency financing mechanism, which is tentatively scheduled for discussion on Tuesday, September 12, 1995.

Ms. McGuirk (ext. 38363) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

An Emergency Financing Mechanism

Prepared by the Policy Development and Review Department

(In consultation with other Departments)

Approved by Jack Boorman

August 22, 1995

I. Introduction

The world economy has benefitted in recent years from the increased openness of many economies to trade and capital flows, contributing to improved efficiency of resource allocation and growth. This increased openness, reflected in increased private capital flows, carries, however, the possibility of greater volatility in the balance of payments and consequent disturbances to the domestic economy, including domestic financial markets. Appropriate economic policies, to which strengthened Fund surveillance can contribute, should reduce the likelihood of such disturbances and help limit the impact of those that still occur. Nevertheless, even with improved surveillance and reporting, the possibility will remain that a large economic or political shock or a sudden reversal in market sentiment could lead to a rapid deterioration in a country's balance of payments and result in a financial crisis. 1/

Against the background of the recent evolution of the global economy and financial markets and developments related to the financial crisis in Mexico, there is broad agreement on the desirability of strengthening the ability of the Fund to respond rapidly to members facing financial emergencies and seeking Fund support. To meet this challenge, the Interim Committee, at its April 1995 meeting, asked the Executive Board to consider how the Fund can better assist members in coping with sudden market

1/ For a fuller discussion of these issues, see "The Role of the Fund - Financing, and its Interactions with Adjustment and Surveillance" (SM/95/169, 7/14/95).

disturbances. 1/ In the same vein, the recent Halifax Summit urged the IMF to establish a new standing procedure--an "Emergency Financing Mechanism" (EFM)--which would provide faster access to Fund arrangements with strong conditionality and larger upfront disbursements in crisis situations. 2/

This paper discusses the basic elements of a possible emergency financing mechanism, the conditions under which the Fund could consider its use, and the possible EFM procedures that would facilitate a timely, yet considered, response. It is proposed to address emergency situations within existing Fund facilities in the credit tranches or possibly under extended arrangements. 3/ The essence of an EFM would be to provide for exceptional procedures to facilitate rapid approval of Fund support, while assuring the conditionality necessary to warrant such support. The procedures could in some circumstances be associated with exceptional levels of access to Fund resources and/or the frontloading of drawings; however, there could well be emergencies facing members that called for a very rapid response by the Fund that could be handled adequately within the usual access limits.

The establishment of an emergency financing mechanism would in no way create an "entitlement"; emergency procedures would be activated in individual cases in light of all relevant circumstances including the nature and size of the problem, the need for a speedy response, the quality of cooperation and information provided by the member, the possible risks of contagion, and the determination of the authorities to implement a program commensurate with the problem.

1/ "Communique of the Interim Committee of the Board of Governors of the International Monetary Fund" April 26, 1995.

2/ "Halifax Summit - Review of International Financial Institutions - Background Document", issued for Information of Executive Directors as EBD/95/86, 6/20/95. The Halifax communique also asked G-10 and other countries, in support of this procedure, to develop financing arrangements with the objective of doubling the amount currently available under the GAB. This subject was discussed by the Board on July 27, 1995. See EBS/95/117 (7/14/95) and the Chairman's Concluding Remarks and Personal Comments (BUFF/95/75, 8/2/95).

3/ Given the intent of the mechanism to foster a speedy response by the Fund--and other institutions--to a financial emergency, it is unlikely that there would be time for elaboration of a medium-term program to warrant support under an extended arrangement. However, circumstances in which modification of an existing extended arrangement might be warranted cannot be ruled out.

II. General Considerations and Purpose of an EFM

In the context of the evolving role of the Fund in an environment of increased globalization and integration of goods and capital markets, the Fund's ability to respond to a financial crisis rapidly and on a sufficient scale is central to its responsibilities under the Articles of Agreement. The Fund already has instruments and the necessary flexibility to respond rapidly to a member facing an acute financing need, as demonstrated by recent actions in the cases of Mexico and Argentina. Nonetheless, a clarification and elaboration of procedures that would be followed in such circumstances would strengthen the Fund's ability to address financial emergencies effectively. It would also provide an additional dimension of confidence to members and to the international monetary system. At the same time, in setting out procedures, care needs to be taken to avoid introducing rigidities that could impede an effective response to emergencies that may erupt and develop in unforeseen ways.

In addition to being able to respond rapidly to financial emergencies, the Fund may also need to be prepared to respond with potentially large and front-loaded access. The Fund's policies on access, including the exceptional circumstances clause, give it latitude to approve access in sufficient amounts and with phasing appropriate to the circumstances. Decisions regarding access and phasing in a crisis situation will inevitably require a large degree of judgment to be exercised by staff, management, and the Executive Board. Where large and possibly front-loaded access is seen as useful to lend added confidence to strong policies intended to stem a crisis, the quality of the program approved should minimize risks to the Fund and also enhance the prospect that not all resources made available will need to be drawn. Moreover, where drawings were made and the member's policies succeed in settling the situation and reversing exchange market pressures, there would be a presumption that the member would make early repurchases.

In considering the possibility of establishing an emergency financing mechanism, several points discussed by Directors in connection with the role of the Fund need to be borne in mind. First, regarding "moral hazard" concerns, the existence of such a mechanism would guarantee neither Fund financial support nor unusual access; these would depend fundamentally on the nature and the size of the problem and the speed and strength of the member's policy response. Similarly, it would not be the purpose of the Fund, in establishing an EFM or otherwise, to provide or convey the impression that it was providing guarantees of any kind against sovereign default. Situations have often arisen and will no doubt continue to arise in which either the Fund is not in a position to provide support or its support is provided in a framework that entails a restructuring of the member's debts. Second, the Fund may not finance large or sustained capital outflows in the sense of Article VI, Section 1. Rather, the purpose would be the opposite: by supporting strong corrective policies, to establish conditions that will forestall or reverse such flows and associated balance of payments pressures. 1/ Third, while the Fund's financing role must remain catalytic, there may be few other sources of financial support that can be mobilized with the speed required to deal with an emergency affecting countries that are traditionally reliant on private markets. The Fund would, nevertheless, have to start--in parallel with negotiation of an economic adjustment program--expeditious discussions aimed at inviting countries and institutions in a position to do so to join it in financing the member's program.

III. Key Features of an EFM

A critical factor in the Fund's ability to respond rapidly to a potential or actual financial crisis is the nature and extent of ongoing cooperation between the Fund and the member. With the efforts underway to strengthen the Fund's surveillance role, the Fund should be better placed both to help prevent financial crises and to respond quickly to emergency situations when they occur. While measures to strengthen Fund surveillance are discussed extensively elsewhere and need not be reiterated here, 2/ timely and regular provision of data and a continuous and close dialogue with members should better provide the Fund and the member with early warnings on developments and help minimize surprises. Such a dialogue should also better enable the member and the Fund to be in a position to agree quickly on the diagnosis and extent of a problem and on measures needed to address it in the event that a financial emergency threatens or arises.

Equally critical to rapid action by the Fund is the member's readiness to take early measures, including prior actions, of sufficient strength, in combination with supporting financing, to forestall or deal with the crisis. Failing that, the Fund will not be able to act rapidly or at all in support of the member concerned. Where contagion effects arising from the member's situation are possible or apparent, the Fund's attention and support would also need to be directed to those other members contending with the spillover effects.

The Mexican crisis earlier this year demonstrated that the Fund can act quickly when the conditions permit and require. The stand-by arrangement

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1/ Indeed, an EFM could be most effective as a preventive instrument and, along with the Fund's readiness to react quickly, members should assume the responsibility to come to the Fund early in an emergency crisis in an effort to avert it or to limit the initial capital outflows and the cost of repair.

2/ See "Biennial Review of the Implementation of the Fund's Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision" (SM/95/22, 1/26/95, and Supplements 1-3), "Statistical Policy of the Fund" (SM/95/115, 5/18/95), and "The Role of the Fund - Financing, and Its Interactions with Adjustment and Surveillance" (SM/95/169, 7/14/95).

was approved by the Executive Board some six days after completion of the negotiations and signature of the letter of intent, speed that was facilitated in part by a series of informal briefings of the Executive Board about the status of negotiations and the likely key parameters of the arrangement. 1/ However, from what in retrospect can be identified as the onset of the immediate crisis to Executive Board approval of Fund support, a period of roughly six weeks elapsed. This experience underscored the need for closer and more continuous surveillance; for early decisions about the role of the Fund in such a case; for quick, accurate diagnosis; and for forceful early action by the authorities. Had these elements been more fully in place, the Fund could have acted even more quickly, which might have allowed confidence to be restored with less need for external financial support.

With this background in mind, the following are suggested for Directors' consideration as general procedures that would constitute an emergency financing mechanism in the Fund.

-- The EFM would be expected to be used only in circumstances that represented or threatened to give rise to a crisis in a member's external accounts requiring an immediate response from the Fund. Identification of such an emergency would be based on an initial judgment by management that a member was faced with an exceptional situation threatening its financial stability and that a rapid Fund response in support of strong policies was needed to forestall or to contain the damage.

-- Conditions for activation of EFM procedures would include the readiness of the member to engage immediately in accelerated negotiations with the Fund with the prospect of early agreement on, and implementation of, measures sufficiently strong to address the problem. At the same time, the member's past cooperation with the Fund, in particular its record of reporting and responding to the Fund's policy advice in the context of regular consultations and continuing surveillance, would have a strong bearing on the speed with which the Fund itself could assess the situation and agree on necessary corrective measures.

-- The Executive Board would be notified immediately of the activation of EFM procedures, the nature of the emergency and the initial outlines of the planned responses by the member and the Fund, and a likely timetable for Executive Board discussion of a proposed arrangement. Strict confidentiality would need to be maintained.

1/ Developments which necessitated reconsideration of the level of access and the extent of frontloading under the arrangement in the very last stages of preparing the arrangement for consideration by the Board resulted from the changed circumstances which confronted the member and should not recur in other cases.

-- A short written report would be circulated to the Executive Board as soon as feasible, describing the member's current economic situation.

-- During the negotiations with the member, the Executive Board would be briefed regularly on economic and financial developments, the progress of negotiations, the likely key parameters of the program (including the level and phasing of access), the likely impact on the Fund's liquidity and the possible need to activate borrowing arrangements, as well as any changes in the initially envisaged timetable for Executive Board discussion of the arrangement. The frequency of such briefings would depend on the pace of developments.

-- In instances where support from other creditors is likely to be important, consultations with key creditors would be initiated at the outset of the emergency. The Executive Board would be informed of relevant developments in this area in the context of the informal briefings.

-- Once agreement had been reached on a program, documents would be circulated as soon as possible. The staff would aim to do this within, say, five days. The Executive Board would be prepared to consider the request for an arrangement as early as 48-72 hours after circulation of the documentation. Decisions regarding key parameters, including access and phasing, would be taken in the context of the Executive Board's consideration of the arrangement as per existing rules.

Early involvement and high frequency briefing of the Executive Board would be the centerpiece of the procedures facilitating a rapid Fund response. Similarly, after approval of the arrangement, in a period of very close monitoring by the staff to allow early and continuing assessment of the effectiveness of the member's policy response, the Executive Board would continue to be briefed closely on progress until the emergency was definitively resolved. In most cases, it would be expected that a full review of the initial policy response and the reaction of markets to these policies would be conducted within one to two months of approval of the arrangement with the aim of modifying policies as necessary in light of the evolving situation.

IV. Financing Aspects

As discussed above, use of EFM procedures may or may not be associated with exceptional levels of access to Fund resources. Even in situations involving exceptional levels of access, the need to supplement quota resources through borrowing arrangements under the GAB and/or other arrangements will depend on the liquidity position of the Fund. Therefore, it is not proposed to establish any formal links between emergency procedures, exceptional access or phasing, and activation of borrowing arrangements.

Questions regarding enlargement and modification of the GAB and the establishment of other associated or separate borrowing arrangements are currently under consideration. Whatever supplementary borrowing arrangements are established, it would be important for the purposes of the EFM that they be sufficiently large, that the Fund be assured of their availability, and that the conditions and procedures for activation be compatible with EFM procedures and the need for rapid Fund action.

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This paper has outlined the basic elements of an emergency financing mechanism, the circumstances and conditions under which it would be activated, and the procedures that would facilitate a rapid response by the Fund to emerging financial crises. If Executive Directors are in broad agreement with the proposed approach, the Managing Director would report to the Interim Committee on this basis, taking into account the guidance provided by the Executive Board.